THE RAILROAD WEEK IN REVIEW

August 1, 2014

"We had a very swift recovery following what was a tough winter. Revenue ton-miles, probably the best indicator of volume gain, increased 14 percent against 11 percent for carloads." Claude Mongeau, Canadian National President and CEO

Canadian National opened Earnings Week Two with second-quarter freight sales of C$2.9 billion, up 18 percent, on 1.5 million revenue units, up 11 percent and RTMs up 14 percent. System RPU gained six percent. Same-store pricing (same customer, same commodity, same car type, same OD pairs, accounting for 75 percent of CN loads) was up less than three percent. Operating income jumped 21 percent to C$1.3 billion; the operating ratio shed another 1.3 points to an industry-leading 59.6.

It was the strongest quarter ever for the grain and fertilizer commodity group, up 35 percent in revenue, 29 percent in carloads, and four percent in RPU. Canadian export grain was half again what it was a year ago; US grain was up 24 percent. Canadian crude accounts for about 60 percent of petroleum/chemical sales, moving 31,000 carloads in the quarter vs. 17,000 a year ago. Energy drives metals/minerals as well: 21,000 cars of frac sand, up 46 percent, partly from a new unit train service into Western Canada.

Forest Products carloads were unchanged yet posted a nine percent gain in RPU, helped by regional improvements in the US housing market; paper remains problematical. Coal revenue increased five percent on 28 percent greater volume yet RPU skidded 18 percent. A doubling of short-haul utility coal to the US for restocking was the primary culprit. Intermodal and auto units increased 15 and five percent respectively.

The merchandise carload outlook is positive for crude oil, frac sand, grains, potash, metals and lumber; less so for met coal exports, sulphur, and anything to do with paper. Chief Commercial Officer J. J. Ruest says capacity "is getting snug. Pricing should be influenced by both the value of our service and the intrinsic value of capacity in and of itself." He feels revenue per car and cents per RTM are "weak measures" of price and yield; better are revenue-cost ratios for private cars, contribution per car-day for CN-owned cars. "Our focus in on upscaling not just adding volume." [*Short lines and other non-Class Is ought to be guided accordingly - rhb.*]

CN uses six key operating metrics — GTMs/train-mile, cars/yard-switching hour, terminal dwell, trailing GTMs/ available HP, car-miles/day, core train velocity. Four of six are better than they were in 2Q2013 (car and train velocity fell short, though not by much); six of six are much better than they were in 1Q2014. CN is running more cars without increasing train-starts for a 12 percent gain in GTMs/employee and six percent more GTMs/gallon of diesel fuel; fuel burn per thousand GTMs improved five percent, though is still high: 1.9 gallons/KGTM.

Chief Operating Officer Jim Vena says the aim is “balancing operational and service excellence,” pushing decision-making to the field and closing information gaps between and among yardmaster, customer service rep and the customer. [*These are gaps that sorely need closing; in the US they are everywhere, according to my anecdotal evidence. In every case they weaken the superlatives we hear on all these quarterly calls. - rhb*] Capex-wise, CN is adding capacity Winnipeg-Chicago and buying more AC power.

Once again, CN shows how to run a low-cost railroad and build the business base around customer supply-chain efficiency. Net income jumped 18 percent to C$847 million; EPS gained 22 percent to C$1.03 thanks in part to the three percent dip in diluted shares. Over the past twelve-month, every dollar in market cap gain was worth C$17 in Retained Earnings. And free cash flow per share before dividends exceeded diluted EPS by 40 percent. Based on an 8.44 percent trailing five-year CAGR, and a 1.5 percent dividend yield, I’m using a per-share intrinsic value of US$71.49, a nine percent upside from the June 30 close. I remain long.

Norfolk Southern was next up, setting quarterly records in operating revenues and income, net income and earnings per share and operating ratio. Revenue-unit volume grew by eight percent yet ops expense gained just three percent; weekly unit-counts averaged about 153,000 in the quarter vs. 141,000 units a year ago. Putting this in perspective, NS saw volumes exceed 150,000 loads in just two weeks of all of 2013, while seeing only three weeks of less than 150,000 loads since the last week in March of this year. Free cash flow before dividends exceeded net income by $66 million or two cents a share.

Freight revenue rose nine percent to $3.0 billion yet system RPU gained less than a point. Merchandise carloads including auto increased seven percent, generating an eight percent revenue gain on less than a two percent RPU increase. Operating expense was up less than three percent; ops income was a billion dollars even, up 22 percent, and the OR shed 3.7 points to a highly respectable 66.5.

What we see here is how to increase revenues and yields more on volume than on pricing and asset productivity is the key. Download the NS Financial Review and turn to pages 14 and 15. Seven out of eight measures — revenue/employee, units/employee, GTMs/train hour etc. — are all heading in the right direction over two years; ops expense/employee is up slightly, but that’s to be expected. NS generated eight percent more GTMs and ten percent more RTMs on just four percent more gallons of fuel. Fuel efficiency improved four percent to 1.22 gallons/KGTM.

Below the line, net income increased 21 percent to $562 million and EPS gained 22 percent on two percent fewer shares. Share price increased 45 percent for the year, increasing market cap by $9.7 billion. Retained earnings increased by $891 million year-over-year, meaning every dollar of RE generated $11 in market cap. Warren B would be proud.

The merchandise carload sector results were particularly good news for the NS feeder line community. Metals/construction gained on steel plus Utica and Marcellus frac sand; the ag group posted carload gains in ethanol, corn, beans and wheat; chems grew not only in crude-by-rail (where short lines have no significant exposure) but in nat-gas liquids where single-carload shipments are more the norm. Paper/clay/forest fared less well where lumber gains offset losses from a northern Alabama paper planet closure. As for the rest of the year, NS expects 25,000 more total crude-oil carloads in 2014 than in 2013, continued strong frac sand and NGL car-counts, a three percent gain in steel production, a firmer southeast housing market, and "robust" bean and corn crops.

