RAILROAD WEEK IN REVIEW

April 21, 2017

"If you look at the CSX service offering as it is today, we can make some significant improvement in our core merchandise category." Hunter Harrison, CEO, CSX

CSX kicked off the Q12 earnings season with revenues up 9.6% to $2.9 billion on 1.6 million revenue units, up 2.6%. Merchandise carload revenue increased 6.1% to $1.8 billion, units increased 3.9% to 699,000, and RPU was up 2.1% to $2,631 per car. Coal revs jumped 30.8% on 2.5% more units and a 27.6% RPU gain. Intermodal revs were up 7.2% on 1.5% more boxes and the RPU increased 5.6% to $631 per box. (Put in carload terms at 1.7 boxes per platform, that's only $1,072 — 38% of what CSX gets for a merchandise carload.)

The revenue unit mix changed slightly to 64.1% merchandise, off 2.1%; intermodal 15.1%, essentially unchanged; coal 18.2%, up three points. Merchandise carloads contributed 64% of RTMs for 66% of carload revenue; coal 23%, of RTMs for 19% of carload revs; intermodal 13% of RTMs against 16% of revs and above the system average revenue per RTM.

Operating expense increased 12.7% to $2.2 billion, yielding just 1.1% more operating income. However, CSX provides a non-GAAP adjusted ops income of $885 million, up 25.7%, by excluding a $173 million "restructuring charge[1]" and carrying the adjusted operating income below the line to an adjusted net and adjusted eps.

The rationale is these items "are not considered indicative of future financial trends." I disagree and prefer not to exclude the charge because there are always non-recurring things and they all have an effect on the bottom line. I am using the GAAP numbers here, and the GAAP operating ratio is 75.2, a 207 basis point improvement.

Net income was $362 million, up 1.7%; eps before the buy-backs (which I exclude because they cloud what's really happening out on the railroad) came in at 38 cents, a penny better than last year. Even though the net gained less than two points, cash from operations was up 38.3% to a $billion and change, nearly triple the net. As a result, free cash flow after capex, dividends and share repos is a positive $173 million vs. negative $93 million a year ago.

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1 From the Quarterly Financial Review: In March 2017, the Company reduced its management workforce by 765 employees through an involuntary separation program with enhanced benefits. The majority of separation benefits will be paid from general corporate funds while certain benefits will be paid through CSX's qualified pension plans. Cash expenditures, most of which will take place in second quarter 2017, will total approximately $90 million primarily related to one-time severance costs. Additionally, the terms of unvested equity awards for the outgoing CEO and President were modified prior to their retirements on March 6, 2017 to permit prorated vesting through May 31, 2018.

Drilling down to specific merch carload commodity car-counts, minerals (mainly aggregates and salt; frac sand is in chems) were the big grower, up 20.7%, though only 4.4% of total vols. The metals & equipment group, another 4.4% of vols, were up 12.9% on domestic steel and construction. Ag products and fertilizers, together 12.4% of vols, were flat and up 1.3% respectively, affected by export grain, ethanol, phosphate, and urea distribution patterns. Forest products were off a point as trucks captured more lumber/panel and paper continued its internet-driven slide.

This being Hunter Harrison's debut call as CEO, I was pleased to hear him say he's zeroing in on yards, having closed four already with more to come. (A small sample of shortline contacts suggests that Precision Railroading is still a Work in Progress where yards and their interchanges are concerned.) He also talked about increasing merch train speeds, which will help transit times (as will shortline pre-blocking — for a fee, of course — for newly flattened yards).

Other takeaways: Running essentially the same railroad seven days a week, the benefits of which we first saw on the CN when they flattened Montreal's Taschereau Yard; halving or even quartering the number of operating divisions; property divestment, which must include a number of light-density branch lines — a great opportunity for extant operators to pick up contiguous or nearby line segments.

The commodity outlook is upbeat for most, though "auto production is flattening out" (no surprises there), crude oil shipments continue to lag, and short-haul domestic coal continues its losing ways. As a result, domestic grains, fertilizers, lumber and building products, and aggregates will continue to be steady growers. And, if we can just get car cycle times down and reliability up, the numbers will be even better. Precision Railroading can help.

