RAILROAD WEEK IN REVIEW

April 22, 2016

"Our operations team demonstrated excellent performance on things we can control: service, cost control, and asset utilization." — Pat Ottensmeyer, President, KCS

"We have a goal of short-lining, idling, or downgrading 1,000 miles of track this year. That remains our full-year target." — Jim Squires, President, Norfolk Southern

Kansas City Southern led off the week's earnings reports with a five percent operating income gain to $188 million even as total revenue dropped seven percent to $563 million. Six of the seven expense lines on the income statement posted minus deltas; only D&A was positive, but that's an internal arithmetic matter. As Ottensmeyer said on the call, "We're out to control what what we can, and to minimize the effect of those elements we can't control." As a result, the OR came in at a respectable 66.6, down 385 basis points vs. last year.

Car counts were flat through the first week of March. Then the rains came. Floods took out three key line segments in Louisiana and Texas for as long as three weeks, sending year-over-year vols down five percent for the quarter. Of course, high waters affect all area railroads and by working together with overhead, haulage and trackage rights accommodations, effects are minimized. But the good news is KCS traffic is holding up, even as these work-arounds cost time and money.

The balanced franchise helps. Chems and the STCC 29 petrols are a quarter of all merch loads (47 percent of total vols), with no other commodity exceeding seven percent (that would be grain) of the merch carload total. Intermodal is catching up fast with the help of Mexico, now 44 percent of all revenue units, with coal/coke holding steady at nine percent.

Below the line, it always gets complicated for KCS, what with foreign exchange puts and takes, preferred divs, payments to "non-controlling interests," and so forth. Still, net income was up seven percent to $108 million, and that, with the superb pipeline of new product and service offerings, gets KCS off to a good start in what promises to be an "interesting" year.

Canadian Pacific did C$1.6 billion in first quarter revenue, down five percent, on 614,000 revenue units, down four percent. Revenue ton-miles slipped five percent, with manifest carloads and automotive representing 67 percent of the total against 70 percent of total revenue. System revenue per revenue unit was off less than a point, with sulfur/ferts and forest products posting double-digit gains.

Operating income increased seven percent, as the 11 percent operating expense reduction turned negative revenue deltas positive. The operating ratio improved 430 basis points to a record 58.9, the third straight quarter below 60. GAAP net income jumped 69 percent to C$540 million and earnings per share shot up 83 percent to C$3.51. However, property sales played a significant role in creating these outsize results. Absent these one-time events, the net is C$384 million, up two percent, and eps rose 11 percent to C$2.50.

CP President Keith Creel says network train speed, terminal dwell, locomotive GTMs per available horsepower, and car miles per day all improved by double-digits vs. a year ago. Average train length, 7,108 feet, and fuel efficiency (less than a gallon per thousand GTMs) settled for five percent gains. So with revenue units off less than five percent, fuel burn down nine percent, and GTMs down five percent, turning in that seven percent ops income gain in a weak economy shows what can be done by watching *everything*.

The revenue split is 70.4 percent manifest carload and auto, 20.2 percent intermodal, and 9.4 percent coal, with the merch sector showing the only increase. Within the merch sector, grain (Canadian carloads outnumber US carloads 2:1) is a third of the total merch car-count, followed by crude oil (17.5 percent), and automotive (14.6 percent). Combine that with the operating performance gains, and one can see yet more incremental revenue flowing direct to operating income as the economy improves. Not a bad place to be.

Union Pacific revenue units slipped 8.4 percent, the most of any road reporting to date, to two million loads (BNSF through Week 13, essentially the end of the quarter, was off 6.6 percent, though winning the volume week sweepstakes at 2.4 million units.) UP brought in revenue of $4.8 billion, down 14 percent. Ops expense also came down 14 percent, leaving operating income down 15 percent. The operating ratio ooched up by a positive oh-point-three delta to 65.1, a still respectable number.

Net income dropped 15 percent to $979 million, though with the four percent share-count reduction, reported eps dipped but 11 percent. Cash from operations was more than twice net income, providing a welcome cushion for capex, dividends, and share buy-backs, and generating a positive free cash flow of $315 million at the end of the day.

Merchandise carloads including automotive were down 2.5 percent, with only auto in the positive column. Which is good because UP sees growth in auto parts in boxcars, up 10 percent. Here, I'd suggest you download Eric Butler's slides. Whereas CSX and KCS provide fairly detailed tables, UP does very well with pie charts and graphics. Not everything adds up to 100 (the three ag bars total 218k cars, yet the pie chart adds to 100), but you at least get a sense of where the action is.

