RAILROAD WEEK IN REVIEW

May 12, 2017

"First quarter Industrial Products volumes were up slightly. Increases in minerals and other commodities that support domestic drilling activity were mostly offset by lower petroleum products volume due to pipeline displacement of U.S. crude traffic and lower plastics volume."
— BNSF Fixed-income Investors presentation, May 9

BNSF first quarter revenue increased 8.9% to $5.0 billion as revenue units were up 6.4% to 2. 5 million loads. Average revenue per unit including fuel surcharge was up 2.7% to $2,005. Of most interest to non-Class I carriers, merchandise carload (ag+industrial) revenue increased 4.8% to $2.3 billion on a mere 1.0% volume gain.

BNSF reports agricultural and industrial products separately, but for our purposes they are better combined. The AAR carload report for week 13 is a reasonable proxy for the quarter and shows 9 of 20 carload commodity groups with modest gains. Ag was essentially flat, though processed food in boxcars, which BNSF puts in with Industrial Products, jumped 11.6% to more than 30,000 units.

Petroleum products — STCC 29 plus crude, with most of the change in crude — dropped 9.6% to 88,017 carloads, and straight chemicals, including ethanol and fertilizers, lost a point to 114,673 units. Sand/gravel, where frac sand lives, jumped 28.5% to more than 80k units, not exactly a surprise but nice to see nonetheless and handily covering the decline in crude oil volumes.

The change in BNSF carload mix since 2006 is instructive (BNSF became part of Berkshire Hathaway in 2010). Ag and industrial products were 9% and 16% of total revenue units in 2016, growing to 11% and 16% respectively. Consumer products was 52% of the total then; it's 53% now; however, within the group, combined domestic intermodal and auto have climbed to 30% of total while international has dropped to 23% from 30%. Coal, not surprisingly, is now 18%, down from 23%, with ag and industrial picking up 4 of the 5 points lost.

Q1 Operating expense gained 11%. Fuel whacked the railroad with a 53% gain on higher prices and the 6% gain in volume. Comp & benefits increased 6% primarily due to higher health and welfare costs, wage inflation, and the volume gain, partially offset by productivity improvements. Depreciation expense increased due to a larger depreciable asset base. Operating income was up 4.9% to $1.6 billion; the OR ticked up 120 basis points to 68.5.

The $3.4 billion 2017 capital program is 65% core network plus PTC, with the balance split between fleet additions and capacity expansions. On the call, Carl Ice spoke specifically of capacity expansions on the former GN lines plus having most of the ex-ASTF transcon double-

tracked. This goes of course to a safer and more productive railroad, with the Personal Injury ratio in the sub-1.0 range; longer pool crew agreements and more merch business to unit trains; and further rollout of the AIM (Assess, Improve, Maximize) initiative with carload customers. (BTW, have you had YOUR short line AIMed yet?)

For the balance of the year, BNSF is banking on increasing US yields, though global competition for grains plus the strong US dollar offer some resistance. Industrial products will be particularly strong in petrochemicals, though crude oil continues to lag due to low oil prices and more pipeline availability.

It also appears BNSF wants to move more industrial products in unit trains — what I suspect is frac sand and aggregates, based on reports from the field. Road-to-Rails conversions will work in BNSF's favor and coal faces continued challenges from the impact of weather, renewables, natural gas, and the fluid regulatory environment.

Genesee & Wyoming April carloads for North America were essentially unchanged, except for the P&W acquisition (see table). The highlighted rows represent 80% of total vols and I'm encouraged to see the six top commodities continue to provide a refreshing diversity to the carload mix. P&W had begun to build a nice STCC 28 business with good RPU over the past few years, and I hope that continues.

GWR NA units							
Apr				2017	2016	YOY	
	2017	2016	% Chg	% Total	% Total	Chg	Cume
Ag Products	17,385	15,440	12.6%	13.5%	12.4%	1.2%	13.5%
Mins & Stone	16,852	16,976	-0.7%	13.1%	13.6%	-0.5%	26.7%
Coal & coke	16,362	14,794	10.6%	12.7%	11.8%	0.9%	39.4%
Chemicals	14,922	15,709	-5.0%	11.6%	12.6%	-1.0%	51.0%
Pulp & Paper	12,808	13,577	-5.7%	10.0%	10.9%	-0.9%	61.0%
Lumber, FP	11,816	11,209	5.4%	9.2%	9.0%	0.2%	70.2%
Metals	11,371	11,413	-0.4%	8.9%	9.1%	-0.3%	79.1%
Petroleum	7,543	7,720	-2.3%	5.9%	6.2%	-0.3%	84.9%
Other	5,848	5,471	6.9%	4.6%	4.4%	0.2%	89.5%
Food or Kindred	4,854	4,901	-1.0%	3.8%	3.9%	-0.1%	93.3%
Waste	4,138	3,038	36.2%	3.2%	2.4%	0.8%	96.5%
Auto	3,123	2,516	24.1%	2.4%	2.0%	0.4%	98.9%
Metallic Ores	1,370	2,093	-34.5%	1.1%	1.7%	-0.6%	100.0%
Carloads	128,392	124,857	2.8%	100.0%	100.0%	0.0%	
Intermodal	695	12	5691.7%	0.5%	0.0%	0.5%	
Total units	129,087	124,869	3.4%	100.5%	100.0%	0.5%	
Less P&W	3,193						
Same-store	125,894	124,869	0.8%				

Excluding traffic from P&W,

• Agricultural products increased 11.9% on increased grain shipments (I'm assuming outbound) in the Mountain West, Central and Pacific Regions.
• Coal & coke increased 10.6% on utility coal in the Midwest Region, partially offset by decreased shipments in the Central Region.
• Chemicals decreased 8.0% on fertilizers and ethanol in G&W's Midwest Region. But, apropos of the P&W chems biz, chems with P&W dipped 5%, not 8%.

Year to date, carloads are up 4.7% but down 6.4% sequentially against March. *Pas mal*, all considered.

All the Big Six Class I results are in, and CN takes first place in five out of the seven performance measures I score. They take year-over-year firsts in revenue units percentage gain, percent change in RTMs, percentage gain in merchandise carload revenues and carloads, and percentage change in operating income. BNSF hauled the most revenue units, and CP had the lowest operating ratio.

Combined industry results for the Big Six plus KCS are breathtaking: $21 billion in revenues on 10.5 million revenue units; RPU for all commodities including intermodal boxes up 2.4% to nearly $2,000; revenue mix is 67% merchandise carload, 19% intermodal, and 14% coal; operating income $6.4 billion; operating ratio a respectable 65.5 average. All in all, a good start to the year and I can only see it getting better.

Listening to the Berkshire Hathaway Q&A live stream on *yahoo.com* was instructive; not that there was much new stuff, but to hear old things in new contexts was edifying. Take ebitda, a favorite tool for valuing acquisition candidates. Warren Buffett still says not counting depreciation is "ridiculous" because it's the way you wear stuff out and save up for its replacement. That's an expense. So are taxes. If you have income, you pay taxes and that's a cost of doing business. The bigger the tax hit, the less you can reinvest in the enterprise.

Charlie Munger takes it even further, saying Buffett "understates the horrors of the subject and the disgusting nature of the people who brought that term into the valuation of business. Now they use it in the business schools. That is horror squared."

Music to mine ears. Never liked non-GAAP metrics because they can be anything you want them to be. Give me the good old Financial Accounting Standards Board (FASB) any day. Mind the GAAP, in other words.

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