Canadian Pacific first quarter revenue increased one percent to $C1.6 billion on a 1.8% gain in revenue units and an 0.8% dip in RPU. Operating expense declined by 60 basis points, helping operating income to a 2.8% gain — $C671,000. The OR dropped another 82 basis points to 58.1[2]. Below the line, net income is off 20.2% thanks to a $C181 million expense hit for "the impact of FX translation on U.S. dollar-denominated debt." As above, I'm not excluding it in favor of a non-GAAP number because it's the cost of doing business.

Grain vols, more than a third of revs, were up up 7.0%, on the best ag products Q1 CP has seen in five years, though the US grain franchise may ease off a bit. Exports were behind the 14.8% jump in potash loads and ferts vols slipped 12.5% because if high inventory stockpiles. Energy/chems carloads came down 5.6% chiefly on crude being down 40% over the past year.

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[2] From the press release: The operating ratio in the first quarter of 2017 includes a $51-million recovery associated with the early departure of the previous CEO. The adjusted operating ratio, which excludes this gain, increased by 240 basis points in the first quarter of 2017 to 61.3.

Frac sand is at record levels (and getting stronger) and steel was a gainer. On the call, Chief Commercial Officer John Brooks said lumber "performed very well," so it must be paper that pushed the forest products year-over-change to minus 5.9%. Domestic intermodal is particularly strong.

During the Q&A, CEO Keith Creel (his debut in this role) said they expect single-digit RTM growth — an especially positive note because "we haven't seen revenue growth since Q3 of 2015." Train weights and lengths are up so one is to expect stronger incremental margins. I'll take it.

Kansas City Southern posted record first quarter revenues of $610 million, an increase of 8.3% over first quarter 2016 on a 5.5% increase in revenue units and a 3.6% RPU increase. Operating income was $211 million, a first quarter record and 12.1% higher than last year, generating a record first quarter operating ratio of 65.4, a 1.2 point improvement over first quarter 2016. Diluted earnings per share came in at $1.38, a first quarter record, and an increase of 38.5% over first quarter 2016.

Frac sand was the big volume gainer, up 60.0%, with its carload gain more than offsetting crude oil's 22.9% decline. (Frac sand and crude oil together account for just 2.0% of total revenue units, so these big percentage changes don't carry a lot of weight.) The chems and petroleum group, KCS's largest, saw vols rise 3.7%.

Grain, the second largest volume producer — and roughly tied with automotive — gained just 1.4%, while automotive carload jumped 38.2% on new production capability in Mexico, with auto parts going in from the US and finished vehicles coming out. The railroad remains a strong player in the merchandise carload business, which represents nearly three-quarters of the franchise revenue. The balance splits roughly 52% intermodal, 48% coal.

The automotive story out of Mexico is well-known, but now comes the petrochemical industry to challenge auto and intermodal as a significant cross-border player. Polyethylene production in Mexico is expected to grow to half again its present size over the next six or so years with much of the output destined to markets in South America, Asia, Europe, and Africa. The Gulf ports of Altimira and Veracruz will look east and north; Lazaro Cardenas on the Pacific side will look west. And KCS will continue to be the dominant player serving these ports.

Then there's the cross-border business. Year-to-date KCS has handled some 1,500 carloads of refined products, split roughly 50-50 between propane and gasoline/diesel. And it came out during the Q&A on the call that the expanding petrochemical business along the US Gulf Coast is looking for places for its output to go, and Mexico is one of them, which means KCS will have loads running both ways.

The 2017 outlook is positive for three-quarters of the commodity volume. Auto benefits from record production levels in Mexico and frac sand supports increased drilling activity. Plastics and

the early results of energy reform in Mexico will help the chems top line, and intermodal looks good for cross-border auto parts and the BNSF service from the PNW and elsewhere, though excess highway capacity can take the edge off. The other 25% of commodity volume is "neutral," or at least not negative — grain and processed food look stable, as do ores, metals, and minerals. Paper brings up the markers.

