RAILROAD WEEK IN REVIEW

October 19, 2018

"Trip Plan Compliance is a very important measure as it reflects not only the railroad's operating performance but most importantly, how we are performing from a reliability standpoint for our customers. — Jim Foote, CEO, CSX

CSX blasted off Tuesday with the first earnings call of the season. Freight revenues grew 12 percent to $3 billion on 1.7 million revenue units — up four percent — and system RPU was up nine percent. Gross ton-miles increased five percent and revenue-ton-miles jumped seven percent, further supporting the more-revenue-per-GTM theme.

The operating ratio shed nearly ten points to a jaw-dropping (for CSX) 58.7 as operating expense dropped two percent and operating income was up by half to $1.3 billion. Net earnings came in at $894 million, a near double. Cash from operations was up 19 percent to $3.4 billion, capex came down 15 percent (14 percent of revenue) and free cash flow before share repos was another near-double to $1.6 billion.

Merch carloads including auto were up a mere five percent. Forest Products was the top performer, up 16 percent thanks to housing and Amazon boxes. The Chemicals group gained five percent as stronger crude oil, waste and core chemicals shipments more than offset the reduced fly ash and sand shipments. Ag & Food grew six percent on grains, though ethanol declines took the edge off. Minerals were up six percent on aggregates.

The Metals and Equipment group posted gains in metals shipments thanks to the growing mill capacity and the demand for construction materials and pipe for drillers, augmented by some truck conversions. Fertilizers were the only negative, off 12 percent, coming from the previously- mentioned closure of a plant that was mainly a short-haul customer.

Carload trip plan compliance is a critical part of running a consistent, reliable scheduled railroad. CSX started measuring TPC at the beginning of the year, and, assigning 1Q2018 an index of 100 as the start-point, the third quarter earned an index of 126. The next step is measuring trip plans from waybill initiation to destination placement. I know a number of shortline operators who are eager to become part of the trip-planning process, if only for the competitive advantage accruing to their customers.

Suffice to say, CSX delivered a Q3 performance that shows what Precision Scheduled Railroading (PSR) can do with leadership and discipline. Hunter must be smiling.

Canadian Pacific stepped up to the plate Thursday, showing what PSR can do even after it's been up and running a while. Freight revenue increased 20 percent to C$1.9 billion on a 14 percent RPU gain and five percent more revenue units to 702,000. Gross ton-miles and revenue ton-miles each grew 13 percent, using just 11 percent more fuel to do so. CP continues to lead the pack in fuel efficiency: Point nine-two gallons per thousand GTM.

The operating ratio dropped another 263 basis points to 58.4 as operating income gained 27 percent to C$790 million. Cash flow from operations gained 23 percent to C$1.8 billion, handily funding a $billion in capex, up 24 percent. Free cash flow after divs but before repos gained 27 percent to C$457. Says CEO Keith Creel,

> We continue to see train weights hitting hit record levels, and fuel efficiency in gallons per KGTM is a CP record, and is the best in the business. Mike Foran [VP Market Strategy, presenter at shortline conference] and his team are creating the proper "constructive tension" as we develop the market strategies that get us the best possible use of our assets.

Merchandise carloads gained ten percent, largely on energy ex-coal, chems, and potash — the old Heat & Eat once again. On the call, Chief Marketing Officer John Brooks said same-store (commodity OD pair and car type) price held to the targeted three to four percent range. On a currency-adjusted basis, quarterly grain revs gained seven percent on what was an all-time record for tonnage to Vancouver. Lumber and panel drove forest products revs up 13 percent. Brooks:

> Strong export volumes from both Canpotex and K+S marked another record setting quarter for potash. Revenues finished up 24 percent — a third straight quarter of record potash volumes. The energy-chemical-plastics portfolio saw revenue grow 58 percent. Though crude oil was a large contributor to this growth, I would also highlight that, excluding crude, ECP was up a record 23 percent, led by LPG, fuel oil, gasoline, and asphalt.

Coming so closely on the heels of the Analysts Day and the Shortline conference, this Q3 earning call strengthens and amplifies the the theme of doing more without increasing the asset footprint. Case in point: At the BNSF shortline meeting in Forth Worth this week, a number of the folks I saw at the CP event six weeks ago told me their Calgary initiatives are already paying off, extending the reach (footprint) of CP at little marginal cost.

Kansas City Southern wrapped the week's festivities Friday with yet more encouraging words. Third quarter railroad revenues were a record for any quarter, $669 million, up six percent on a four percent increase in revenue units. Merchandise commodity loads including auto gained five percent with chemicals up 15 percent — the largest single merchandise category with double the vols of ag products and metals. Says CEO Pat Ottensmeyer, "We saw a number of our oversize growth opportunities continue to hit full stride in the quarter and feel very good about the condition of the business in a number of those areas."

Third quarter operating expense gained just under three percent in spite of double-digit gains in purchased services and fuel. The operating ratio was a reported 62.0, though, adjusting for exceptional hits such as flood recovery in the third quarter from Hurricane Harvey last year, the OR would be 63.4. Cash from operations slipped four percent to $706 million, and capex came down 11 percent, so FCF after dividends but before repos increased nine percent to $198 million.

Looking ahead, chems including NGLs, energy ex-coal, ag products, and minerals — 75 percent of the book — are looking up, whereas paper, frac sand, coal, and crude are looking less robust. Regarding NAFTA, let me quote from the WSJ Ottensmeyer interview nearly a year ago:

> I'm confident my three daughters and future grandchildren are better off because of NAFTA. And a modernized agreement could help more. I believe the ambassador and President Trump can achieve that objective for all of us, and I want to help them do so.

The BNSF shortline conference in Forth Worth this week was another rousing success. The good news is the morning senior management chats (much conversation, few PPTs) and afternoon workshops answered lots of questions and presented even more shortline opportunities. The bad news is, unfortunately, awful weather and airline delays stole the Friday I had hoped to use to write it up for this WIR.

But it's an ill wind that blows no good, so I can use next week to garner more attendee feedback. We also get Q3 results from CN, NS and UP next week, so watch this space.

RailTrends 2018 is coming to the Times Square Marriott in NYC November 29-30. Yes, that's seven weeks away, but there are still reduced rate rooms available. A couple of weeks ago I highlighted Friday's "Short Lines' Competitive Advantage" panel. Thursday we get CN President Jean-Jacques Ruest, CSX President Jim Foote, KCS Chief Innovation Officer Brian Hancock, and CP CFO Nadeem Velani representing the Class Is.

Backing them up we have Oliver Wyman Partner Rod Case, Ron Batory of the FRA, the Don Broughton-Tony Hatch Rail vs. Truck argument, Amtrak EVP Stephen Gardner and others. Co-founded by my good friend Tony Hatch and Progressive Railroading magazine, this is the 14th consecutive running of RailTrends, and I can guarantee you'll get your money's worth — I've been to most of the 13 previous iterations and have always come away encouraged and refreshed.