RAILROAD WEEK IN REVIEW
July 20, 2018

"We're interested in growing both price and volume. And we are intently focused on making sure that, in the process, we receive the value that our capacity is worth." — Beth Whited, Executive Vice President and Chief Marketing Officer, Union Pacific

CSX reported second quarter results late Tuesday, posting revenue of $3.1 billion, up six percent, on 1.6 million revenue units, up two percent. The operating ratio plummeted nearly nine points to a record low 58.6 — the first time any US railroad broke 60. System RPU increased four percent to $1,185. Merch carload revenue including automotive increased a whopping six percent, with particular help from metals and forest products, both up more than ten percent, offsetting the five percent decline in ferts. All other commodities had revenue increases.

Merchandise carloads slipped a point, with fertilizer carloads the main culprit, off 18 percent, thanks mainly to the closure of a customer facility in late 2017. Elsewhere, chemicals were flat, with stronger municipal waste, and energy shipments offset by reduced fly ash shipments. Agricultural and food slipped two points as export grain gains partly offset an ethanol downturn.

Minerals carloads gained four percent due to stronger aggregate shipments for construction and paving projects. Paper and lumber boosted forest products six percent; metals rose three percent on increased mill capacity, greater demand for construction and pipe, and greater success in truck-to-rail conversions. Auto picked up eight points on stronger demand for trucks and SUVs, which drove higher North American vehicle production for this segment.

Operating expense dropped on every line but fuel and equipment/rents. The former jumped 36 percent as the cost of fuel went up exactly that much. Fuel burn was up 1.5 percent on 2.6 percent more GTMs; gallons per KTM are now down to 1.03, a worthy accomplishment. Car hire/rents increased 7 percent, RTMs gained a respectable six percent. Below the line, net earnings were $877 million, or $1.01 per share, versus $510 million, or $0.55 per share in the same period last year.

There can be no doubt the railroad is running a lot better. Average train velocity in miles per hour, train length, terminal dwell in hours, and car-miles per day have all improved sequentially as well as year-over-year. The personal injury rate improved 27 basis points to 0.91, a laudable goal in itself, yet the FRA Train Accident rate deteriorated 60 basis points to an unfortunate 3.72. On-time arrivals and departures both slipped a bit to 61 and 85 percent, respectively.

On the call, CEO Jim Foote highlighted the trip plan initiative and its ability to yield better customer service and asset efficiency. Tracking every car and container keeps better tabs on operating glitches, the better to fix them without delay, and take steps to present any recurrence.

That's very good news. One of my complaints about Class I performance is that what happens to the cars once off short lines rail's is up to the Class I, where TPC can make or break customer expectations. Trip plans don't cover short lines — yet. But that extension is inevitable. And it ought fix interchange irregularities once and for all.

Canadian Pacific was next up. Second quarter total revenue increased seven percent to C$1.8 billion on 679,000 revenue units, up two percent. Operating income gained three percent C$627,000, up three percent, even as ops expense jumped nine percent (the 44 percent gain in the price of fuel was no help, making up a fifth of the total dollar increase). The OR gained 136 basis points to a still-respectable 62.4.

Merchandise carload revenue (including auto, and representing more than two-thirds of CP's freight revenue) gained eight percent, with only sulfur/ferts taking a loss, and that was due to an unplanned supplier plant outages and a somewhat delayed planting season. Potash exports, accelerated grain shipments, chemicals and crude oil (60 trains a month run-rate; 20,000 loads in Q2) were up nicely; the minerals, metals, and forest products groups all contributed.

Unfortunately, neither the formal remarks or the presentation slides shed much light on operating performance. Where, for example, was something like that marvelous Operating Performance slide Keith used two years ago owing rates of improvement for such key metrics as car miles per day, average train speed, and GTMs per available horsepower? He has said repeatedly —and correctly —that there's more to life than the operating ratio. This should be Exhibit A.

Net income dipped nine percent to C$436 million, due almost entirely to a C$113 million swing in foreign exchange gains and losses on long-term debt. Free cash flow (cash from operations less capex and dividends) was up by nearly half to C$291 million, though share repos brought than number to a negative. Says CEO Keith Creel,

> We have very strong obligations to existing customers and we need to make sure that, as we layer on growth, we can pick partners who can grow with us.…I'm talking about turning assets and velocity. We can help our customers control their costs and earn additional business, but we have to earn that opportunity. We've worked hard to create a very reputable, dependable service model, and we're focused on taking on business at a strong margin or strong return in a disciplined manner.

