RAILROAD WEEK IN REVIEW

January 20, 2017

"From the very beginning of this remarkable transformation at CP, what some have called the greatest corporate turnaround in history, Hunter and his team have been focused on implementing the operating plan, building a strong bench and preparing for the future." — CP Chairman Andrew Reardon on Harrison's decision to retire Jan 31

Two common threads emerge among the three Class Is (CP, CSX, UP) reporting this past week. First, revenues and car-counts for the Q are off less than they are for the year, suggesting the worst of the car-count slowdown may be over. CSX did particularly well: Q4 revenue up 9.2% vs down vs. 6.3% for the full year.

Second, operating expense is held to a smaller percentage increase than revenue, making the operating income change a positive multiple of the revenue gain. For example, fourth quarter UP ops income gained 2.5% against revenue down 0.8% and operating expense down 2.6%. The operating ratio benefits as well, down 119 basis points for UP.

In the final analysis, though, I really think that to understand how railroads really work, one must think long term. Assets are expensive and long-lived, employees hire on for a sustainable life style, and customers have been and will be in business a long time. So, although Q4 results may be somewhat improved year-over-year, what's the 5-year trend and what's the likelihood of it continuing? Or reversing?

The rule holds especially true for short lines, where margins are thin and where the Class I economy of scale is lacking. The question then becomes, where are my connecting roads doing best and where are they likely to invest for the future? And how do I direct my investment to capitalize on their investment?

On the one hand, STCC 28 chems, STCC 29 petrochemicals, and fertilizers are doing better than other STCCs. Paper for packaging has a future, but only in select lanes in Plate F 60s turning fast; Plate C 50s are being scrapped as fast as they're made empty. Think Heat and Eat: non-coal energy related or can be turned into food-- the STCC 01s and 20s, mainly. On the other hand, coal is the best example of what not to do. The double-whammy of enviro regs and cheap nat gas has caused many coal-fired generating stations to close permanently. Whole trains are in storage. Coal-centric branch lines are mothballed or spun off.

Thus the clever short lines are investing in storage capacity, in equipment that can turn twice a month, and in owned power of one or two models with high availability. The five-year traffic trends are best in bulk, fungible, mid-value commodities that move best in one type of car that can be cleaned and turned promptly. That's where the Class Is are headed to replace lost coal revs; short lines must go precisely there to if they are to survive.

CSX opens the 2016 Q4 Earnings Call series with $3.0 billion total revenue, up 9.1% on 1.7 million revenue units, up 4.6%. Merchandise carload (all but coal and intermodal) revenue increased 6.2% to $1.9 billion; merch RPU eked out a 2.0% gain to $2,571. CSX did an admirable job holding its expense to a mere 2.2% gain, powering operating income up 27% to a $billion even. The OR shed 4.6 points to 66.9. Net income slipped 1.7% to $458 million, though absent a $115 million hit for debt repurchase, the delta would have been slightly positive.

Whereas car-counts for every merch commodity group ex-auto posted year-over-declines for the full year, only metals — mill closures and non-recurring drilling pipe — remained off for the quarter (but only by 3.1%), and the forest products group (both wood and paper) was unchanged as lumber/panel gains offset losses in the 26 sector.

This is a far cry from the full-year merch carload story. Carloads are down in 14 of 16 merch commodity lines excluding Other and Auto. The only positives are aggregates and waste/scrap — hardly revenue leaders. Every major line is down; chems including ferts (but not STCC 29 or crude) are down; paper takes a huge hit — lumber less so — in forest products; none of the metals are showing any life. Even intermodal dropped 3 points.

Continuing the full-year view, if you reduce the merchandise carload sector to those commodity lines where most short lines do the most business, you'll find these groups are down less — 4% — than the CSX total — down 6%. This suggests that CSX carloads that don't touch short lines are down more than those that do, and that short line gains are masking organic CSX losses.

Union Pacific's fourth quarter revenues slipped 0.8% to $5.2 billion as revenue units were off 2.6%. Only ag products among the four merch carload commodity groups was up (7.4%, export grain a major contributor); industrial products dropped 5.4% and the crude oil drop off put chems down 4.8% whereas the Week 52 AAR carload report has straight chems up 5.0%.

Total operating expense came down 2.6% on lower payroll and car hire, leveraging a 2.6% jump in operating income and taking the OR to 62.0, a 1.2 point improvement. Below the line, net income was up 2.4%, though, after the 3.6% reduction in diluted shares, per-share earnings gained 6.3% to $1.39.