Overall, I'm impressed with the results and the energy KCS leadership exhibited on the call. The six percent increase in revenue units turned into 15% more revenue ton-miles thanks in no small part to the four percent RPU gain the franchise was able to create. The company continues its move to owned vs leased locomotives, producing 12.1% more GTMs on 9.95 more fuel, increasing RTMs per gallon by 2.7%. Its all bodes well.

Genesee & Wyoming March and quarterly carloads are up 3.5% and 5.2%, respectively. January's surge, up 11.4% mainly on coal and ag, was a big help as Feb was only up 80 basis points year-over-year. For the quarter, P&W "new carloads" added 7,908 rev units, less than 2% of the total. March by itself was up 3.5% — 1.4% if you exclude P&W — so you can see acquisitions help total vols. Note, too, the wide swings month to month above, with Feb down 8.7% from Jan and Mar up 9.1% from Feb.

The commodity mix changes little. Ag was flat to coal's up 41% on re-stocking in the midwest; coal, ag, aggregates including frac sand, and chemicals are the top four volume producers. With the exception of coal, no commodity group lost or gained more than a fraction of a point as a percent of the total carload volume. If you break out coal and overhead, neither of which are meaningful to the vast majority of short lines, loads are up 5.3%, which, in a so-so economy, suggests the SL community is holding its own

The P&W mix is instructive: Nearly half the 2,842 revenue unit total is equally split between intermodal boxes and aggregates. Automotive, chems, and metals dominate the other half. Last I looked, IM boxes earned less than $100 each, and aggregates are not known for high multiples. We also know comp & benefits eat up half the P&W revenue stream. It's a good thing GWR strengths elsewhere can subsidize this property.

The coal portion of last week's first quarter carload mix needs some elaboration. There's more to the demise of eastern coal than nat gas and enviro regs. It has to do with economics and the sheer number of eastern coal-burning power plants. Climatewire (a publication of the environmental news service E&E News) reports that a "tragic flaw" in the 1970s Clean Air Act "largely exempted existing power plants from air regulations" and so they've kept running.

Moreover, the exemption has let older plants stay in business that would not, "were it not for grandfathering." In short, while environmental regulations do play a role, low natural gas prices are coal's "most formidable enemy." Running a close second is the sheer cost of converting old-technology coal plants to cleaner facilities or building new ones. S&P's Global News service, SNL, estimates the cost of a new 600 MW coal plant at more than $2 billion.

As a result, says Climatewire, “more than100 coal plant proposals have been cancelled or rejected by regulators in the last few years, in many cases in recognition of the financial risks posed by likely future carbon regulations.” To cite one example, American Electric Power stopped generation at 10 coal-fired plants across five states in May, all of which burned Central Appalachian or Northern Appalachian coal.

Worse, AEP calculated that the cost to upgrade coal-fired units at four power plants in Virginia and West Virginia that were retired in May would have been so high it did not even compile cost estimates for the work. Thus one can see why nat gas first beat out coal as the top source of electricity back in April, 2015 — 31% nat gas, 30% coal.

Then there’s the matter of geography and age. As of 2011, the Energy Information Administration listed 589 coal-fired power plants in the U.S., down from 633 coal-fired power plants in 2002. An other list shows a sample of 615 coal-fired plants by output in kilowatt hours. Nearly two-thirds are in the 20 to 750 KW-hour range, suggesting a lot of smallish plants serving limited areas. For example, until recently Pennsylvania alone had 40 coal-burners; then comes Ohio at 37 and Virginia at 21. New York and Florida had 17 each.

In the west, where population growth and the demand for electricity came later, we have, for example, Texas with 22 coal-fired plants, California with eight, and New Mexico with a mere four. And I’m betting it’s safe to say these are PRB-fed, away from population centers, and newer. And so it is that railroad coal tonnage is in serious decline in the east, as much as a result of economics as regulation, and holding its own in the west.

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