RAILROAD WEEK IN REVIEW
January 22, 2016

"The growth opportunities we see coming online, coupled with stronger than ever operations, makes us confident and excited about our future." — Dave Starling, CEO, Kansas City Southern

None of the four of the Class I railroads reporting fourth quarter earnings thus far posted year-over-year revenue gains. UP got hit hardest, down 15.4 percent; CSX was next worst with quarterly revenue dropping 12.9 percent. KSC was next in line, down 6.9 percent and CP was least scathed, down 4.1 percent. Volume deltas did not follow suit exactly. UP dropped 9.1 percent, CSX was off 6.1 percent, CP was close, off 5.9 percent and KCS vols slipped but 2.5 percent. BNSF, though not reporting earnings, saw vols dip 3.8 percent QTD through Week 52.

All posted declines in carload revenue ex-coal, and only CP eked out a slight — 1.7 percent — gain in system RPU. Merchandise carloads declined by mid-single digits across the board, including BNSF; CP alone took merchandise RPU up, 5.0 percent. All but CP took operating expense down by low double-digits; KCS wins the OR delta prize, down 330 basis points.

Union Pacific reported $4.9 billion in fourth quarter freight revenue, off 16 percent, and operating income of $1.9 billion, down 19 percent. Net income was $1.1 billion, down 22 percent. The operating ratio was 63.3, up 174 basis points. UP moved 2.2 million revenue units, down nine percent, taking declines in every commodity line but auto. Coal was the big downer, down 22 percent, and I was surprised to see industrial products down 16 percent. Ag vols slipped five percent, and chems including crude oil came down two points.

Chief Marketing Officer Eric Butler said on the call domestic grain was up, but not enough to offset negative export deltas in soybean meal, DDGs, and ethanol. In chems, price spreads shot crude oil vols down by two-fifths, while NGLs and LPG were up five percent. Frac sand loads were half what they were a year ago and metals were off nearly a third. Coal vols dropped 22 percent on lower demand and intermodal slid seven points on slowing imports.

The commercial outlook for 2016 calls for a slow start, with volumes increasing as the year progresses. Ag exports will lag against domestic gains, though bean meal may not approach 2015 levels. Crude oil will continue to suffer on global price spreads and ferts will take a hit; NGLs may help save the day. Metals and minerals won't win any prizes, though building products will benefit from any housing uptick. Intermodal is a mixed bag: good highway to rail conversions, not so good on slow consumer discretionary spending.

The railroad is running better. On the call, Chief Operating Officer Cameron Scott noted improved train-speed (better than six years ago and with seven percent more cars-on-line), yard dwell, fitting assets to the work at hand, running longer trains, and doing so more safely. While revenue units dipped 16 percent, GTMs and gallons of fuel consumed were down 14 percent.

Canadian Pacific's fourth quarter report cites record earnings per share after non-GAAP adjustments and another sub-60 OR, repeating the record set a year ago. On a straight arithmetical basis, excluding adjustments, net income was off 29 percent to C$154 million and per-share earnings without the share buy-back were down a similar amount. I think it's important to make this distinction because Precision Railroading, to use Hunter Harrison's phrase, depends on asset turns and winning ways with customers. What happens below the line is arithmetic.

CP freight revenue of C$1.6 billion, down four percent, came on 649,000 revenue units, down six percent. CP posted volume growth in Canadian grain, sulfur/fertilizers, and forest products. All others saw declines, with US grain, potash, crude oil, and metals/minerals off double-digits. Operating expense was a billion loonies even, down four percent, even with the revenue slippage. I've already mentioned the OR and net income deltas, above.

The most telling part of the quarterly earnings call was in the Q&A following the prepared remarks. CEO Harrison had said in his opening comments, "We're going to provide a kind of an abbreviated version of what we normally do this morning, because I think there's going to be a lot of interest in the [M&A] (a not so veiled reference to the NS acquisition effort) activity." We were not disappointed.

Several analysts posed questions about various aspects of the proposed transaction. I can best summarize Harrison's responses thus: We see a lot of moving parts and things are happening almost daily that we didn't expect. It's becoming a political process and that could change our approach. At the worst, and M&A fails, we still have a great railroad in Canada. We thought we could facilitate some changes, "but other people see it differently and so maybe all of our strategy changes."

Asked whether CP's appetite for M&A might be "wavering," Harrison said that long-term, M&A will happen, we just don't know when. The rules are changing even as we speak, and if the deck is stacked and somebody's not playing by the rules, we have to adjust accordingly. All indications are shareholders are in support if this transaction, "but they don't call the shots."

Street analyst notes seem to suggest the NS deal as originally outlined may be in jeopardy. Scott Group, Wolfe Research: "Harrison steadfastly believes in long-term rail consolidation, but he suggested CP might be preparing to walk away from its proposed merger with NS." John Larkin, Stifel: "Harrison and Creel expressed frustration and distaste… for regulators making preconceived decisions regarding a potential proposal." And Cherilyn Radbourne, TD Securities: "CP appears to have been surprised by the level of political opposition, and, although we do not expect the company to back away easily, its next move appears less certain."

Kansas City Southern brought up the earnings markers for the week. Total revenues decreased seven percent to $598 million as total revenue units slipped three percent to 556 million. Operating expense came down 11 percent — always a good sign when expenses drop at a faster rate than revenues — and operating income posted a modest two percent increase, to $219 million. Net income slipped a point to $139 million, a decent accomplishment given all the moving parts KSC has to publish below the line.

Commodity carloads ex-coal and intermodal were off three percent. Chemicals/petroleum ex-crude was up eight percent on NGLs and plastics. Industrial/consumer shed 14 percent, driven by continued weakness in metals business. The combined ag/minerals group delivered a two percent increase with strength in the food products and ores and minerals segments, offset by slightly lighter grain volumes. Carload volumes in the energy group, which includes coal, crude, and frac sand, jumped 11 percent on utility coal, believe it or not.

Operationally, KCS continues to make great strides in running a better railroad. Chief Operating Officer Jeff Songer highlights a few. Starting last January in the US and spreading to Mexico in 2016, KCS set up inter-division trains that eliminate crew changes, making better use of the upgraded 70 mph track speed.

There is now a joint KCS/BNSF/UP territory dispatch team at Spring, Texas. Sanchez Yard is adding capacity to run trains through Laredo more quickly and at lower variable cost. They've cut average cycle times at Lazaro by six hours through better coordination of train departures, and KCS will be putting new fuel-saving technology on a fifth of their units in 2016 (already KCS is down to 1.4 gallons of fuel per thousand GTM).

I get the sense that the steps started some years ago to have better, more cost effective assets in place, from crews to locos to track speed, plus the aggressive new-business pipe line, are beginning to pay off. We've gotten past the over-promise, under-deliver plague of a few years ago, when results didn't show up as fast as anticipated. Rather, I think that KCS has an excellent handle on what they can do with what they have and capitalizing on the franchise thus created.