CEO Wick Moorman concluded the presentation portion of the earnings call saying, "We are obviously very pleased with our second-quarter results. I am very proud of the way that our team kept our costs in check, even in the face of an unexpected volume surge. We continue to see strong fundamentals in most of our businesses and we believe that the US economy will continue to recover at a reasonable although not robust level for the balance of this year and next, which should also help us to continue our upward momentum."

Union Pacific batted cleanup for the week, making it three for three roads reporting double-digit operating income gains for the quarter. Total revenue increased ten percent to $6.0 billion on eight percent more revenue units and a mere 1.5 percent RPU gain. Merchandise carloads including auto and crude oil were also up eight percent, though crude was actually down 24 percent thanks to price spreads that made the Bakken product less competitive.

The revenue comps for the first six months are revealing: Industrial products carloads — forest products, construction materials, metals, minerals, and waste — generated 19.6 percent of revenue on 670,000 carloads, whereas intermodal brought in 19.9 percent of revenue on 1,237,000 units. Virtually all industrial carloads are single-car moves with local freights at both ends and average $3,200 apiece. Intermodal is all unit train with no local service, represents about 728,000 carload equivalents at 1.7 boxes per intermodal platform, and averages $2,100 per platform. Looks like pretty good money to me.

The 15 percent jump in ethanol moves, favorable DDG, STCC 20 foods, and imported beer markets helped ag products to a 16 percent volume gain. Frac sand, lumber and construction materials propelled the industrial products commodity group to a 12 percent car-count gain and chemicals units actually slipped a point thanks to crude while petroleum products, fertilizers end export potash were the bright spots.

Chief Commercial Officer Eric Butler concluded his conference call presentation by saying grains and ethanol look good in the 2014 back half and into 2015. Crude oil could be weak, depending on spreads, though frac sand demand will continue strong. Construction materials are looking up in Texas and California, and he's "cautiously optimistic" about lumber. Forward coal depends on nat gas prices, inventory levels and, as always, the weather; auto parts and finished vehicles ought to be OK. "If the economy cooperates, we expect a strong second half.

The weather was not kind to the operating side, what with numerous washouts, flooding, and mud slides wreaking havoc on network velocity and fluidity. Happily, having alternate routes to mitigate some of the weather impact, adjusting transportation plans to use otherwise out-of-route alternate yards and gateways, adding 800 units to the active loco fleet, and hiring 3,200 TY&E employees, double the original 2014 budget, helped. Case-in-point: Industry spot-and-pull was 94 percent to plan and fuel consumption remained right at 1.15 gallons per thousand GTM.

UP sports a 25.6 percent five-year trailing CAGR including dividends, suggesting an intrinsic value of $125 per share, a 20 percent margin of safety above the quarter's closing price. Net debt-to-cap is under 30 percent and each dollar in retained earnings gain generated $ 6.24 in market cap. Perhaps not best-of-breed, but none too shabby given that free cash flow after capex but before dividends came in 23 percent higher than EPS.

BNSF reports Friday within the Berkshire earnings. However, we can get a sense of how the railroad performed volume-wise using the Week 26 carload reports for quarter-to-date through June 28. Total revenue units increased five percent to 2.6 million; industrial products carloads were up four percent and ag products grew 11 percent for a merch carload gain of six percent. BNSF combines intermodal and auto under "consumer products," up six percent.

Compared with rival Union Pacific, BNSF was ahead in total revenue units but lagged in year-over-year percentage increases by 330 basis points. More important to non-class roads, UP is the stronger merch carload competitor with a million-plus units, up eight percent units to BNSF's 713,000, up six percent. Look for full-quarter volumes and financials in this space next week.

As for operating performance, the AAR Performance Metrics for BNSF show cars-on-line in the mid-250 thousands throughout the quarter while system train speeds hovered consistently in the 21-mph range. Yard dwells remained right around 30 hours for the entire quarter. During the UP Q&A, Scott Group asked whether "the implications of the BNSF service issues" might contribute to UP share gains. CEO Jack Koraleski said only that "there are some places where we've been able to pick up share" but questioned how "sticky" some of that really is.

In Schwab's latest *Market Perspective*, "The Bull Stumbles," the writers see accelerating economic growth. Elsewhere, a different Schwab note says the consensus second-quarter growth is almost seven percent above what it was a year ago. "Aggregate results from the 44 companies that have reported so far are up five percent and the 12-month forward PE ratio is currently at about 15.6 relative to a long-term average of about 13.5."

Rails by comparison sport an 18.7 average 12-month forward PE ratio with individual names in a range of 15.4 (CSX, NSC) to 22.2 (KSU), according to the thorough work of Morgan Stanley's Bill Greene. But (Schwab again), "For 4 weeks now, the indicators have shown that market participants have been preparing for a larger pullback in the three to five percent range. With the recent events in Ukraine and Israel, and weakening economic data out of Europe, there are still plenty of catalysts out there to worry about."

I'm concerned because as the market goes so goes the merch carload sector so critical to most non-Class I rails. That's why in the above reports I've put particular emphasis on those commodity sectors. Merch carload ex-crude and ex-auto still accounts for more than half Class I vols and as carload goes so goes operating income; ergo, the commodity OD pairs with the best yields are the best places to go looking for new business. See JJ, above.

Still, for all the talk of trucks off the highways, it seems to me more and more single carload business is finding its way into trucks and from trucks-on-own-wheels to trucks (containers) on flat cars. Heat-and-eat remains the dominant carload theme and those not in this game may soon be in a going-out-of-business sale mode.