RAILROAD WEEK IN REVIEW

July 28, 2017

"The global growth and market environment remained positive throughout the quarter, with positive economic surprises coming from Europe, making up for less positive data in the United States and Japan." — Windhaven Quarterly Review, July, 2017

Canadian National's second quarter results are impressive. Total revenue is C$3.3 billion, up 17%, on 1.4 million revenue units, up 14%. RPU increased 3% to C$2,185. Ops expense increased more than revenue, up 18%; operating income was C$1.5 billion, up 16%, and, because the ops expense gain was greater than the revenue gain, the OR gained 60 bips to 55.1, still best in class.

Net income was C$1.0 billion, up 20%. Free cash flow before dividends and share repurchases jumped 41%; 46% on a per-share basis. (To me it looks like FCF per share is getting greater traction because it's not affected by below-the-line items or share buybacks.) These and other numbers give CN percentage gains in more categories than other railroads and by a significant margin.

Of seven major commodity groups from ag products to coal to intermodal, five posted year-over-year volume gains; the merch carload group was up a few basis points more than the system's up 14% gain, above. As for specifics, the presentation slides were detail-light, and the best way to track changes by commodity is to follow the transcript of the presentation remarks and the Q&A that follows. Doing so will give you a sense of how to enhance your own merch carload relationship with CN. Excerpts:

Total revenue units are up twice the industry average, with all-time records in 3 groups: international containers, automotive finished vehicle, and frac sand, which dominates the metals/minerals group and is likely to keep doing so. There's a new frac sand mine in Wisconsin and existing customers are increasing carloads.

Crude oil remains a spot business — one can expect volume growth in the second half and CN has the resources to support, especially if grain slacks off. In chemicals, natural gas liquids, plastic pellets, and condensates are down. Potash is up 20%: Uralkali and Canpotex have both settled contracts with the Chinese.

Canadian grain carloads are up 23%. The CN grain service area is adding to country elevator capacity either as new-builds or expansions of existing elevators. And CN is building a major grain transfer facility in Prince Rupert for the summer season. Saint John is getting into the potash export business with 205-car trains to keep unit cost down, allowing CN to compete on a lower cent-per-RTM and make money despite of that.

Says CEO Luc Jobin, "We see very good, economically sound, long-haul growth, much of it in customer-supplied cars, We receive lower RPUs because we don't own the cars; however, the grain book is a mix of single-car and unit train moves and that affects RPU."

Asked whether rumors of CSX hiring away from CN had any merit, COO Mike Cory confirms they've lost "a few front-line supervisors," but not enough to impact the normal course of business given CN's bench strength in operations management. In sum, a strong call of the sort we've come to expect from CN for lo these many quarters.

Norfolk Southern posted $2.6 billion second quarter total revenue, up 7%, on 6% more revenue units. The bad news is that the merchandise commodities (more on this below) were off nearly a point, with all but metals/construction in the negative column. Operating expense was held to a 4% increase, leveraging a respectable 15% ops income gain to $888 million; the OR shed 2.3 points to 66.3, a full point less than Hunter was able to carve from CSX.

Net income was $497 million, up 23%; eps came in at $1.71 after 2% reduction in share-count. Cash from operations was $1.6 billion, up 10%; free cash flow after capex but before dividends and share repurchases was $2.37/share, an impressive 41% improvement.

Getting back to the merchandise carload categories, as noted above, only the met/con group carloads increased, and that mainly on frac sand. Chemicals got knocked down on crude oil, and here's why. The AAR Week 26 carload report shows chems including fertilizer lost 4%, and petroleum prods (STCC 29) plus crude shed 12%, and represent less than 30% of the reported chemical carloads. (In a month or so when the second quarter QCS comes out, we can drill down still further.) The freight revenue split is still dominated by merchandise/auto at 61%; intermodal is 23%, and coal, 16%.

The earnings call formal remarks and Q&A were instructive. CEO Jim Squires presented a road map for short lines to add value to the partnership(slides 5,6) — reduce Norfolk G&A by becoming easier to do business with; be prepared to operate nearby light-density lines; support yard consolidation by blocking for the distant node (COO Mike Wheeler talked about block-swapping during the Q&A); develop measures to quantify the value you bring to the partnership; find ways to enhance your customers' experience (and show NS exactly where they are perceived by the customer as falling short, using specific names, dates, events, and costs).

Chief Commercial Officer Alan Shaw's says paper (slide 11) is down mainly on truck competition (other roads saying the same). I suspect much of the decline is in paper that wants to move rail but pricing isn't market-competitive or the car spends too many days en route. The best antidote is to tell NS what the shipper needs in terms of transit times, car supply, first-mile/last-mile service, and price. Then document any NS pushback and have the NS short line sales rep participate in follow-up customer visits.

