THE RAILROAD WEEK IN REVIEW

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"The vigor of our performance reflects our ability to leverage the strength of our franchise and its diversity." — Luc Jobin, CFO, Canadian National

Canadian National led off the second week of Q3 earnings reports with a jaw-dropping 53.8 operating ratio. Moreover, CN bested its Class I peers with percentage gains in total revenue, manifest carload revenues, average revenue per revenue unit, and operating income. Total revenue came in at C$3 billion; even though car counts slipped six percent, system RPU gained nine percent, partially on fuel surcharges.

Operating expense dropped five percent, with fuel down a third; operating income gained 16 percent and the OR dropped five points to that enviable 53.8 number (more on this below). Below the line, net income was up 18 percent and earnings per share rose 21 percent as CN's aggressive share repurchase program continues.

On the call, CN touted operating improvements as key to the low OR with GTMs per train-mile, cars per yard-switching hour, terminal dwell, trailing GTMs per horsepower, car-miles per day, and train velocity all heading in the right direction. However, with GTMs off five percent and manifest carloads off 11 percent, it follows that with fewer freight cars cluttering up the railroad, one has more room to move and can move what's there with fewer resources than if the railroad were full.

Yet Chief Operating Officer Jim Vena says the sub-60 OR is sustainable. The year-over-year drop in fuel expense was a one-time event; prices are likely to stay where they are. There will always be quarterly variations — weather in Q1 and Q4, e.g. — "but clearly we're looking at a sub-60 environment and FX is not really a significant concern."

This is where listening to the call and reading the transcripts comes in handy. Whereas the Prepared Remarks are always carefully scripted, such is not the case with the Q&A. Asked about real-time operating changes, Vena said train-starts dropped 13 percent; train-miles were four percent less, yet train-lengths were up an equal amount, putting more cars on fewer trains running fewer miles. GTMs per train-hour were up ten percent.

The ratios of bad-order cars to the total serviceable fleet and overtime hours to straight time both dropped double-digits. "Old date" cars, those remaining in yards beyond their trip plan dates, also fell by double-digit percentages; on-time originations and arrivals were up smartly. In short, CN ran the trains faster, ran the trains longer, put more tons on the trains, and put the cars through the yards more quickly. That's what you can do with the space freed up.

Total merch carloads were down 90,000 units, of which 62,000 were due to a CN-served iron mine closing in August (the annual impact is some 260,000 cars moving just 26 miles). In forest products, lumber won on strong growth in U.S. housing, losing some vols to weak Asian exports. Offshore wood pulp export benefited from a pulp mill reopening in Northern B.C.; paper volumes were down 14 percent — not surprising.

Crude oil shipments were sequentially flat with last quarter at 23,300 carloads, but down a third year-over-year, a casualty of the crude-oil price spread that drives carload vols and making crude-by-rail pricing increasingly transactional and short-term in nature. LPG, refined products, plastics, and ferts continued to perform well.

Grain loading dipped in Canada thanks to low grain stocks but is on the mend. The US grain business was slightly down — a major corn processing plant in Memphis closed permanently earlier this year. The Metals & Minerals group carloading shed 15 percent on the frac sand cut back due to reduced oil drilling. Cheap steel imports hurt CN vols in semi-finished steel, scrap iron and iron ore.

The outlook is for consumer-driven demand to support growth in lumber/panel, grains/ferts, crude oil and NGLs. Crude-oil vols will continue to be spread-driven, and CN can add value in the "transactional" lanes. CN is not banking on significant volume gains in steel, iron ore, coal or frac sand. However, CN *is* banking on ramping up RTMs faster than revenue-unit volumes. Thus the message to feeder railroads is to feed CN high-rated commodities traveling long distances in private equipment.

[As an aside, Chief Commercial Officer Jean-Jacques Ruest says 55 percent of CN revenue is in US dollars. "We're faced with a weaker Canadian dollar so we're driving the US dollar as a competitive wedge to bring Canadian products to the US — for example, lumber from BC, where most of the labor and wood costs are in Canadian dollars, and where you can get paid in US dollars. Same with export. We price through the US and Canadian ports in US dollars and since part of our costs are in Canadian dollars, we can be even more competitive."]

Norfolk Southern third quarter revenue dropped ten percent to $2.7 billion as carloads and containers declined three percent, with every commodity group down except auto and chems. Worse, RPU was off across the board — down seven percent system-wide. Operating expense shed seven percent; operating income was $822 million, down 18 percent. Net income slid 19 percent to $452 million; earnings per share were off 16 percent at $1.49 after buy-backs.

For me, there were three big take-aways. First, CEO Jim Squires says NS is "looking hard at underutilized assets in some parts of our network," meaning, of course, coal routes. Chief Operating Officer Mark Manion enlarges: "We're continuing to make strategic reductions associated with our decrease in coal volumes," to wit, 300 route-miles out of service or with reduced investment, or, as I see it, just short of abandonment.

