RAILROAD WEEK IN REVIEW

January 27, 2017

"We'll talk in bits and pieces about the 2017 outlook, but obviously, the political and economic uncertainty is probably first and foremost on most of our minds." — Pat Ottensmeyer, President and CEO, KCS

Kansas City Southern reports Q4 flat revenues, flat carloads, ops income down 3.7%, net income down 7.0%, and takes 137 basis points out of the OR in the bargain. Among all the rails reporting quarterly earnings, KCS presents the cleanest slides leaving the least to the imagination, and giving the best direction of all where volumes (not earnings per share) are likely to be going forward and why. Take a look at the slide set under investors at *kcsouthern.com* and see if you agree.

Freight revenues for the Q came in unchanged at $576 million on 555,200 revenue units, also unchanged. Chief Commercial Officer Brian Hancock explains: "Revenue in Q4 was impacted negatively by foreign exchange; if you eliminate the impact of foreign exchange, our fourth quarter revenue would have been up 3%. Volume was also flat [yet yielded] 6% growth in our industrial consumer carloads, a 10% carload increase in our ag and minerals business, and a 19% increase in automotive." Chems and petroleum ex-crude, paper, and lumber fared less well.

Operating expense increased 2.2%, which, when added to flat revenues, produced the ops income slippage mentioned above. Even though system train speed improved 4% against a year ago, dwell worsened as volumes to/from Mexico increased and terminals got clogged. As result, comp & benefits and car hire increased 11% and 17%, respectively. Below the line is noisy as usual; net income to common shareholders was $129.6 million, down 7.0%.

Fuel consumption warrants a word. GTMs were up a point as was fuel burn, yet RTMs were up three points, meaning more RTMs per GTM, and less time and energy spent dragging non-paying tonnage around. Fuel burn remains at 1.35 gallons per thousand GTM. I'm also pleased see full-year operating cash flow up half a point against full-year net income down one point. As a result, free cash flow after divs and share repos turned positive — not by much, but positive.

Peering into 2017, Hancock sees favorable trends for two-thirds of the book and a neutral outlook for the rest — no negatives. Strongest are cross-border intermodal, chemicals/petrol products, and automotive — parts in, finished vehicles out. He's less sanguine about ag products, minerals, steel, white goods (appliances, to us mortals), and forest products — not declines, necessarily, just not the snappy outlook seen elsewhere. All in all, a positive taste is left.

Canadian National Q4 saw RTMs up 4.2%, best in class, while revenue units gained 3.3%, even though freight revs gained only 1.2% as RPU was off on mix. Total revenue increase 1.6%

to C$3.2 billion and operating expense gained less and a point, leveraging a 3.0% ops income gain and dropping the OR to 56.6, down 60 basis points and an industry low. Below the line, the net gained 8.2% to C$1.0 billion, helped by a C$76 million property sale in Montreal.

Loco efficiency continues to improve. GTMs gained 3.8%, yet fuel burn was up less than half as much, breaking a thousand GTMs per gallon for the second year in a row, and again attaining the Holy Grail of less than one gallon per thousand ton-miles: 0.94 from 0.96 a year ago.

Chief Commercial Office JJ Ruest says export beans and corn helped US grain results, US housing starts pushed lumber and panel moves up 6%, potash produced 20% incremental revenue, while sulphur from oil and gas declined 30%. Frac sand revs gained 7%, as the resurgence in drilling activities have sequentially improved sand carloads in Q4.

JJ's merchandise market outlook calls for upsides in US housing, finished vehicle sales (implies steady raw material moves as well), frac sand (crude by rail iffy), base metals, and finished steel.

Norfolk Southern stepped to the plate Wednesday, rounding quarterly Class I earnings calls. Total revenue slipped 1.1% to $2.5 billion on 1.8 million revenue units, up 2.0%. Operating income rose to $761 million, up a whopping 18.5%, as ops expense was dropped 7.8%. The OR shed more than five points to 69.4. Net income increased 15.2% to $416 million.