Re freight diversion from CSX, Shaw said during the Q&A, "We're going to capitalize on opportunities that fit our network. And if customers see that we provide a predictable, efficient service product that meets their needs, whether that's in competition with truck or another rail carrier, then we're going to go after that business as long as it fits our network and we can drive value to our shareholders."

On hump yard conversions, COO Mike Wheeler says, "Where we idle a hump we do a lot more block swapping and more blocking further into the network. That gives us good productivity, because the cars are getting through there faster and providing even better service, because of less time on the network getting to the customers. Where it's a big yard in a great location, we can do a large amount of block swapping." This plays exactly to short line pre-blocking, which both CSX and CP have said they specifically encourage.

Asked about market share, Squire took the lead. "Any market share shift is in the early stages and is pretty minimal. It's there, but it's minimal. So far, for this year, about 80% of our revenue is committed. Most of what is uncommitted so far for the remainder of this year is in export. And in any given year, we're going to renegotiate about 50% to 60% of our revenues." And here 80% is committed, suggesting a strong vote for the NS service offering.

My take: NS is going about its business improving the network at its own pace and all EHH has done at CSX has only accelerated that pace. As NS market extenders, short lines are, in an artillery simile, front-line observers out there to call in the firepower. A key target is replacing the export and utility coal uptick, which is opportunistic and not sticky. Ergo merch carloads have to fill in the void. Feeder lines now touch about 20% of NS vols. Do I hear 25?

Frac sand was mentioned in nearly every earnings call as being a very good thing for the merchandise carload sector. If I were running a short line where drillers make up more than, say, 20% of my book, I'd keep a wary eye out.

I'm beginning to hear rumblings of shorting the oil market. Take Russell Clark of Horseman Capital Management, who has gained a following as a successful short-seller in a long world:

> When I look around the world for an industry with a huge divergence between capacity and margins, I come up with the US shale industry. It's an industry that shouldn't exist. It only exists because capital is so cheap. And they're sort of hoping crude will go back to $80. But the more they drill, the less likely that's going to happen. [*As you increase supply faster than demand, prices will fall. — rhb*]
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> In the Permian, it's all about focusing on very small areas, which suggests to me that this falling cost of production has almost nothing to do with technological improvements at all. They're finding very good areas and drilling them intensively. Trouble is, the shale cracks formed by two wells too near each other actually start to interfere with each other.

> The pressure to get the oil out of Pipe A could actually drop because water and sand poured into it starts to leak over to Pipe B, drilled by your competitor. So if you have a crack in Well A a that cracks over into Well B, then the pressure goes for that one. Consequently, there seems to be a natural limit to how much shale drilling you can do."

Raoul Pal of Global Macro Investors observes that the amount of crude oil in storage in the U.S. is at an all-time high, and it's the result of the fracking revolution. He also senses that "despite the appearance of OPEC 'production cuts' in the press, the cartel is still producing to its own near all-time highs. Its members are desperate for cash… And they'll cheat on quotas all day long. Meanwhile, global oil demand growth is very weak."

Says Raoul, "Once oil breaks $44, it will sink to $20. With oil trading around $45 a barrel now, there's still time to get in." In other words, the fast-money crowd is driving up prices as even as supply begins to exceed demand. Then everybody wakes up. They start dumping shares because they see the bloom is off the oil supply/demand rose. And shorts make a killing.

All of which makes the hand-wringing about what Harrison is doing at CSX rather beside the point. As I've written before, transportation is a derived demand and with declining demand for moving sand, fewer cars of it will move. In which case, sand freight revenue goes to zero and the fixed-cost side of operating expenses remains. In short order, an operating ratio of 70 becomes the new Holy Grail.

Short lines face an even greater threat. For the 300 or so short lines not owned by Genesee, Watco, Corman, or other holding companies, operating ratios are typically in the 90s or worse. Were it not for 46Gs and other subsidies, the operating ratios could quickly go north of 100. The only salvation is to focus on the heat (LPG, petrochemicals, etc; not coal, ethanol, crude oil or frac sand) and eat (grains, grain mill products, package food and beverages, and even fertilizer) side of bulk commodities to get anywhere close to break-even.

In sum, it's one thing to know what happened in the past, whereas it's another thing altogether to be able to predict with some certainty what's coming down the pike in the future. Do I upgrade that bridge, lease additional six-axle power, hire more T&E guys? This is all non-fungible stuff and you have to know you'll get your money's worth. And that's one reason why I bring up this frac sand thing.

Have a safe week.