RAILROAD WEEK IN REVIEW

February 19, 2016

"Divide 72 by the compound interest rate to find the number of years it'll take a given investment to double in value." — Rule of 72

We spend so much time talking year-over-year by quarters and from week to week, we sometimes need to step back and see what the longer term looks like. After all, railroading is a capital-intensive business, where assets' lives are measured in decades, not days. Here are the four-year traffic growth trends for each of the Big Six North American Class Is.

Year	BNSF*	CN	CP	CSX	NS	UP
Total Rev Units						
2012	9,622	5,059	2,669	6,409	7,107	9,048
2015	10,232	5,485	2,628	6,761	7,479	9,062
% chg	6.3%	8.4%	-1.5%	5.5%	5.2%	0.2%
CAGR-4	1.54%	6.40%	-0.39%	1.35%	1.28%	0.04%
Merch ex-coal, IM						
2012	2,792	2,882	1,308	2,668	2,335	3,865
2015	3,559	2,815	1,332	2,860	2,538	4,115
% chg	27.5%	-2.3%	1.8%	7.2%	8.7%	6.5%
CAGR-4	6.26%	-0.59%	0.46%	1.75%	2.11%	1.58%
***BNSF 2015 wk 52**						

The numbers are drawn from my WIR year-end review tables based on the individual names' published financial reports. Total revenue units include everything that moves for money (each intermodal container or trailer is a revenue unit). Merchandise ex-coal and intermodal is the entire STCC list of everything moving in carload service, including finished vehicles, auto parts, and crude oil. I show both numerical average change and CAGR over the four years. (I suspect much of BNSF merch leadership is crude-by rail. QCS data shows quick rev unit ramp-up 2012-2013, peaking at 3x closest rail in 2014.)

We're truly in slow growth mode, in parallel with the economy in general. A number growing two percent a year compound interest takes 36 years to double, per the Rule of 72. Given that a $150,000 boxcar will last 50 years, a bridge 100 years, and nominal tie-life can be 40 years, you really don't need an aggressive CAGR to get your money back over the life of the asset.

Canadian National CFO Luc Jobin had an instructive conversation with host Brandon Oglenski at the Barclays Industrial Select Conference on Tuesday. For 2016 Jobin sees the

energy challenges going more toward specific OD pairs, whereas the consumer/industrial landscape is broader and more encouraging.

CN originates nearly nine out of every ten revenue units on the road, and serves more than two-thirds of the destinations for those units. Being less exposed to energy (coal, oil, nat gas, and related commodities), it has more direct control of service options for some 90 percent of its revenue sources.

With the Canadian dollar now down to about 72 cents US, the impact on vendor costs in Canadian dollars and revenues in US dollars is significant. Canadian heavy crude is less subject to the vagaries of Brent/WTI pricing, so volumes are less volatile. The Canadian-US intermodal franchise benefits from expanded port capacity at Prince Rupert and Vancouver, matched with US terminal expansions at Memphis, Indianapolis (thank you, Tom Hoback), Joliet, and Detroit.

In the carload sector, yield management is under the microscope, especially in the lower tranches where revenue/cost ratios are more modest, yet where — listening between the lines — opportunities exist to increase vols at reasonable incremental cost and where the added carloads will contribute to branch-line overhead cost recovery.

Mirroring comments made in the past by CN compatriot JJ Ruest, Chief Commercial Officer, Jobin says CN seeks “sticky” customer relationships, where the service offering is such that the economics of changing vendors can be quite unattractive. Which in turn leads to keeping ORs in the low 60s or less. Jobin calls it a “balancing act” — being nimble and responsive to customer supply chain requirements while at the same time lowering the incremental cost of each carload added for that customer.

Finally, the first call on cash from operating activities is always network upkeep — track, power (90 new units to sideline 35-40 year-old units and their higher operating costs) — followed by “strategic opportunities,” among these being “bolt-on” acquisitions of short lines. Jobin says CN uses all its capex opportunities to increase system train-speed, and we ought to count on capex running a consistent 20 percent of revenue going forward. Looks to me like the merchandise carload model is alive and well at Canadian National.

The CP-NS jousting continues. Hunter Harrison took his case for a “non-binding shareholder proposal” with NS to the Feb 10 BBT Transportation Services Conference and the Feb 17 Barclays Industrial Select Conference, a few hours after Jobin’s remarks, above. The tone at BBT was almost conciliatory, Hunter saying CP isn’t looking for a proxy fight, preferring “just to enter a dialog.” If NS shareholders don't oblige, it could be the end of the discussion, in which case CP will redouble its efforts to run “one hell of a CP railroad.” See transcript on CP website.

