RAILROAD WEEK IN REVIEW

January 19, 2018

"As people earn more money, they eat fewer grains and more protein. Raising cows, chickens, or pigs uses grain less efficiently than just producing grain. For example, it takes 3.5x more grain to produce one calorie of chicken compared to one calorie of grain. For eggs, it's 2x, hogs are 5x, and beef is 6x. — Alan Boyce, former fed economist and bond trader turned farming investor, RealVision, January 2018

CSX reported 4Q 2017 net earnings of $4.1 billion, or $4.62 per share, versus $458 million, or $0.49 per share in the same period last year. These GAAP numbers include a $3.6 billion net tax reform benefit resulting from the Tax Cuts and Jobs Act of 2017 and a $10 million net restructuring charge. Excluding these two items, fourth quarter 2017 adjusted net earnings were $573 million, or $0.64 per share.

Because every railroad is taking these tax credits below the line, I have endeavored to use the non-GAAP results excluding the tax benefit. To get year-over-year comps I've reverse-engineered the reported numbers to get an estimate of what the tax liability would have been to arrive at the adjusted net earnings — the 64 cents reported above. This note covers CP and KCS as well as CSX and they all use the non-GAAP earnings number.

Then there's the fact that CSX has changed its reporting periods to coincide with the calendar year and away from the previous system of using 52/53 week year ending on the last Friday of December. Says CSX in a note to the financials, "To maintain this calendar, every fifth or sixth year an extra week was added to the fourth quarter and year, making the reporting period 14 weeks and 53 weeks, respectively. In 2016, the fourth quarter and fiscal year included this extra week."

The present report thus represents 92 days, whereas the Dec 2016 report covered 98 days, a difference of a week. For that reason, last December's revenue numbers have been cut back a week, so that, for example, the previously reported 4Q2016 freight revenue of $2.86 billion is reduced to $2.78 billion. This move is to be applauded because it puts all reporting railroads on an equal calendar basis.

With the house-keeping now out of the way, let's look at the reported results — less the tax adjustment, above. Q4 net income was $573 billion, even with last year before the restructuring charge. Revenue dipped six percent to $2.9 billion as revenue units declined eight percent to 1.6 million, even though system RPU increased two percent to $1,788.

Merchandise carloads including automotive — using previously-reported 4Q2016 vol comps — dropped 11 percent on negative deltas in every commodity line. Chemicals got hurt in energy markets and by a non-recurring 2016 benefit from a large soil remediation project. Auto declined with North American vehicle production. Ag & food lost a bit on reduced exports; minerals slid thanks to more attractive trucks rates; ferts slipped on a plant closure; forest products came down on pulp and paper; the metals group lost out to fewer steel and larger equipment moves. Coal was off five percent as short-term export growth couldn't offset utility losses; intermodal also shed five percent because international trade growth wasn't enough to cover domestic losses.

Operating income before equity earnings in affiliates was essentially unchanged at $1.0 billion and the operating ratio improved two points to 64.8. Both comp & benefits and car hire came down double-digits and there were middling changes in the other expense lines. Capex dropped 15 percent to $2.0 billion, from 22 percent of revenue to 18 percent. Capex for 2018 will be in the $1.6 million range. The focus on running a scheduled railroad continues.

Canadian Pacific reported total Q4 revenue of C$1.7 billion, up five percent, on 679,000 revenue units, up five percent. Operating expense increased four percent, generating a five percent ops income gain and an OR of 56.0, down 16 basis points. CP continues to lead the pack in fuel burn, less than a gallon per thousand GTMs. Below the line, CP earned C$469 million, up 22%, pre-tax benefit.

Potash carloads increased seven percent on domestic demand, while grain slipped four percent with U.S. grain revenues down against tough comps. Forest products, energy/chemicals, and the metals/minerals/consumer commodity groups all posted solid volume gains. Frac sand demand continues at roughly 21,000 carloads a quarter and crude oil jumped by some 18,000 carloads. Coal was up eight percent (no details given) and intermodal units grew by six percent. System RPU was flat on mix and price.

CP expects mid-single-digit revenue growth this year. In bulk, global potash demand continues, the coming Canadian grain crop looks like the season just past, and U.S. grain carloads may be off once more. On the merchandise side, look for more refined petroleum products, increased crude-by rail demand, and an increase in aggregates and metals to support infrastructure spending. Autos will not excite, whereas domestic intermodal will "continue to outpace the Canadian economy" and the Ohio Valley extension will increase the intermodal footprint.

Kansas City Southern Q4 revenue increased ten percent to $660 million on 585,600 revenue units, up six percent. Merch carloads including auto, frac sand and crude oil also increased six percent with particular strength in chemicals, petroleum, automotive, and energy. Operating expense increased nine percent, propelling ops income to $237,800 — up 13%; the OR dropped 77 basis points to 64.0.

Chief Operating Officer Jeff Songer summarizes operating results thus: "Velocity of 27.3 miles per hour was down approximately 2% versus prior year, dwell of 23.6 hours improved four percent versus the same period last year. Lingering Harvey impacts, Mexico flooding issues, and holiday seasonal impacts drove the increases in dwell versus Q3.

“For the full year, resource productivity initiatives delivered total volume growth of five percent, against a three percent headcount increase. GTM was up nine percent with a five percent increase in active locomotives. On-time departures and arrivals improved eight percent and nine percent respectively.” Gallons per KGTM remain at the 1.3 level for the quarter and year.

Chief Commercial Office Brian Hancock notes that the chemical and petroleum business unit revenue increased 24 percent on “solid performance and our longer length of haul southbound refined products and LPG business as well as our heavy fuel oil.” Paper was up due to increased brown paper demand; crude oil and frac sand both saw significant volume gains, the former “driven by the increased production in Canada with decreased pipeline capacity paired with [more favorable] price spreads.”

Grain carloads came down six percent on export trends to Mexico, and food products slipped 13 percent on a shift in sourcing trends; volume declines were offset by favorable pricing and a longer length of haul. Auto vols grew five percent, thanks mainly to new model launches. Intermodal unit counts increased seven percent aided by the new cross-border services and a slight drop in RPU due to mix and shorter length of haul.

The outlook for 2018 is encouraging with 90 percent of the franchise in the “favorable” column. Petroleum products, plastics, ag products, metals, cement, and crude oil are all looking up; paper is stuck in neutral. On the down side, utility coal takes more hits and Texas brown sand could displace some white sand at the frac sites.

On NAFTA, CEO Pat Ottensmeyer noted that “KCS is confident North American trade will continue due to its economic importance and massive existing supply chain infrastructure. Round Six of talks begins in Montreal Jan 23, when the most contentious U.S. proposals (rules of origin, government procurement rules, ISDS foreign investment protection, the five-year sunset) are expected to be addressed.” He also said, “Approximately 60% of current U.S.–Mexico trade does not depend on NAFTA, and about 30% of KCS’ revenue comes from cross-border franchise moves.” I think his confidence is warranted.

Next week we’ll hear from NS, CN, and UP to round out the listed Class I reporting season. GWR reports Feb 8 and I expect we’ll have to wait until the end of Feb for Berkshire.