RAILROAD WEEK IN REVIEW

October 26, 2018

"BNSF shortline carloads were up 15 percent through August with construction, building and petroleum products accounting for more than half the gains. — Merril Lieb, AVP

Canadian National led off Week 2 of the 3Q2018 Earnings season. Freight revenues increased 15 percent to C$3.5 billion as revenue units crept up three points but RPU leapt nearly 12 percent, keeping same-store price — a backward looking measure of price in the last quarter's full book of business — at the five percent level. Core pricing from recent renewals concluded in the last 90 days averaged just under five percent; average length of haul was up a point.

Most of the Q3 revenue growth came from CN's rail-centric merchandise and bulk supply chain product. Says CN President Jean-Jacques Ruest,

> As frac sand and lumber volume declined in September, we took the opportunity to onboard more crude business, pushing oil revenue up C$80 million year-over year. Other refined products revenue was up 16 percent.
>
> Lumber and panel revenue grew by 17 percent, driven by U.S. housing starts and by export demand. Canadian grain revenue gained 14 percent, partly due to export tonnage being ahead of last year; U.S grain revenue was up 22 percent in Q3 with stronger U.S. Gulf export.

Though total units and merchandise revenue units each increased by only three percent, the pricing trends remain solid as demand exceeds supply. For Q4, CN is aiming for longer lengths of haul, generating more revenue per carload and RTM. As it was, Q3 revenues per RTM were up 10 percent on four percent more RTMs and GTMs. More money for the same work.

COO Mike Cory showed how they did it. Even as they finished 22 out of 27 capacity projects between Winnipeg and Prince Rupert — the remaining five to be completed before winter really sets in — CN continued to move historically high volume levels, with all ten of the top ten workload days in CN's history occurring in the last three weeks.

As for the operating metrics, train speed was flat overall as the increase in traffic in the Winnipeg to Edmonton corridor offset improvements gained in the southern region, notably improvements in locomotive utilization and car velocity overall. Terminal dwell was essentially flat, though Cory says they were able to keep up with customer demand throughout the quarter.

Operating expense was up 19 percent; ops income was C$1.5 billion, up eight percent, and the OR was 59.5, down 236 basis points and still an enviable number. Free cash flow after capex and divs was C$732 billion, off 49 percent largely due to the capacity work in the west.

Norfolk Southern on Wednesday brought in total freight revenue of $2.9 billion, up ten percent on five percent more revenue units and a six percent RPU gain. Operating income was up 14 percent to a $billion even. Operating expense gained nine percent; the OR dropped 110 basis points to 65.4. Fuel surcharge collections more than doubled to $184 million; back these out and operating income becomes $836 million, up just three percent. The OR sans FSC is 69.7, *up* 112 basis points.

Below the line, net income was $702 million, up 39 percent, thanks to 30 percent income tax drop. Free cash flow after capex and divs but before share repos was $931 million, up a whopping 50 percent on a 17 percent gain in cash from operations.

Chief Commercial Officer Alan Shaw began his remarks noting that Q3 was the seventh consecutive quarter of year-over-year revenue gains, with seven quarters of strengthening RPU, eight quarters of volume improvement, and five consecutive quarters of year-over-year increases in RPU less fuel. As noted above, total revenue units increased five percent, led by chems including crude oil, up 11 percent, and intermodal, up eight percent. Merchandise carloads including auto crept up three percent. Shaw concludes with a clear opening for short lines:

> Pricing to the value of our product remains a key element of our strategy, positioning NS for growth with both our existing customers and new customers. We maintain a sharp focus on productivity and capacity and consistently work to understand customer's markets, partnering for their success and enabling long-term value for NS shareholders.

COO Mike Wheeler told how NS achieved records in train length, ton-miles per crew-start, fuel burn per ton-mile, and operating ratio. Once again the "clean sheeting" process has significantly reduced car re-handlings, improved train performance, and cut dwell times. Wheeler says doing these things creates capacity and that is no doubt a true fact. Now I want to see how clean sheeting improves *car* performance between OD pairs. He specifically mentions shortline pre-blocking, and there's an invitation if I ever saw one.

CEO Jim Squires alluded to the Precision Scheduled Railroad in his remarks, saying, "We will implement PSR principles where they lead to a better result for customers and shareholders." NS was the leader in scheduled railroading with its Thoroughbred Operating Plan (TOP) 20 years ago, built on many of the principles Hunter Harrison was using on the Frisco. I think as NS returns to the TOP tenets, it will be able to do more with less. Everybody will benefit.