For the record, here is the verbatim text of the shareholder resolution that has been presented to NS: *RESOLVED, that the stockholders of the Company [NS] hereby request that the board of directors of the Company promptly engage in good faith discussions with Canadian Pacific*

Railway Limited ("Canadian Pacific") regarding a business combination transaction involving Canadian Pacific and the Company, without in any way precluding discussions the board of directors of the Company may choose to engage in with other parties.

Harrison's Barclays comments struck pretty much the same tone, saying he's been thinking about railroad consolidations in the east since before he left CN. He sees a lack of bench strength at NS with the relatively close departures of Don Seale (marketing), Mark Manion (ops) and Moorman and would just like to get his thoughts about strengthening the property before the shareholders.

He laments the industry's duplication of facilities, where parallel Class Is have the same facilities in the same place, seeing shared assets as one way to lower costs and add franchise competitive advantage (much, I sense, as the Conrail Shared Assets Operation has done for NS and CSX). However, in his conversations with Munoz at CSX and Moorman at NS, it appears that they all saw pretty much the same needs, only to have the suggestions shot down in the lower ranks.

The key to running any railroad — the long-haul, straight shot CN or CP, messy short-haul, switching-intensive NS, CSX, or Frisco (where HH started) — it all boils down to Precision Railroading: having a plan and executing it. It's what took ORs at CN and CP from the 90s to the 60s and HH sees no reason a why similar approach can't achieve the same result at NS. The goal, says Hunter, is a merger that offers compelling value. If that's not in the cards, then the CP focus becomes more buybacks, bigger dividends, and possibly "smaller acquisitions that would enhance" the CP franchise.

But I'm not convinced we're anywhere near the end of the game. For its seventh-inning stretch, CP on Tuesday said it it will seek a declaratory order from the STB to confirm the viability of the voting trust structure that CP has suggested as part of its proposed merger with Norfolk Southern, and that the railroad "intends to proceed" with or without Norfolk's cooperation.

It's my understanding the voting trust would allow shareholders to get paid before the deal closes, with NS and CP retaining their independence while the regulatory wheels turn. And since I'm way out of my league here, let me defer to *Railway Age* Contributing Editor Frank Wilner, himself a former STB chief of staff, who writes in part:

> There is no time limit on the STB having to rule on the request for a declaratory order or provide one. If the STB does not provide a definitive answer as to whether the voting trust is independent and can be imposed, should CP manage to convince NS stockholders to tender their shares, then CP is back where it started before seeking the declaratory order.
>
> CP must overcome allegations that the voting trust it envisions is a sham to put CP in control of NS pending a merger application and decision, which is contrary to the purpose of an independent voting trust. How the CP request is worded and how the STB views it are, of course, all that matter.

If the STB rules against the voting trust framework as proposed by CP, there is not much CP can do. It is most rare that a federal court overturns an expert regulatory agency decision — especially where, as in this case, the STB has discretion in the matter rather than a clear mandate in the statute. Numerous Supreme Court decisions have solidified the sanctity of expert regulatory agency decisions, which generally can be overturned only for arbitrary and capricious intent on the part of the regulators.

For its part, NS still maintains it sees no benefit in continuing the conversation without CP providing a "compelling value" and having addressed the regulatory hurdles.

Over on Wall Street, Tom Wadewitz at UBS writes, "The issuance of declaratory orders is a common practice by STB with respect to track abandonment procedures and there are few examples of declaratory orders related to M&A. Nonetheless, a favorable response from the STB would provide a leverage point for CP, while a negative response from the STB would likely result in CP ending their campaign to combine with NSC (CP communicated in the past that voting trust approval is necessary to proceed with a potential deal)."

And Scott Group at Wolfe Research writes, "In the near term, we believe the stocks reflect almost no merger premiums. And we'd continue to assume very low probabilities of mergers for now. Even with this as our base case, our favorite large-cap rail is NSC where we expect the most margin improvement over the next 2-3 years from the worst base currently."

Parting on a more positive note, Frank Lonegro, CFO at CSX, told the Barclays crowd on Thursday how, over the past five years, CSX has offset the rapid decline of coal vols, dealt with the ups and downs of the petroleum segment, and grown its merchandise and intermodal franchises at a faster rate than the economy. Add to that running a smarter railroad that facilitates more aggressive pricing, and CSX delivered a five-year earnings CAGR of four percent, leading to sub-70 OR for 2015.

For 2016, CSX predicts vols may slip as much as ten percent in Q1, with coal off another 20 percent-plus, while most other markets post year-over-year declines as the year progresses. Lonegro concludes, "We continue to focus on the things most in our control, realigning the network to match decreased demand in some markets and adjusting to increases in others, and a mid-60s operating ratio longer term." Can't argue with that.

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