RAILROAD WEEK IN REVIEW

October 27, 2017

“We’re building long-term sustainable value for our customers. Carloads on CP’s dedicated train program are up 15%, and trains in key lanes are cycling about 16% faster year-over-year.” — CP Chief Marketing Officer John Brooks.

Being on the road for an entire week gets one behind in one’s reporting. CSX and CP both announced third quarter results on Tuesday the 17th and KCS followed on Friday. CN reported after the close this Tuesday, followed by NS and UP. I’d like to provide some take-aways from the BNSF shortline meeting as well. So let me do BNSF, CSX, CP and KCS here and do CP, NS, UP and GWR (reports Oct 31) next week.

The BNSF shortline meeting was concise and to the point. The session kicked off Wednesday afternoon with a series of commodity and services workshops, with President Carl Ice and his senior managers providing the broader views Thursday morning. A clear shortline focus was the common thread throughout the breakout sessions, something I found quite refreshing after having sat through years of “this is what we do” with no real shortline message.

In ag products, export grain tonnage now exceeds domestic tonnage with short lines touching nearly a third of all shuttle train sets. The goal is getting 300+ miles/day and two to three trips a month. That’s why turn times on short lines are so important. In construction and forest products, panel and OPSB demand is up 4%; paper is flat and pulpboard is holding its own. At 100,000 board-feet per center-beam (that’s $40,000 inventory per car), cycle time is vital. BNSF prefers to load its own cars as opposed to TTX as a mater of quality control.

In chemicals and petrols, the Texas Gulf dominates in NGL production. Storage-in-transit yards are getting bigger, and export plastics are being transloaded to containers at the ports. As for equipment, BNSF has some 130,000 cars in its manifest network and is looking to reduce that number by increasing car miles/day, and reducing the number of boxcar types from the present 22 to something more reasonable. BNSF wants to cut average customer place-release time to two days from five, and would like to see shoreline dwells reduced (many short lines are still more than ten days, about where we were ten years ago).

Thursday morning was given over to awards and senior management team remarks, most of which further amplified the whys and wherefores of the commodity break-out sessions. Railroad president Carl Ice continues to beat the drum for added capacity. This is only right given the emphasis we got from all the carload groups on the need to turn cars quickly and efficiently. After all, more cars out on the line and not on industry tracks need more space, especially if you’re going to turn the cars quickly.

On the commercial side, Group Vice President for Industrial Products Dave Garin has retired after more than 20 years in that slot. Succeeding him is John Miller, moving over from Ag Group VP. Miller's successor in ag successor is Sam Sexhus, formerly VP Transportation. Having an ag guy now running IP and an ops guy running ag continues the kind of follow through typical of BNSF.

We also heard from Katie Farmer, VP for Service Design and Transportation Support. She is responsible for not only railroad operations scheduling but also for service design across the commodity groups plus shortline development. She was previously VP for Consumer Products (intermodal and auto), which certainly qualifies her for scheduling operations.

All of the Thursday speakers carried through on the same themes: efficiency and equipment velocity. From a shortline viewpoint, better car turns equal lower rates as car replacement cost is driven by car miles per day. The longer the turn time, the higher the rate, and the less competitive advantage shortline customers have vis-à-vis their competitors. Here's a challenge: average customer dwell place-release is five days. Can you reduce it to two?

Farmrail System won the coveted BNSF Shortline of the Year award for 2017. Specifically, the short line's "entrepreneurial spirit and diligence in attracting new customers," was a key consideration, says Merril Lieb, AVP for shortline development. The Farmrail System primarily moves agricultural products and frac sand, increasing total 2016 carloads by 25% year-over-year. Minnesota Northern won a "special recognition" award for expanding its 61% grain unit train participation 2015-2016.

As usual, the BNSF shortline workshop program continues to be top-notch. A prodigious amount of thought and energy goes into every year's session, and the attendees' response shows a great appreciation for it. Mark your calendars for the 2018 outing in Oct. See you there.

CSX broke the ice for the Q3 reporting season, as it always does. Gains were smallish, as one might expect given the changes taking place. Freight revenues ($2.6 billion) and revenue units (1.6 million) were up less than one percent each. Merchandise carloads were off 5% — every commodity group but metals (the only positive number) posted mid single-digit negative deltas. Coal and intermodal were both up more than 5% as ton-miles now split 63% merchandise carload, 23% coal, and 14% intermodal.

Operating expense was unchanged, yet operating income gained 4% to $876 million. Below the line, net income gained a point and earnings per-share gained five points, though on a same-share count before repos only 88 bp. The operating ratio was 68.1 vs. 69.0 a year ago. Year-to-date free cash flow/share after capex before divs, repos came in at $1.52, up 45%.

