THE RAILROAD WEEK IN REVIEW

October 30, 2015

"Developing new business remains an important part of our strategy, whether we grow existing markets, develop new business with existing customers, or find new market opportunities." — Lance Fritz, Union Pacific President & CEO on 3Q earnings call.

Union Pacific total third quarter revenue decreased about ten percent to $5.6 billion in spite of what UP calls "another quarter of solid core pricing gains." Revenue units slipped six percent to 2.4 million. Operating expense came down 13 percent, generating operating income of $2.2 billion, and a record-low 60.3 third quarter OR. Below the line, net income dropped five percent to $1.3 billion and eps was off just two percent to $1.50 on the heels of a three percent reduction of diluted shares costing $2.8 billion, roughly half the year-to-date capex spend.

Comments on the call provided excellent color on car-count deltas. Carload volume declined in five out of six commodity groups with coal down the most at 15 percent; auto was the only gainer with a five percent gain. Core pricing gains of four percent were not enough to offset decreased fuel surcharge and mix, so average RPU dipped four percent.

Ag product vols were off three percent on the 11 percent reduction in grain vols; slight gains in domestic moves couldn't offset the one-third drop in export grains. July and August saw the largest domestic soybean meal crush on record, resulting in a 17 percent increase in soybean meal shipments. Partially offsetting this was a four percent decline in ethanol shipments. Food and refrigerator product volumes were flat for the quarter partly on declines in frozen meat and potato shipments.

Chemicals carloads came down three percent in spite of the seven percent gain in plastics shipments, thanks to stable resin pricing and strong export volume. But crude was off 40 percent on commodity prices and spreads. Ferts dropped ten percent as soft grain prices and market uncertainty resulted in farmers delaying fertilizer purchases.

Industrial products revenue units declined 12 percent. Cutbacks in shale drilling resulted in a 31 percent decline in minerals volume, primarily driven by a 36 percent decrease in frac sand. Metals volume was down 26 percent as lower crude oil prices suppressed drilling-related shipments and the strong US dollar drove increased steel imports. Demand for construction products resulted in a one percent volume increase in the third quarter, driven by continued demand in support of Texas road and construction projects.

Coal carloads were 15 percent less than last year. Southern PRB tonnage was down 12 percent with low nat gas prices pushing the coal share of electricity generation down to 35 percent from 38 percent a year ago. Colorado-Utah tonnage was down 32 percent, driven again by soft domestic demand and reduced export shipments.

Intermodal units dropped four percent. Domestic boxes were up a point for best-ever 3Q domestic intermodal volume. The west coast labor follies continue to take their toll, sinking international boxes by nine percent. Recall it was in 3Q 2014 when cargo owners advanced peak season shipments in anticipation of port labor strikes. With relatively high inventories some international intermodal customers have reduced orders and not all east coast diversions have migrated back to the West Coast.

The outlook suggests low commodity prices and abundant global supply have created uncertainty about grain vols; truckers continue to eat the reefer fleet's lunch in the food and refrigerator sector. Coal is another downer due to low NG prices, higher than average coal inventories and lower export tonnage.

Chems is a mixed bag: LPG up, oil-related down. The IP group sees mins and mets off as drilling activity slows, a slowly strengthening housing market, and an uptick in construction products, particularly in the south. Continuing truckload conversion to rail from highway is on track to produce the seventh consecutive year of record domestic intermodal volumes; international may slow on soft retail sales.

The whopping 13 percent ops expense drop is a result of UP's success in adjusting resources to service demand. Total T&E workforce at the end of Sep was ten percent smaller than it had been three months ago; the active locomotive fleet is down 140 units from the end of the second quarter. UP is running record train lengths in nearly all major categories, improving average terminal dwell by an hour (still over 28 hours, so nothing to brag about), and achieving a 95.3 percent satisfaction rating from customers on industry spot-and-pull, a two point improvement.

BNSF's annual short line conference, once again at the Worthington Renaissance in Fort Worth, attracted some 200 souls representing most of BNSF's 200 shortline, regional and switching railroad connections. Once again, the agenda was comprised of three parts: Thursday morning breakout sessions with the commodity and support groups, Thursday afternoon formal presentations from senior management, and Friday morning individual meetings as needed.

Setting the scene, BNSF is the only Class I reporting revenue unit growth in the third quarter. Through Week 39 (Oct 4), ag was the big winner with carloads up 14 percent year-over-year. Intermodal gained four percent and coal (!!) six. Industrial Products loads (alas) came down seven percent as double-digit gains in grain and "other" could not offset losses in metals and energy-related commodities from crude oil to pipe and frac sand. See table below.