For example, STCC 20 processed foods in boxcars are up, indicating a possible share grab from the trucks. Auto parts are in boxcars here; what's moving in containers goes in the intermodal column. In chems, you get only three bar charts and a more detailed pie chart; the plus for short line is the industrial chems growth. Industrial products includes frac sand in the minerals group and drilling pipe in the metals group. On the call, Butler said construction aggregates are doing well in the south as the weather has cooperated with those outdoor projects.

The slide 11 outlook highlights less export grain but more domestic, more auto parts in boxcars, slowing ferts as the growing season ends, minerals and metals off with drilling, and lumber running parallel with construction products. All of which flows positive to COO Cam Scott's comments about running a safer, faster railroad. Velocity and terminal dwell both posted year-over-year improvements as UP leads the pack in building places for freight to go.

The message to the UP feeder railroad community is to find traffic that can bring low-cost, decent-yielding carloads with meaningful volumes that can contribute directly to increased operating income. Doing more with less is key: the T&E (train and engine) workforce is 22 percent smaller than it was a year ago, and UP is handling 13 percent fewer GTMs with 15 percent fewer active locos. That says a lot.

Norfolk Southern turns around. First quarter operating income shot up 19 percent to $723 million even as revenue dipped six percent to $2.4 billion on 1.6 million revenue units, down three percent. NS showed how, in bold italics, paying attention to crew starts, re-crews, pricing, locomotive fleet size and composition, yard size and location, and pricing to demand can re-energize a property. And that really came out in the confidence, poise and pacing of the earnings call presentations.

Merchandise carloads were up three percent, with gains in every category save chems (down five percent mostly on crude). Intermodal units were unchanged, though if you back out the now-discontinued Triple Crown Service, traditional units gained six percent, including a 15 percent uptick on the international side. Coal carloads dropped another 23 percent, coming down to 14 percent of total revenue from 29 percent six years ago.

Every operating line item but depreciation posted a year-over-year decrease, showing, as did KCS, how controlling what you can control cascades through to operating income. The OR dropped more than six points to 70.1, a new record low. Says CFO Marta Stewart, "The first quarter historically has the highest OR of the year, so this result is very supportive of our anticipated full-year operating ratio below 70." Net income is up 25 percent to $387 million; cash flow after capex, dividends, and share repurchases is $105 million in the black vs. $357 million in the red last year.

COO Mike Wheeler highlighted a number of significant operating improvements. "We've reduced yard operations at 25 locations system-wide; have taken 150 units out of our yard and local fleet, a 12 percent reduction; have cut crew-starts by three percent, re-crews by 51 (!!) percent; and have boosted GTMs per train-hour by six percent."

All of which I think is leading to a faster, less-expensive, more nimble railroad that will continue to build merch carload volumes. Says Chief Commercial Officer Alan Shaw, "We see a lot of opportunity in our consumer-based market because of our improved service product. And even with pressure on corporate profits now, shippers are looking to shift to intermodal because it still is a lower priced option than truck." As is carload, and that can only be good for the feeder lines.

Canadian National completes the 2016 Class I first quarter earnings call season next Monday. I'm expecting BNSF to report as part of the Berkshire Annual Meeting April 30 (rev units down 6.7 percent through Week 13, April 2); Genesee & Wyoming will be up April 28 at 1100.

Pam Am Railways has reopened the Waterville, Maine intermodal facility after several idle years. The occasion is the burgeoning bottled-water thirst of the denizens of southern New England and the environs of NYC. The Poland Spring brand (a division of Nestle) has eight spring locations in Maine, and the Bradbury Spring in Kingfield is just 45 miles from Waterville, where our story begins.

Getting trucks this far north in Maine is one long fezzle to begin with, so a fleet of intermodal containers operating in a closed loop is the obvious solution. Bradbury loads three 20-container blocks a week at Waterville, heading south over 80 miles of the former Maine Central to Portland, where, also three times a week, they join 15-container blocks of water from other near-by springs for the move south.

Moving 105 containers of bottled water a week is a mere drop in the bucket, so to speak. As the service rolls out, it'll attract other truck-starved Northern Maine freight customers, adding volume and density to the lane. As well as more water bottles.

The Poland Spring story is yet another example of what regional railroads are doing to reinvent themselves as freight patterns shift. PAR, once a heavy-haul printing paper road, is morphing into a property catering to specific customer supply chain needs and is creating the infrastructure to serve those needs.

The week before the first Poland Springs train I visited the Watervillle ramp and hi-railed about half the Waterville-Portland main. What I see is a clean property in an excellent state of police and repair, supporting 70-car merch trains sporting 1:1 horsepower to trailing-ton ratios and assuring a quick ride over the road and happy customers at the other end. Would that other regional rails could build on this model.