The outlook is favorable for coal, neutral for ag/food, metals/equipment, with all others negative. CSX cites "improving truck market fundamentals," which I think means truckloads are up on

improved consumer confidence. However, some truck capacity constraints from ELD and driver shortages could diminish their edge. If so, intermodal could be back in the running even with the present unreliable transit times: system on-time arrivals are running 48% vs 54% a year ago.

But wait, there's more. In Wednesday's press release, we're advised that Jim Foote, formerly of CN, is the new COO and Chief Marketing Officer (his gig at CN before leaving the fold some years ago). As for Cindy Sanborn and Fredrik Eliasson, "both plan to resign effective November 15 to pursue other interests, but will remain engaged in supporting the transition until early 2018." And Ellen Fitzsimmons, EVP Law and Public Affairs, among other things, retires mid-November, though "will remain engaged in supporting the transition until early 2018."

Canadian Pacific reported C$1.6 billion in freight revenues in Q3, up 3%, on 664,000 revenue units, up 3%. Merchandise carloads gained 7% with strength in potash, chemicals/energy-related, and metals/construction. Coal was up two points and intermodal lost a like amount. System RPU dipped 30 basis points on mix and foreign exchange. Operating expense gained less than one point, pushing operating income up 5% to C$690,000.

Fuel expense increased 9% mostly on price; fuel burn was up 4% on 3% more GTMs, though still posting an enviable 0.94 gallons per thousand GTMs. The operating ratio shed a point to 56.7 and net income jumped 47% to C$510,000 largely on a foreign exchange gain. Free cash flow per share jumped a whopping 37% before dividends and share buy-backs.

On the call, CEO Keith Creel cited significant volume gains in frac sand and export met coal, adding that "We're building long-term sustainable value for our customers." To which Chief Marketing Officer John Brooks adds, "Our dedicated trains are cycling about 16% faster year-over-year in our key lanes. So despite a smaller crop and smaller expectations in our territory, our customers have signed up for a dedicated train program that's up 15% year-over-year." Once again, service quality in the eyes of the customer wins share. He adds,

> Our new partnership with Genesee & Wyoming and Bluegrass Farms will make CP the first railroad to offer a direct service route from Vancouver to southern Ohio. The new terminal is strategically located on the I-71 corridor between Columbus, Cincinnati and Dayton, and offers a new import and export link to key Asian markets.

It pleases me to see route expansions like this. I have always said short lines are great market expanders that can get Class Is into markets they could never reach otherwise. Now to recover the CP access to eastern Pennsylvania lost with the D&H sale to NS…

Kansas City Southern brought up the markers for the week. Freight revenues were up 9% to $634,000 as revenue units rose 3% to 576,400 units. Happily, RPU was up a healthy 6% to $1,099, posting gains in every commodity line but stone-clay-glass (includes cement, brick, wallboard, e.g.) and helped by double-digits gains in metals and frac sand.

KCS held operating expense to just a 5% increase, leveraging a respectable 17% operating income gain to $234,000. The operating ratio improved 256 basis points to a healthy 64.4. Fuel efficiency played a critical role. Total expense increased 19% on the 16% per-gallon price hike, plus the 3% gain in gallons consumed. However, GTMs were up 6% and GTMs per gallon improved 4%, though KCS is still three-tenths of a gallon shy of the holy grail of a gallon per thousand GTMs. (That's a minor quibble, to be sure.)

Below the line, net income to common share holders increased 7% to $129,000. Year-to-date net income is up 18% to $412,000, though free cash flow after capex but before dividends grew a paltry 3% to $287,000.

Out on the railroad, average AAR train speed hit 27.4 mph and terminal dwell improved to 21.6 hours, down 10% from the previous quarter — this in spite of the hurricane hitting Houston and environs, a critical KCS corridor. Looking ahead, the outlook is favorable for chemicals plus intermodal, petroleum — some 57% of total units. Ag, industrial, consumer, and automotive products — another 25% of total units — are less favorable, and energy-related commodities from frac sand to crude oil to utility coal may slip some.

The market for refined products in Mexico is a bright spot, with major terminals planned for San Jose Iturbide, San Luis Potosi, and Salinas Victoria. In these areas the goal is to build storage tanks and 90-car unit train capacity to serve dense population and manufacturing areas. As one would expect, NAFTA came in for some questions and comments during the Q&A. Railroad President and CEO Pat Ottensmeyer sums it up thusly: "We are still hopeful and confident that NAFTA will be modernized. And even if things don't turn out the way we would hope, North American trade will continue and we will continue to play a role in those supply chains."

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