Union Pacific closed out the week Thursday. Three themes emerged during the prepared remarks, reinforced by additional comments during the the Q&A. First, fit. No more boutique unit trains. When the car is leased, it goes, assuming commodity OD pairs fit the network. Second, car velocity in car-miles per day for the entire trip, dock-to-dock. (To do it right, they'll have to capture the shortline portion of the move.) Third, car handlings. Pre-block, block for the distant node, run longer trains, skip class yards. Short lines can contribute to all three.

Third quarter results did not astound as the three themes are still a work in progress. Revenues increased ten percent on six percent more revenue units and a four percent increases in RPU. Operating expense gained ten percent; operating income was up nine percent, the OR was 61.7, unchanged. Net income rose 33 percent mainly on the lower tax exposure. Free cash flow after divs and capex was $2.2 billion, up 43 percent, largely thanks to the tax-boosted net income.

Ag and industrial, the two market segments of most interest to shortlines, saw volumes increase two and nine percent, respectively. In the former, gains in feed grains and biofuels were offset by a decline in export wheat. In the latter, double digit gains in construction, lumber, metals, plastics, and industrial chemicals were the major contributors. Chief Commercial Officer Kenny Rocker said the outlook calls for a general uptrend across all commodity groups, save for long-haul frac sand and export wheat.

Much of the operating discussion centered on the UP 2020 operating plan and how customers will benefit. There is every intention to roll it out system-wide as they go up the learning curve on the Mid-America Corridor, where UP already sees positive results by shifting from a car-centric ops focus from one geared to trains. Moving cars as released cuts dwell times, car classification events, and power requirements. Thus balancing moves to fit the network generates more revenue per asset employed.

As noted above, the tenets of UP 2020 are still a work in progress. In addition to getting out of the boutique unit train concept, UP needs to re-examine way-freight frequencies and how they can affect customer perception of UP as a supply-chain partner. CEO Lance Fritz mentioned specifically the need for greater reliability to create new customers and add value for existing customers. UP 2020 exists in part to do exactly that and short lines are ready to step up.

The BNSF shortline conference in Forth Worth lived up to its theme of "Delivering Success Together." The morning program was devoted to conversations as opposed to presentations (no power-points, no obvious scripts, lots of Q&A). BNSF President Carl Ice led off, followed by COO Katie Farmer. Chief Commercial Officer Steve Bobb, Group VP Ag Products Sam Sexhus, and Group VP Industrial Products John Miller talked generally about the carload franchise and the value short lines add to the transportation product. Juan Acosta, AVP for State and Government Affairs, rounded out the morning program.

After lunch we got into the specifics. Whereas earlier in the day the conversation was mostly general direction, objectives and accomplishments, the afternoon featured small-group breakout sessions — heavy on specifics and data geared to short lines. All the commodity presenters said they welcomed direct conversations with shortline representatives, provided much food for thought.

The 200+ BNSF short lines touch 11 percent of total revenue units and a third of industrial and ag products carloads. Year-to date merchandise commodities ex-auto have generated 2.3 million loads system-wide; and, of the 17 commodity groups, all but one are up (the laggard is misc ag products, two-tenths of one percent of total revenue units).

Clearly short lines are making a considerable contribution. Year-to-date some 100 short lines have identified more than 400 new business opportunities, closed on half of them, with a quarter still in progress. Short lines are active in the grain shuttle program, too, handling 18 percent of shuttle volumes across 37 origins and eight destinations.

Each of the commodity presenters — Ag Products, Metals & Minerals, Petroleum (both crude and STT 29), Chemicals & Plastics, and Building Products — walked the shortline attendees through the business potentials, possible headwinds, and short line contributions. We also learned about the cross-overs between AAR commodity groups and where BNSF manages them — e.g. ethanol and fertilizers in ag instead of chemicals — and why.

I think this format — high level framing in the morning, commodity specifics in the afternoon, makes the best use of everybody's time. BNSF deserves extra credit for skipping presentations on coal, finished vehicles and intermodal, none of which are of particular interest to the shortline group as a whole. The Fort Worth Omni was a great venue, with all the events reasonably close to one another — too often the convention hotel facilities are so spread out you can walk 3,000 steps in a day just covering the bases. Well done, BNSF. See you next year.

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