# RAILROAD WEEK IN REVIEW
## October 21, 2016

*"We are confirming our earlier guidance that we expect to see sequential revenue growth from the 2016 first half into the second half." — Pat Ottensmeyer, President, KCS*

**Three Class I railroads** reported third quarter earnings this week — UP, KCS, CP — and we have the BNSF Week 39 carload report to provide additional comps. The common thread is one of ag products up, automotive up, energy including coal, crude, and frac sand down, intermodal disappointing, and general merchandise commodities from aggregates to plastics providing offsets. In fact, both BNSF and UP merch carloads are down only a point or two, whereas even intermodal was off a multiple of that.

**KCS led off the week** on Tuesday, posting five percent sequential volume growth and six percent revenue growth for the quarter. Year-over-year revenue slippage was a mere point to $581 million, excluding the $20 million foreign exchange hit and the sudden 11 percent drop in the cost of a gallon of diesel fuel. They only took a point-plus out of ops expense, creating a nine percent dip in ops income — before the exclusions mentioned above.  The operating ratio rose 175 basis points to 66.9 as the revenue drop masked the fuel savings. The YTD operating ratio improved nearly three points to 65 even.

The revenue and volume bar chart is in percentages, and I wish it weren't. We see smallish positive deltas in Chemicals/petroleum and Ag/minerals revenue and larger negative revenue deltas in Energy and Automotive. The Chems/petrol group is 12 percent of revenues, Ag/minerals is another 12 percent. Combined, Energy and Auto comprise 13 percent of revenues, roughly half the other two. Would that the chart reflected same.

I'm glad to see COO Jeff Songer's slide on train speed and dwell. Moving cars faster costs less, adds value to the supply chain, and facilitates higher rates. However, railroading being an outdoor sport, the weather works wonders when it takes out bridges and floods your railroad. Then there were service hiccups in Mexico, adding dwell hours and taking velocity down. Q4 is getting better already.

Fuel expense came down 14 percent on three percent fewer gallons burned and the 11 percent price drop mentioned above. GTMs were off less than three percent and gallons per KGTM stay stuck at 1.35. But it's all heading in the right direction, and, with 90 percent of anticipated Q4 volume in the non-negative column, the faster, smarter railroad will be even more valuable.

**Canadians Pacific's Wednesday call** was a continuation of the Keith Creel mantra: It's all about controlling what we can control and doing it well.  The focus remains running the lowest-cost railroad one can, while still creating premium product that can command a price premium. Years ago I scolded CP for not charging what they could, and I think over the past few years the Hunter and Keith show has been most satisfying. Q3 was no different.

Each of the six key operating measures — train speed, weight, and length; car-miles per day; GTMs per available horsepower; gallons per thousand GTMs — show improvement, with the last achieving the Holy Grail of breaking below one. And though RTMs were off six percent, revenue per RTM slipped only three percent. More money per RTM is what you want but you have to earn it. See Keith's six metrics above.

Freight revenues slipped nine percent to C$1.5 billion with the biggest bites in Canadian grain —- ten percent of vols, down 15 percent in revs and ten percent in carloads — and metals/minerals — eight percent of vols, down 18 percent in revs and 14 percent in vols. Happily, US grain loads partially offset the late Canadian harvest, with carloads up 11 percent. Expect more of the same in Q4.

The expense lines are uniformly red — smaller than a year ago. Absent a credit for the D&H sale a year ago, ops expense dropped 12 percent against the nine percent revenue decline, which says good things about the railroad but gets hidden in GAAP numbers. Still, the 57.5 operating ratio is among the lowest of the low, and is 220 basis points better than a year ago.

**UP rounded out the week** with $4.8 billion in freight sales, down seven percent (five percent if you back out fuel surcharges) on 2.2 million revenue units, down six percent. Ag was the clear revenue leader, up seven percent on 11 percent more carloads, contributing 19 percent of revenues on 21 percent of revenue ton-miles (RTMs). On the call, Chief Marketing Officer Eric Butler said "robust US grain supply and lower commodity prices" helped grain exports, wheat exports gained on favorable global market conditions, and ethanol ticked up.

Industrial products — wood/paper, construction materials, minerals, metals, etc. — were off 11 percent. UP saw particular weakness in frac sand (drilling cutbacks), construction products (mainly weather-related in the Southern Region), and metals (strong dollars vs. cheap imports). The chemicals group at UP includes crude oil, where volumes were cut in half year-over-year.

That sounds like a lot, but the UP petroleum commodity group (crude oil, STTC 29 petro-chemicals) makes up only 15 percent of total chemicals volume. The STB waybill sample data says UP runs a constant 40,000 STCC 29 units (plus or minus) per quarter, so one can take the deltas to be crude oil. UP's Week 39 petrol products dropped to 49,000 from 56,000 units, so the drop was mainly crude. Shortline nat gas and asphalt shingle vols are safe.

Coal loads dropped another 14 percent on stubbornly high stock piles of PRB coal in spite of the warm weather. Intermodal box-counts came down nearly nine percent, mostly international. Weaker global trade, softer domestic sales, high retail inventories, and the Hanjin situation helped. Looking ahead, grain and ethanol will keep ag ahead of the curve. In chems, NGLs and industrial chemicals will support gains for the group. Metals are mixed and lumber depends on housing starts. Coal will muddle along to the downside and intermodal expects no surprises.

UP took operating expense down four percent, resulting in an 11 percent operating income decline to just slightly shy of $2 billion, when put against the seven percent revenue drop. The OR added 182 basis points to a still-respectable 62.1 vs 60.3 a year ago. Capex came down a fifth to $2.9 billion, 18 percent of revenue, mainly thanks to a slower rate of loco deliveries.

CFO Rob Knight's slide 21 is a bit disconcerting. The pure Q3 numbers show a 1.5 percent slippage in system RPU and 3.4 percent year-to-date. The bar chart shows a clear down-trend, from four percent in last year's Q2 to the point just announced, losing two full points in the past year. Knights says the trend reflects "a competitive marketplace and a soft economic environment." Lower rates will affect both ISS and allowance-based short lines, so it behooves one to look for commodity OD pairs that can support decent multiples and lightning-speed car turns.

**BNSF sponsored its annual short line workshop** in downtown Fort Worth this week. I've been going to these events regularly for more than 20 years and every one surprises and amazes. I'll give you the full summary next week, after I've rounded up the usual suspects for their feedback and editorial comment.

**Jim McClellan,** a dear friend of more than 20 years, departed this life October 14 for that great roundhouse in the sky. An architect of the eastern railroad scene as seen today, Jim was part of the core USRA group that created Amtrak, wrote the Final System Plan that ultimately led to the formation of Conrail, and then, as Senior VP for Planning at NS, helped take Conrail apart.

Jim hired a bunch of us shortline guys to make sure the Conrail short lines didn't get short-changed in the merger, and, as a result of his foresight, not one Conrail short line that gained a connection with NS filed for conditions, and that work became the genesis of EP 575 and the ASLRRA/Class I Railway Industry Working Group that lives on to this day.

Even after his retirement, he stayed actively involved with the railroad industry on the speaker circuit, staying in regular touch with friends and former colleagues, and continuing to ask, "What's next?" He will be sorely missed.