Union Pacific reported on Thursday. Second quarter total revenue increased eight percent to $5.7 billion, with four percent more revenue units (2.2 million) and a four percent gain in average revenue per unit. Net income was $1.5 billion, or $1.98 per share — an all time quarterly record for UP even without the benefit from corporate tax reform. The quarterly operating ratio came in at 63.0, up 1.1 points, due in part to the 36 percent jump in the price of diesel fuel.

Volumes are trending up. UP is now running about 180,000 loads a month vs. 160,000 two years ago. Ag products came down on reduced wheat exports, partially offset with gains in feed grains and ethanol exports. Frac sand increased on drilling activity (though local sand may bite into this in Texas), and the STCC 29s benefitted from strong demand. Industrials saw gains in construction rock, drilling pipe, and general industrial activity. Core price increased three percent and for the full year is projected to exceed rail inflation. The second half outlook calls for continued strength in ethanol exports, STCC 20 foods, and plastics.

UP has realigned its commodity groups to just four: agricultural, energy, industrial, and premium — ag and energy revenue units shed a point each; industrial and premium were each up six percent. That said, drilling down into the commodity breaks lets you see a better picture of the merch carload sector performance.

Revenue Carloads (thous.) reclassified to fit other RR comps			
285	289	-1%	Agriculture + Ferts
73	59	24%	frac sand
58	48	21%	Crude STCC 29
118	119	-1%	automotive
452	427	6%	Industrial
986	**942**	5%	Total merch
256	284	-10%	Coal + coke
562	527	7%	Domestic Intermodal
421	392	7%	International IM
2,225	**2,145**	4%	Total Units
			As reported
387	391		Energy
1,101	1,038		Premium
452	427		Industrial
285	289		Ag
2225	2145		Total

Operating expense increased ten percent to $3.6 billion, taking the ops income gain to just five percent, $2.1 billion. As noted above, higher fuel prices helped push the OR up a point, and the fuel consumption rate (gallons per KGTM) also increased six percent. GTMs increased four percent while RTMs dropped three percent, exacerbating the effect of the fuel price hike.

AAR terminal dwell was up four percent and system train speed dropped four percent, both contributing to higher labor costs, fuel burn, and care hire. I seem to recall a UP data point that a one mile an hour change in system train speed is worth 250 locomotives, so the 13 percent increase in active locomotive units is understandable.

Moreover, the late May tunnel collapse in Oregon forced UP to reroute traffic through Salt Lake City, incurring additional transit time of four to five days, not helping either train speed or car utilization. Still, train size increased for intermodal, manifest, and grain trains — best ever for grain and a second quarter record in the manifest network.

Cash from operations for the first half totaled $4 billion, up about 17 percent year over year. Free cash flow (cash from operations less capex less dividends) increased 45 percent to $1.3 billion, making the fixed income side very happy, to be sure.

The week's wrap was Kansas City Southern. Total revenue increased four percent to $682 million on a one percent gain in revenue units and revenue per unit up nearly three percent to $1,141. There were revenue gains in five of six business units with energy the outlier. Cross-border volume and revenue were record-breakers. System velocity improved slightly year-over-year, but slipped sequentially; terminal dwell increased both year-over-year and sequentially.

Drilling down into the commodity groups, KCS is fortunate in having a quarter of total revenue units in the lucrative STCC 28 and 29 groups plus crude oil. Coal is but eight percent, intermodal 44 percent, and no other single commodity group accounts for more than six percent of total volume. Moreover, the KCS capex program directly supports Mexico's FDI (Foreign Direct Investment) program in the refined petroleum products, plastics, and automotive sectors.

Operating income was $246 million, up three percent, as ops expense increased five percent, and leading to a 64.0 operating ratio, a 44-basis point deterioration. Even though payroll, purchased services, and car hire all came down, having the cost of a gallon of fuel jump 15 percent hurt. A partial offset is seeing GTMs/gallon up nearly two points, as well as fuel burn per KGTM holding steady at 1.3 gallons. Net income was up ten percent, largely as a result of a lower income tax hit. Free cash flow after capex and dividends increased 42 percent to $87 million.

For the second half, KCS sees a positive outlook for 90 percent of its total revenue unit count. Only coal, crude and frac sand are in the other ten percent. The cross-border intermodal product has further room to grow, and the railroad supports an admirably low leverage ratio of 2.2 times ebitda. All in all, a respectable showing.

I'm encouraged by the week's showing. All four roads reporting posted increases for total revenues, operating income, total revenue units, and merchandise carload revenues. Three of four moved more merch carloads than a year ago (CSX slipped slightly) and free cash flow was positive in every case. GWR, NS and CN report next week. Stay tuned.