Chief Operating Officer Cameron Scott showed (slide 15, if you're singing along) has a flat re-crew rate of 2.4% — excellent in anybody's book — and on the call said it's a record low 2.2% for the year. System velocity slipped half a mile per hour, implying the need for 125 more loco units to handle the job at hand (from the archives: a one MPH system velocity improvement saves 250 units. Updates anybody?) Terminal dwell is down a point, and short lines can help.

My sense is UP now measures shortline interchange/on to interchange/off in days and may in some cases measure days between customer placement (actual or constructive) and release back to the railroad. Once again, on Thursday's call, CFO Rob Knight reiterated the UP goal of re-investable rates, which means the longer a car stands still the higher the car replacement portion of the rate.

Canadian Pacific closed out the year with Q4 revenue off three points to C$1.6 billion on unchanged revenue units. Operating income gained 5.9% to C$717 million, thanks to significant savings in payroll, rents, and purchased services; the OR shed nearly four points to 56.2, a record low. Net income increased 20.4% to C$384 million.

Every one of the six key CP operating measurements shows improvements for both the quarter and full year: network speed, terminal dwell, train accident frequency, average train length, fuel efficiency, and personal injuries. Less time chasing stuff done wrong means more time chasing new business, and — with two-third of its carload volume in bulk commodities from grain to ferts to chems — the quarter's payoff is in double-digit volume gains in most. There was no commodity-specific outlook on the call, other than a "strong bulk outlook."

Hunter Harrison will retire Jan 31, passing the CEO baton to Keith Creel, and will take vacation leave between now and then. The formal separation agreement calls for a "limited waiver" of Hunter's non-compete obligations, in exchange for which Harrison will forfeit some C$118 million in CP benefits and other fees. The previously agreed post-retirement consulting contract is also void. HH will sell all his CP shares by May 31.

Meanwhile, the street is abuzz w rumors that HH is teaming up with former Bill Ackman partner Paul Hilel's Mantle Ridge hedge fund to make a run at CSX. Unlike the CP attempt to buy NS, this is simply a proposal to change leadership, much like the Children's Fund action in 2008. I can see such an attempt accelerating the present CSX downsizing plans and encouraging NS to do more of the same.

GWR closes out 2016 with Dec carloads up 3.8% — 2.6 points of that comes from the P&W acquisition. The same six commodity groups still make up the top 80% of vols — coal and ag seem to be swapping the top spot. Chems ex-petrol remain constant; metals seem surprisingly strong and forest products lag.

P&W adds these vols: aggregates, 778; automotive, 456; STCC 28 chems, 418; metals, 194. GWR also reported 652 "carloads" intermodal on P&W, but I need to get a better understanding as to what's being counted. In 2015, P&W was doing more than 1,000 boxes a month and that number was diminishing. Back when GWR was reporting NA intermodal, they counted platforms, not boxes. At a national average of 1.7 boxes per platform, 652 platforms could mean 1,108 boxes. Let me come back to this later.

System-wide same-railroad highlights:

• Coal & Coke up 23.9%, primarily on utility coal to Midwest and Central regions. I suspect this of being PRB off BNSF or UP;

• Metals up 16.6%, primarily in the Northeast Region, probably drilling-related;

• Minerals & stone down 10.3%, primarily in construction aggregates in the Coastal, Central, Midwest and Northeast regions.

For the full year, GWR did 1.57 mm units, off 4.7% from the 1.65 mm units in 2015. That's still better than the down 8.2% the AAR reported last week. The message to the Class Is ought to be clear: the short lines do better because they know their customers better because they go see their customers. I'm hopeful we'll begin to see some glimmers of Class I merch carload growth offsetting the coal losses in 2017. Or else we'll just see more shortline gains covering up Class I losses. The GWR earnings call is Feb 8.

Commenting on last week's Silk Road remarks, reader Larry Gross says, "Suez routing for North American bound cargo only generally makes sense from Asia origins west of and including Singapore. Anything else tends to move east and either hit the US West Coast or the East Coast via the Panama Canal."

Moreover, "I am skeptical that the land-bridge option across Asia will handle anything more than a tiny fraction of the freight, given the many railroads involved plus two changes of gauge. Even if the Suez gets blocked you can still get there going around Africa, and these are the very biggest ships 18,000 TEU+ so good slot economics assuming they are full. I would be very surprised if you see significant volumes of US bound cargo using the land-bridge option anytime in the near/medium term."

Perhaps and probably. My point in bringing this up is to show that China has options to break the sea-borne lock on exports, and, given the money they're throwing at rail infrastructure and equipment world-wide, they have the resources to meet the challenges.