THE RAILROAD WEEK IN REVIEW

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"It takes reinvestability to get on the Union Pacific network." — Jack Koraleski, CEO, during the Q4 conference call Q&A

Union Pacific presented clean, encouraging results for the 2014 fourth quarter. Revenue increased nine percent to $6.2 billion, operating income was up 20 percent to $2.4 billion, net income rose 22 percent to $1.4 billion. Earnings per share gained 26 percent to $1.61 on a three-percent dip in share count. The OR came in at a resectable 61.4, down 3.5 points.

Revenue units increased six percent to 2.4 million, of which 44 percent was merchandise including auto and crude oil; merch also posted the largest volume gain, up nearly ten percent. Within merchandise, the Industrial Products group includes crude oil, frack sand (up 28 percent) and pipe. The STCC 29 petroleum products (up five percent) remain in the Chemicals group, by itself up five percent. Ag products gained four percent on export grain, record ethanol production, and imported beer (I'll drink to that!).

In chemicals, ferts vols gained 17 percent partly on potash exports; crude-oil carloads increased seven percent on Niobrara (Watco a player here) and Uinta origins. Together, crude oil plus STCC 29s make up what the AAR calls "petroleum products," and crude is 46 percent of the total. Responding to a question about drilling rig count and the low price of crude oil, Chief Commercial Officer Eric Butler said there could be some diminution, though the well-capitalized E&P companies will keep going regardless and likely pick up any slack.

Coal is, has always been, and will continue to be the base-load fuel for its PRB utility customers. Says Butler, "I feel pretty good about our coal outlook because there's been a re-thinking on the part of many of the utilities about coal as a base-line fuel as a risk hedge against the natural gas volatility."

Butler concluded his remarks with a look at expected 2015 volumes. It's a mostly positive picture for UP's non-Class I connections. Ethanol production margins could be skimpier given blend requirements and gasoline price trends. Industrial chems will be OK given cheap and available nat gas fueling the trend toward near-shoring. The tea leaves are positively aligned in housing and construction, especially along UP's southern lines.

As for intermodal, "consumer demand and highway conversions will drive growth in domestic intermodal in 2015. In international intermodal, we would expect increased imports to drive growth this year; however, the deterioration of productivity at west coast ports is having an impact on our volume early in the first quarter." All-in, a clean and encouraging call.

Canadian Pacific CEO Hunter Harrison opened the call saying, "This is the best quarter I've ever been associated with, which I think sets the foundation for us going forward." CP pushed total revenue up 10 percent to C$1.7 billion on revenue units up less than a point; goosed RPU nine percent, cut 600 basis points out of the OR for a jaw-dropping 59.8; and drove net income to C$460 million, up 36 percent. The aggressive share repurchase program propelled eps up by 40 percent. CP expects to do it again in 2015: revenues up 7-8 percent, a sub-62 OR (FY 2014 was 64.7), and an eps gain of 25 percent or more.

Potash, crude oil, and metals/minerals/consumer were the double-digit volume gainers. Grain and forest products volumes were unchanged. Manifest carloads, including crude oil, frac sand, and auto, increased five percent. Crude had been tagged as a big grower for next year, perhaps to 200,000 units. Now that's been changed to 140,000 units, up 27 percent from 2014's 110,000. CP President Keith Creel said on the call the oil mix is now about 55/45 light/heavy crude, but as Alberta loads pick up the ratio of heavy to light will pick up.

Says my friend Tony Hatch regarding crude oil on CP:

> The oil price drop was the topic of the day in Q&A – and despite CP's larger-than-industry exposure to Crude-by-rail, they still say the price drop's positive impacts outweigh the negative. CP noted that the effect on industrial products and container shipping (reduced "slow-steaming" leading to more reliable scheduling; improved consumer spending) should be larger than the impact on CP crude oil carloads.
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> In addition, Creel noted that the 40 percent intermodal cost advantage may be reduced at current diesel fuel prices to the 20-25 percent range. Rail service advantages far outweigh highway constraints like driver shortage and regulator matters as a modal choice determinant.

Lastly, pricing. I've long said that CP didn't charge enough and needed to get service to where they could get rates up. On the call, we learned that legacy contract pricing, especially in crude oil, is not where it ought to be; as the old fold, new contracts will be properly priced. Moreover, says Hunter, leverage on the cost side can be converted to top line vols and revs.

Bigger trains let CP bring new vols with the same head-count. Even if crude slows, CP has the network capacity to add incremental revs with new business elsewhere. The previously proposed ten percent earnings CAGR can be met as decreasing costs and better service maintain and increase revenue levels. Could be. CP sports a 17 percent trailing 5-year eps CAGR. Add to that the one percent dividend for an 18 percent forward growth rate. Share price $227 anybody?

Kansas City Southern took fourth quarter revenues up four percent to a record $643 million on revenue units up five percent to 569,800; operating income was $214 million, up 9 percent; system RPU $1,087, flat; the OR came in at 66.7, nicely down 1.4 points; net income was $142 mm, up 24 percent. Best of all, revenue from so-called strategic growth areas — automotive, x-border intermodal, crude oil, frac sand, Lazaro-Cardenas — increased 15 percent.

Commodity carloads ex-coal and intermodal, including automotive, increased two percent to 249,200 units. Grain posted all-time high record volumes and revenues in 2013 because of the recovery from the drought of 2012. "This year we're down seven percent," says Chief Commercial Officer Pat Ottensmeyer, "but our grain business is back to normal and we should see steady single-digit growth for 2015 and beyond."

Chems/STCC 29 petrol carloads increased four percent; energy (frac sand, oil, coal) loads grew eight percent. Industrial/consumer carloads, alas, were up just a point: Pulp and paper were up, metals were down on fewer drill-pipe loads in the face of the current situation.

KCS is trying to stay ahead of the volume and pricing curves by adding headcount, infrastructure, and locomotives. The lower crude oil price is a net positive; longer-term crude by rail (less than one percent of KCS volumes is crude oil; petrol prods plus oil are about four percent). The 2015 outlook is positive — strategic growth areas are ahead of the curve, especially as the manufacturing base in Mexico expands into other household goods - furniture, e.g. In his closing remarks, CEO Dave Starling said today's growth rate is a "springboard" to future gains. I like that.

Shortline operator Iowa Pacific Holdings has announced record volumes and revenues in 2014. Freight carloads totaled 58,325 for the year, up 20 percent year-over-year. "We had strong growth at several railroads, but particularly at our two railroads in the Permian Basin," said Steve Gregory, Executive Vice President of Marketing. "While there are headwinds for 2015 due to the steep drop in the price of oil, we have new customers coming on line in the first quarter and expect the two Permian railroads to grow modestly in 2015. January is off to a strong start."

Total revenue for Iowa Pacific was over $80 million for the first time, thanks to the growth in both freight and passenger volumes. "It was our best year ever in both revenue and operating income," said Ed Ellis, President and Chief Executive Officer. "In spite of the challenges facing the oil field, our business is sufficiently diversified that we are expecting another record year for both freight and passenger in 2015."