THE RAILROAD WEEK IN REVIEW

October 18, 2013

"The fact that KCS delivered revenue growth in all of its business units speaks to the strength and diversity of this franchise." -- KCS President Dave Starling

The CSX third Quarter Earnings Call transcript and slides are loaded with clues for short lines, switch carriers and regional railroads to bring added value to the relationship. The formal remarks will tell you what CSX has done in the quarter; mining the Q&A for shortline-specifics can be very worthwhile -- more on this below.

First, the basics. Total revenue came to $3 billion, up four percent, on a three percent volume increase to 16 million units. Coal revenue was down nine percent as carloads declined seven percent, and CSX took a two percent RPU decrease. Clarence Gooden said on the call merch carloads plus intermodal boxes comprise 82 percent of CSX revenue units, starting to cover the coal decreases (Michael Ward says coal revenues are off $750 million since the peak).

Merch carloads ex-coal and IM but including crude oil and autos are up five percent and system RPU is up one percent, suggesting the gains in revs came more from increased revenue units than from pricing. Mix is as balanced as I've seen. Of the nine merch carload commodity groups only food/consumer accounts for less than three percent of total units and chems (including petroleum) is highest at eight percent, putting merch carloads at 42 percent, a record high.

Operating expense was up five percent, yielding operating income unchanged at $855 million. Comp & benefits, material & supplies and fuel were the big gainers, though mostly on unfavorable comps. The operating ratio was 71.5, up 103 basis points. Locomotive fuel expense came down two percent against the three percent GTM gain thanks in part to more GTMs per crew-start. Equipment rents came down two percent on lower loco lease numbers. RTMs were up 3.1 percent against 2.7 percent more rev units, indicating more payload per revenue unit. Net income $463 million, up 2 percent; EPS $0.46, up 5 percent on 2 percent fewer shares.

The fourth quarter outlook for the commodity groups comprising 70 percent of total volume is "favorable," with a record corn crop propelling ag products, energy-related markets helping chems, a recovering steel market, and housing-related commodities rounding out the merch picture. Met coal looks better than thermal, and highway conversions continue to boost intermodal numbers. Auto, food/consumer, and waste/equipment (10 percent of vols) are neutral; domestic coal, highway aggregates and phos/ferts are unfavorable (21 percent of vols).

Union Pacific led off their Thursday call with record quarterly results in revenues, operating income, operating ratio, and diluted EPS. Total revenue was $5.6 billion, up four percent on flat vols; RPU was up five percent on pricing, volume and mix with fuel surcharge unchanged. Ag products are still down -- by four percent -- on the summer drought and drops in export and feed grains; export wheat to Brazil thru Gulf ports is a bright spot.

The Industrial Products commodity group was up nine percent, highest of all commodity groups, on energy related materials (frack sand, pipe, etc) and housing starts. Chems vols increased three percent with crude-oil off five percent (West Texas sourcing for California is an offset), petroleum products (LPG etc) up ten percent, and regular STCC 28 chems including ferts up nine percent.

Operating expense increased 1.5 percent; operating income hit nearly $2 billion, up ten percent. The operating ratio came down 178 basis points to 64.8. GTMs dipped 1.7 percent and, with revenue units unchanged, reflects a mix delta to shorter hauls, lighter loading. RTMs came down 1.5 percent, with merch carload commodities representing 46 percent of the total (60 percent of total revs) and generating 2.5 times the revenue per RTM of coal. Net income was $1.2 billion, up 11 percent; UP earned $2.48 per share, up 13 percent, on two percent fewer shares.

The fourth quarter outlook is positive for ag products, auto, chemicals -- though crude-oil price spreads may have a dampening effect -- and industrial products with energy- and housing-related shipments in the lead. EVP Marketing Eric Butler puts it this way: "Assuming an improving economy and a normal weather patterns, we expect to finish the full year with a slight volume increase, which, combined with pricing gains, will generate profitable revenue growth."

Personally, I think UP's ability to take more variable cost out of railroad operations is paying off. COO Lance Fritz talked about how fewer slow-order miles and closing high-risk crossings, particularly in the south, contribute to tighter place-pull service commitments and improved network resource allocation. Being nimble is key, and in my opinion the nimble short line is the best UP fit.

Kansas City Southern wrapped the week on Friday. Third quarter revenues were $622 million, up eight percent, on three percent more revenue units. System RPU was up four percent; the mix is entirely appropriate for a property this size: 69 percent carload including auto, 15 percent intermodal, and 12 percent intermodal.

Merch carload vols were up two percent on low- to mid-single digits in every group with ores & minerals the outlier, up 28 percent. Frac sand, crude oil, non-utility coal & coke were up double digits while utility coal dropped six percent. Operating expense was up just six percent, pushing ops income up 11 percent to $200 million.

The operating ratio was 67.8, down 93 basis points. Ops costs continue to come out: over 4 years line-haul revs are up 65 percent while operating expense grew but 21 percent. System velocity, dwell and daily cars-on-line all remain in a range as revenue units continue their upward trend. Cross-border revs are up 16 percent with auto the biggest contributor. The 2013 outlook continues positive for all commodity groups save ag products.

Net income to common shareholders increased 31 percent to $118 million; diluted eps came in at $1.07, also up 31 percent on no change in share count. KCS still presents a very noisy income statement below the line. Equity earnings, debt retirement expense, foreign exchange gains and losses, payments to "non-controlling interests" and preferred dividends all nibble away at core earnings. On the other hand, cash from operations was a healthy 241 percent of net income, up 60 basis points, and enough to support capex and non-preferred divs with $143 million in FCF left over.

Shares are trading at 40x TTM earnings -- vs. low teens for the other rails -- and nearly 4x book -- only CN and CP are higher. Conclusion? KCS is doing all the right things in building the business profitably and is a good example to follow.