RAILROAD WEEK IN REVIEW

July 27, 2018

"CN's leadership team and I are committed to re-establishing best-in-class operational excellence on a sustainable basis, to growing the value of the Company, and to building the CN brand." — Jean-Jacques Ruest on being appointed President, Chief Executive Officer, and Board Member of Canadian National this week

Canadian National opened Earnings Week Two on Tuesday, posting revenue of C$3.6 billion, up nine percent, on 1.5 million revenue units, up six percent. Operating income increased by seven per cent to C$1.5 billion; the OR inched up 67 basis points to a still-respectable 58.2. Below the line, net income jumped 27 percent, helped by C$229 million in property sales.

The increase in revenues was mainly attributable to increased volumes of Canadian grain, coal, overseas intermodal traffic, frac sand, refined petroleum products and U.S. grain, freight rate increases, and higher fuel surcharge fees, partly offset by the negative translation impact of a stronger Canadian dollar. Merchandise carloads represented exactly half the YTD volume mix, accounted for 69 percent of freight revenues on 63 percent of RTMs, and brought in the highest revenue per RTM. Every merch commodity but auto was up, proving that the carload product is alive and well in Canada. Here's the split geographically:

	2Q18	2Q17	YTD18	YTD17
Canada	$ 2,438	$ 2,222	$ 4,597	$ 4,409
U.S.	1,193	1,107	2,228	2,126
Total revenues	3,631	3,329	6,825	6,535
Pct U.S.	33%	33%	33%	33%

Operationally, CN is getting back to its old self. The train performance exhibit shows 23 percent more car-miles per day, terminal dwell down 20 percent, seven percent more trailing GTMs per available horsepower, and three percent more GTMs per train mile. Fuel burn takes the brass ring with an industry-leading 0.92 gallons per thousand GTMs. Cash from operations dropped to 119 percent of net, down from 144 percent a year ago. Free cash flow after capex and divs was cut in half as a result, to a still-positive C$502 million.

The revenue outlook for the second quarter calls for continuing strength in demand for frac sand, US lumber, metals, Canadian grain, and export coal. Crude by rail capacity is expected to increase slightly in Q3, and is already sold out. Auto sales and US grain are flat, and there will be a downtick in potash carloads.

All in all, not a bad quarter, with CN recovering nicely from the earlier wobbles. And it's certainly a great opening for Jean-Jacques Ruest, tapped for President, Chief Executive Officer, and Board member of CN effective immediately. I've known JJ for more than 20 years and he has always been one of the top railroad marketeers out there. It was Ruest who first talked about the need for railroads to be "supply chain partners" of their customers, a concept that has by now spread throughout the entire railroad community.

Ruest, 63, has been with CN for 22 years, the last eight as Executive Vice President and Chief Marketing Officer. He joined CN in 1996 as Vice President, Petroleum and Chemicals. He was appointed Vice President, Industrial Products in 2003, Vice President, Marketing in 2004, and Senior Vice President, Marketing in June 2006. Prior to this, Ruest worked for 16 years at a major international chemical company. As a result, he brings a customer's viewpoint to railroad operations — a sorely missing trait until now. Bon chance, JJ.

Norfolk Southern stepped to the plate Wednesday. Second quarter operating revenues of $2.9 billion increased 10 percent compared with second quarter 2017, as overall volumes were up six percent reflecting growth in all three major commodity categories — intermodal, merchandise and coal. Railway operating expenses increased $107 million, or 6 percent, to $1.9 billion compared with the same period last year, largely a result of higher fuel prices, higher incentive compensation, and increased costs associated with overall lower network velocity.

Income from railway operations was $1.0 billion, an increase of 18 percent year-over-year, a quarterly record. The railway operating ratio was 64.6 percent, a second-quarter record. All merch carload commodities of interest to short lines posted gains in carloads and revenues — loads up three percent, revs up eight percent, RPU up four percent. Frac sand, NGLs, ethanol, fertilizers and even forest products contributed significantly. NS expects second half performance to continue at these levels, citing strong demand in energy-related commodities such as crude oil, frac sand, and ethanol.

COO Mike Wheeler says all-time quarterly train length allowed NS to handle six percent more revenue units with only a one percent increase in crew starts. In addition, NS perpetuates its own quarterly fuel efficiency record. All of these factors combined to help drive a record second quarter operating ratio. NS is more fluid in the south since resumption of hump operations at Chattanooga, with a hybrid model — shoving local traffic over the hump and bypassing the hump for block swaps of through traffic.

Net income was $710 million, up 43 percent; cash from operations grew 16 percent to $1.8 billion. Free cash flow after capex and divs was $18 million vs. minus $307 million a year ago. NS, like UP, is at its best when moving forward at a deliberate pace, having buckets of money to make things work. They realize that creating customers is Job One and if shareholders are happy with that, then fine. If not, let them invest elsewhere. As for shortline interchange partners, consistency rules. What goes on beyond the interchange largely determines customers' perceptions of the railroad as a supply chain partner. NS gets high marks.

Genesee & Wyoming reported its strongest quarterly carload growth for its North American properties since the 2011 first quarter. They ran 430,000 revenue units, up eight percent with coal/coke, metals, and aggregates — representing 61 percent of the carload portfolio — up double digits; system RPU was north of $600. (You night want to compare their RPU by commodity with what you're getting and see if you're in the ball park. To be sure, they get paid for a good chunk of their loads under ISS, but it's a worthwhile check, regardless.)

Same-store commodity moves also gained eight percent. Coal/coke jumped 28 percent as a utility that was shut sown for maintenance last year was opened for business and a second utility came on line for the first time. However, ag products were down two percent as market conditions, barge competition, drought, and changes in off-shore sources impacted car-counts. Finisheds Steel and ferrous scrap helped the metals markets and the petroleum exploration trade continued to buoy aggregates traffic.

Total NA revenue was $340,000, up eight percent, including $80,000 in "freight-related" and "other" non-freight revenues from NA operations. The former include ancillary fees for railcar switching, track access rights, crewing services, car-storage, and so on. "Other revenues" come from from third-party car and locomotive repairs, property rentals, railroad construction and other services not directly related to freight transportation. Operating expense rose ten percent; NA operating income was $80,000, up less than a point, for a 76.4 operating ratio, a slight decline of 160 basis points vs a year ago.

Consolidated revenues — NA, Australia, Europe — increased ten percent to $595,000 and consolidated operating income was up three percent to $103,000. Net income eked out a one point gain to $49,000. That said, the North America contribution is still the dominant business, accounting for 57 percent of total revenue, 81 percent of operating revenue, and only 52 percent of operating expense. For the full 2018 year, GWR is guiding to NA revs of $1.3 billion, and an OR in the mid-70s. Looks good to me.