RAILROAD WEEK IN REVIEW

July 22, 2016

"We're constantly looking to make a reasonable return, so that [every move is] a re-investable piece of business." — Lance Fritz, Union Pacific earnings call.

Union Pacific second quarter revenue units dropped 10.5 percent on freight revenues down 12.6 percent; system RPU dipped 2.3 percent. Once again, fuel surcharge (FSC) fees cloud the picture, being about $200 million less than a year ago. Back that out and revs are down 8.5 percent. The carload commodity revenue and RPU numbers reflect the FSC decline, and, although there's no way to back out the FSC effects by commodity line, it partially explains the 2-point spread between the reported declines in revenues and volumes.

Merchandise carloads including auto and crude came down 10.7 percent. Chief Marketing Officer Eric Butler always includes a few slides showing where the commodity changes occur, and it is here short line owners can go to put their franchises up against the UP results. In his earnings presentation, he doesn't necessarily comment on every commodity in each group, though the mix percentages are directionally very helpful.

Operating expenses posted negative deltas everywhere but Depreciation and Other, down 10.6 percent overall. Operating income was $1.7 billion, off 14.8 percent and the OR was 65.2, up 110 basis points. Below the line, net income declined 18.7 percent to $979 million. Cash from operations was $3.5 billion, 180 percent of net, up from 160 percent a year ago. Free cash flow after capex and divs was a $billion even, five times what it was a year ago.

On the call, especially during the Q&A, we were treated to a number of tidbits that short lines can use to tweak their operations in support of UP's efforts to right-size the network for the volumes at hand and what's likely coming at them next year and beyond. First, cycle times. I'm not a heavy-duty note taker, but I heard references to "re-investable pricing" several times. This goes back a couple of years to Jack Koraleski's remarks on the topic.

As I recall, Jack's message was, "We have to have rates that include the cost of replacing the equipment when it wears out." That implies adequate contribution per car-day as the car moves between origin and destination; if a short line is on either or both ends, the dwell on the short line will affect contribution per car-day. Thus the way to support re-investable pricing is to turn the cars promptly.

Second, core (same-store) pricing, which increased two percent. This fits with the low end of the pattern we're seeing elsewhere and is certainly achievable given the growing tightness of transportation resources among truckers, barge operators, and containership lines. But here again, the short line, precisely because of its being so close to the customer, is in a great position to tweak the service offering to fit supply-chain requirements.

Third, finding customer-specific solutions. I remember some years ago working on a supply chain problem with a short line shipper whose customers were local to UP some distance away. UP worked with us so we could time releasing loads by destination so as to minimize transit time, then tracking trip-plan compliance. Needless to say, that made for a happy customer who saw real value in the enhanced service offering.

Elsewhere: Auto parts are up more than finished vehicles. Parts are mostly moving in containers, but a third of it is in carload service. Auto production in Mexico is replacing some domestic origins, but net-net UP sees the shift as a positive. Grain storage vols are greater than average but with a bigger harvest coming it will have to start moving and UP is ready. Housing starts are up in some regions more than others, depending on demographic trends, but sequentially positive. The outlooks for LPG and industrial chemicals are generally up; fertilizer may be down sequentially but larger crops require a greater supply of nutrients.

My take is that UP's realigning fungibles to support near-term demand and the capex program to support longer-term needs will pay off in good time. The UP short line meeting is about a month away and I'm hopeful short lines will go through these results looking for ways they can add value to their UP relationships, then try them on in their breakout sessions.

Kansas City Southern second quarter revenue units were unchanged at 537,300 in spite of drops of a thousand cars or more in ores/minerals, frac sand, and intermodal. Total revenue dropped three percent to $547 mm thanks to foreign exchange and fuel price; absent these anomalies, revenues increased two percent. Because of the foreign exchange and fuel effects (see below), RPU dipped three percent — double-digit declines hit seven commodity groups.

Operating expense came down 13 percent, producing an 18 percent ops income jump to $220 mm, taking 679 basis points out of the OR, to 61.3. Below the line, net income rose seven percent to $108 mm; eps gained 10 percent to $1.10, though without the share repos, eps was a buck-nine. However, going back to the reported $1.11, you can fairly adjust eps for the foreign exchange loss and the FX income tax hit. Then you have $1.22 eps for the present quarter vs. $1.03 year ago — up 18 percent.

KCS, like its larger peers, is working hard to control what it can and right-size the resources to the work. Seven percent of the US T&E workforce has been furloughed and 15 percent of the loco fleet is stored. Fuel optimization technology is in place on 20 percent of the road fleet (1/3 of units), and the program is moving to Mex as well. They've cut idling fuel burn with auto shut-down features and as a result limited the road burn increase to a mere point to haul two percent more GTMs. Gallons per thousand GTMs remains at 1.38.