Commodity carloads did best in ag/consumer/government,metals/construction, straight STCC 28 chems, and intermodal. Chief Commercial Officer Alan Shaw says, "Merchandise volume declined 3%, though Mets/Const benefited from increased steel shipments; Agriculture volume increased 1% on soybean export and corn volumes. Paper/Clay Forest volumes declined as a result of increased truck competition." Merch carload RPU was up 1.4% including fuel.

He says the outlook is for improving economic conditions that will produce intermodal volume gains, a moderated rate of decline in coal, and more of the same lumpy performance in the commodity groups key to short lines. Shaw wraps by saying, "We are steadfast in our commitment to meet evolving customer expectations that support long-term growth and shareholder value." I'm hopeful that means cutting transit times, increasing service reliability and predicability, and pricing to the market, not the computer's cost model.

As an aside, drilling down into the commodity groups within each income statement group is very useful. Start with the YTD column of weekly carload report on the website and build a spreadsheet that has columns across for the major groups and the AAR commodities down: chems in Chems, lumber in Paper/Clay/Forest, grain in Ag, etc. Go to the Mapping key and see how some commodities are split between groups — 34% of chems is in ag, e.g. Ignore that; stick to the groups where the most of the goods go — Other in ag, e.g.

When you're done, you'll see that, for 2016, seven out of 18 commodity lines are positive: two are auto and petroleum, which are slim pickings[1] for short lines, so the five that are important to short lines are up: STCC 28 chems, food/kindred, lumber/wood, and the STCC 26 paper group. Not up by much, perhaps, but at least not down. Now you can pitch your own railroad's commodity strengths accordingly.

Stifel's John Larkin, the only rail analyst I know who's actually been involved in running a Class I, writes from the University of Denver Transportation Institute's Executive Capstone Seminar, "The railroads need to change their game plans." There is finally a realization that they "cannot lower costs ad infinitum as a long term pathway to sustainable shareholder value creation, and are starting to focus more heavily on how to grow their core businesses."

The reason is that true value creation comes from "serving customers so as to meet their supply chain requirements, increasing market share, and finding innovative ways to offer new lower cost and more competitive service offerings." More to the point,

> The regional and short line railroad industry continues to do what many of the class I rails struggle to do. That is to provide tailored, customer responsive service in a cost-effective manner. Several panelists suggested that the regional and short line construct is no longer primarily a labor cost arbitrage play. Rather, it is a customer service play. Perhaps the class Is could learn a lesson or two from their smaller brethren?

His remarks about short lines doing it better are right on target. The Reading & Northern, a 320-mile regional railroad in central Pennsylvania, reports 2016 was a record-breaking year, handling some 20,000 revenue units, up 16% year-over-year, with more employees, more track, more locomotives, more freight cars, more facilities and more customers than at any point in its history. Key to this growth is continual and targeted infrastructure investment. For example:

— Acquisition of the Humboldt Industrial Park in Hazleton, PA, adding ten miles of new track mileages and more than three mile of brand new track construction;
— Installing more than 15,000 replacement ties, installing more than 20,000 linear feet of rail, relieving choke points with newly installed CTC, and building a dozen new switches;
— Acquiring six more R&N 4-axle locomotives (a 20% increase to the locomotive fleet) and 162 additional freight cars, thus increasing the fleet to 1179 railcars;
— Adding a dozen new customers, mostly with the Humboldt acquisition, and increasing head-count by 10% to more than 200.

Two things stand out when you visit this property: the impeccably maintained double-track ex-Reading main line and the capacity to provide customer service nearly on-demand with no ancillary fees. R&N Owner/CEO Andy Muller puts it this way: "I expect our railroad to grow. I

[1] STCC 29 is in Petrol Prods — LPG, asphalt, etc. They do well on short lines. You can get the NS break between crude oil and petrochemicals from the STB QCS tables.

expect our superior service will help our customers grow and as they grow we will benefit. I expect our reputation to encourage more businesses to locate along our lines. We will always take care of our customers and our employees. That is the cornerstone of our success."

And that's what Larkin's talking about.