Second, Chief Commercial Officer Alan Shaw says 50 percent of all NS freight revenue is tied to commodity pricing or foreign exchange, hurting carloads of coal, steel, frac sand, crude oil and export traffic. Moreover, "Inventory builds have softened freight shipments since the second quarter." On the plus side, "International intermodal, automotive and natural gas products all had large gains in the quarter."

Third, market-based pricing reigns more than ever. "As our business mix changes, we continue our focus on the bottom line," so it behooves feeder lines to know where those levels lie before they even approach NS for rate quotes. Though Shaw didn't say it in so many words, NS is looking to increase RTMs faster than carloads, meaning higher-rated commodities moving longer distances. See also CN's Ruest, above.

Manion, I think, does a fine job linking velocity and profitability. This, during the Q&A:

> Aside from the improved customer service side, velocity increases really help us reduce headcount and our overall asset base, including locomotives. Expenses decrease as our asset turns increase (re-crews were down six percent in Q3); T&E overtime went down and I think we'll continue to see a favorable trend in fourth quarter.
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> As our fluidity improves, as our velocity improves, we can be more scheduled with our engineering department. They get more track time. They get out on the railroad when they need to be. They don't accumulate the overtime they otherwise would. So in short, improved velocity just drives a lot of good things when it comes to cost reduction.

Moving into the fourth quarter, Shaw sees commodity and export half of the NS revenue base markets flat to down year-over-year. For 2016, NS will clear the negative utility coal comps from cheap gas, continuing with guidance of 20 million tons of utility coal per quarter. Reduced fuel surcharge revenue will continue through the fourth quarter with comps improving in Q1.

If you really want to know how freight revenues are doing, you have to back out the pesky fuel surcharge. In 3Q2014 NS collected fuel surcharges of $368 million, leaving pure freight revenue of $2.655 billion. This year, NS fuel surcharges were $113 million, down $255 million — 69 percent — leaving pure freight sales of $2.600 million, down two percent, not down ten percent, as reported. Adjusted operating income becomes $709 million, up 12.5 percent, after subtracting fuel surcharge from the top lines for both years, not down 17.6 percent

Genesee & Wyoming third quarter operating revenues increased 26 percent to $546 million; same railroad operating revenues, excluding the $23 million negative impact of foreign currency depreciation, declined 11 percent primarily due to weakness in iron ore, coal and metals shipments. Consolidated operating income dipped five percent to $117 million for an operating ratio of 71.2, up half a point. Net income was off 13 percent; eps was off 14 percent.

North American Q3 freight revenue was $214 million, including $4 million from the Arkansas Pinsly lines, off ten percent; total revenue including non-freight was $575 million, down nine percent, with more than half of the decline due to the combined impact of currency and fuel surcharge. Operating expense posted significant declines in payroll, car hire, materials and trackage rights, and held to an eight percent improvement. Operating income declined 10 percent due to weakness in twelve out of fourteen commodity groups.

Auto and auto parts traffic came down 25 percent due to lower export volumes, thanks largely to the strong dollar. Steel and metallic scrap dropped 24 percent due to competition from imported steel. "Other" dropped a third on lower overhead volumes. Lumber and forest products traffic was down two percent on the weaker housing market and loss to trucks in the Pacific region. Mineral & stone traffic was down a point on weaker frac sand shipments in the Midwest region.

The RCP&E got good marks during the Q&A. CEO Jack Hellmann says the road is doing "better than expected." Even though ag is off a bit because farmers are keeping so much product in storage awaiting better prices, "We've got a lot of things like cement and [bentonite] clay that are moving extremely well." Chief Commercial Officer Mike Miller thinks stored grain could add 20 percent to present car-counts, especially if exports kick in.

Hellmann adds, in response to another question, that RCP&E volumes have been good for seller CP (though not mentioned by name), as well as for other connecting Class Is. " We think the actions speak for themselves. [The RCP&E] is way ahead of where we thought it was going to be at inception, and we hope that this and other similar transactions we've done with the Class Is" would lead them to view GWR favorably for future spin-offs. What a case study.

RailTrends 2015 is just around the corner. It's November 19-20 at the W New York Hotel, 541 Lex at about 50th, billed accurately as "a two-day conference for ALL of the rail-industry disciplines and stakeholders." The venue is a great place to meet and greet and get industry insights from the movers and shakers. A sampling: CN's JJ Ruest, Watco's Rick Webb, GWR's TJ Gallagher, Oliver Wyman's Rod Case, rail analysts Don Broughton and Tony Hatch ("Out of the "Rail Renaissance" and back into the dark ages?"), and FRA's Sarah Feinberg, to name a few. And That's just Day One. I'll be there.

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