Floods took out a UP bridge south of Houston where KCS has rights. This was the second consecutive quarter of Houston-area flood damage, this time causing a three-week shut-down along the route KCS utilizes for its cross-border traffic. While bridge repairs were being made, KCS had to detour considerable traffic onto other carriers' routes, presumably the ex-SP and ex-Santa Fe routes still extant in the area. On the call, it was noted the impact on ops expense and revenue was minimal thanks to the cooperation of the various railroads.

The Mexican Fuel Excise Tax Credit is an attempt to reduce diesel fuel prices in Mexico, currently double US prices. About 40 percent of the present fuel price is a government-imposed excise tax; recent legislation seeks to allow "certain Mexican transportation providers" to recover said tax through a credit — $34 mm in 2Q2016 to cover back to Jan. The legislation extending the beyond this year has yet to be enacted, though the Mex government is expected to implement market-based pricing by 2018. (Sounds like the ever-hanging 45G tax credit in the US).

Looking ahead, the four out of five KCS commodity groups — all but Industrial/Consumer — that account for 86 percent of KCS volume are seen as generating improved or at least stable results the second half of the year. At the end of the call CEO/president Pat Ottensmeyer remarked on the fiscal and operational heath of the property. Cash from operations increased five percent to184 percent of net income. After capex, dividends, and share repos, the railroad returns $29.2 mm in free cash flow. The net margin is a respectable 20 percent, and operating income covers interest expense more than eight times. Sounds good to me.

Canadian Pacific second quarter results continue the mantra of moving more tonnage at lower total cost, building volumes by lowering customer supply chain cost. (Which works as long as transportation buyers who are scored on lowering annual transport expense are over-ruled by production managers who are scored on total Cost of Goods Sold, of which transportation is a small part.)

The railroad moved 614,000 revenue units, down eight percent year-over-year, with total revenue C$1.45 billion, down 13 percent. System RPU was down five percent due in part to double-digit drops in grain (both Canadian and US), and crude oil.

Operating expense dropped 11 percent with significant declines in all line items but depreciation, which increased. Operating income was down 15 percent and the OR increased a point to 62 even. Below the line, net income sank 16 percent to C$328 mm; C$312 mm before certain foreign exchange and tax adjustments.

In many ways, CP is a bulk resources company, with grain, fertilizers and coal making up a third of total year-to-date volumes (the entire merch group including auto represents half of all revenue units) and 55 percent of RTMs. On the call, Keith Creel said, "Grain is king. We have more acres planted, more bushels per acre, and added railroad capacity to handle it."

CP is keeping a scorecard to make sure shippers and receivers do what they say they will so CP can have the right resources in the right place. (Feeder lines can help by turning cars quickly. I would measure the time lag between interchange-on and placed for loading, between place and release, and between release and interchange-off).

CP expects record harvests, up by 70 mm tons or more. Dedicated trains are going to 134 cars from 112 cars, which can be handled with the same three locos as for the 112s, so the only added cost is fuel. Creel notes these trains are sold out already and they're looking at adding grain cars to merch trains for even more capacity. As for fuel, CP has achieved the Holy Grail of less than a gallon per 1000 GTMs (0.97), burning 15 percent less fuel on 14 percent fewer GTMs, increasing GTMs per gallon by 1.3 percent.

Big trains running on a scheduled railroad mean more bushels per train start, fewer train starts, fewer cars in the fleet, fewer locos in grain service, and higher margins. As volumes increase, resources are there to handle the increase at low incremental cost. And starting soon, CP is rolling out door-to-door trip plans by individual non-bulk carload, adding yet more supply-chain value to the railroad service product. I was, to say the least, impressed with the call.

So much for earnings. Now for the really important stuff. Union Pacific 4-8-4 No. 844 steam returns to the rails this week, making several public appearances in Colorado and Wyoming. Delivered in 1944, the 844 is the last steam engine built for Union Pacific and recently underwent a nearly three-year restoration at UP's Steam Shop in Cheyenne, Wyoming.

The locomotive 844 is scheduled to pull The Denver Post Cheyenne Frontier Days train on Saturday, July 23, between Cheyenne and Denver. In conjunction with the trip, public displays are scheduled for No. 844 in Greeley, Colorado, and Cheyenne, Wyoming:

- Thursday, July 21 – 10:45 – 11 a.m. MT, 902 7th Ave. in Greeley
- Saturday, July 23 – 8:30 – 8:45 a.m. MT, 902 7th Ave. in Greeley
- Saturday, July 23 – 12:30 – 3:30 p.m. MT, 121 W 15th St. in Cheyenne
- Saturday, July 23 – 6:30 – 6:45 p.m. MT, 902 7th Ave. in Greeley
- Sunday, July 24 – 2:30 – 2:45 p.m. MT, 902 7th Ave. in Greeley

I've done this line segment several times when the UP ran the office car train before the annual short line meeting. Great piece of railroad. Happy chasing!

Earnings reports next week: CN Monday, NS Wednesday. Berkshire (BNSF) Friday I think. GWR rounds it out Monday, August 1.