The commodity breakouts were excellent for sorting out the strengths and weaknesses. The ag products story is one of winning back what had been lost to Union Pacific during last year's winter of discontent. They're getting three turns a month on shuttles with shortline origins turning as well as BNSF local origins. Export grains are off a bit as China grows more of its own corn; fertilizers are off because farmers are holding back on low commodity prices; and ethanol has hit the blend wall where gasoline burn is too low to absorb the mandated ethanol production.

Revenue Carloads/units QTD			
2015 week 39	**2014 week 39**		
533,298	574,030	-7.1%	Industrial Prods
186,974	163,574	14.3%	Agriculture
720,272	737,604	-2.3%	Total Mdse
590,336	559,020	5.6%	Coal
1,354,186	1,300,535	4.1%	Consumer Prods
2,664,794	2,597,159	2.6%	All-in

Ag operating metrics are hitting their stride. Cars in shuttle trains average better than 300 miles per day; cars in single-car lanes are getting 220. Release-to-depart time at shortline interchanges is down to five hours from 30, and single car past-dues have dropped from thousands to minuscule. Car availability, consistent service and momentum mean more shuttle volumes with fewer train sets, keeping BNSF's 25,000-car grain fleet fully employed.

The forest products group did 41,000 carloads in the quarter, split roughly 50-50 between paper/fiber and lumber/panel/OSB with paper flat and wood products up nine percent. Working against paper volumes are mergers reducing producer names and line conversions to more profitable paper types. Pricing has morphed to the 60-foot, Plate F, 100-ton carload from the hundred-weight. In lumber, BNSF sees more OSB substitution for the more traditional dimensional lumber and panels, though southern yellow pine is an attractive growth area with its better producer margins than the British Columbia fir.

The BNSF Construction Prods group is really a mixed bag — iron and steel, iron ore, asphalt, aggregates including frac sand, and minerals — and has not had a good quarter. Every commodity in the AAR reports list is down, most by double-digits. The global steel over-supply combined with scrap-fed mini-mills and substitution of aluminum for steel has trashed the taconite business. Low oil prices are depressing drilling activity and frac sand demand, though some player have discovered cheap brown sand from Texas works as well as the high price Wisconsin product.

After lunch, railroad President and CEO Carl Ice took the stage for his usual no-notes, no-slides update. I found it refreshing to have a railroad president talk about the company culture, where establishing objectives and the tools to do the job rules. Proof of the pudding: train starts are up a third, yet injuries are down more than third. They're getting high marks for meeting or exceeding customer expectations, a key consideration in winning back the business they'd ceded to UP during last year's service lapses.

The railroad is running 215,000 cars a week, the best since the previous high in 2006. They've invested more than $60 billion over the 20 years since BNSF became a corporate entity, using operating profits to create a better, faster railroad (only seven miles of single track remain on the ex-Santa Fe transcon, e.g.). In short, says Ice, "We're getting the most out of what we have."

Next up were Chief Marketing Officer Steve Bobb and VP Service Design Sam Sexhus. Most of the conversation (Bobb and Sexhus alternated) went to the capex program (see transcon, above) and how adding layers of protection shrinks the opportunities for failure. Of this year's $6 billion capex budget, 48 percent is for adding core route repair and replace.

Another 25 percent for new capacity (new double-track segments, longer passing tracks, directional ABS Twin Cities-Chicago, e.g.); 23 percent on cars and locos; and four percent on PTC. Asked if they're facing "stranded assets" in coal lines a la NS and CSX, the answer is no — most coal is PRB origins and fewer coal trains leaves more room for everything else on the core routes.

Industrial Products Group VP Dave Garin and Ag Group VP John Miller then teamed up w Bobb to add to what the breakout session marketeers had said earlier in the day. In IP, says Garin, the need to lower shipper supply costs keeps all the tools on the table — short lines, transloads, unit trains, single-car moves, etc. Boxcars still have room to play a larger role and unit trains will prevail where the low-cost model wins.

(Listening between the lines, I'm betting BNSF would welcome short lines blocking for the distant node so blocks of cars don't have to go over the hump. A day saved in each of the three hump yards the average manifest carload sees could create a significant competitive advantage.)

Miller sounds quite positive in the ag outlook. Even though there is a rising global demand for protein, supply is rising faster than demand, pushing commodity prices down (Miller confirms that corn and crude price-volume charts mirror each other). However, US producers face global competition so end-of-season stocks are rising and farmers are storing rather than taking the lower prices. That also means BNSF is becoming "incredibly efficient," and the shortline model can be a good fit.

I have barely scratched the surface of all the information provided on so many fronts. The session was unbelievably content-rich in terms of opportunities for greater shortline collaboration. Congratulations to all whose fingerprints are on this conference. Well done.

End Note: I'm sending this early as I will be with the Lexington Group for the balance of the week. Look for NSC, CNI, and GWR earnings in WIR for Nov 6.