RAILROAD WEEK IN REVIEW

April 19, 2019

"As for the quarter, solid performance across many disciplines produced both record financial results and record service… running the railroad on time during difficult weather conditions and, as a result, CSX set new records in Q1 for just about every service metric." — Jim Foote, CSX President and CEO.

"Numerous factors are contributing to the overall service improvement. PSR initiatives, reduced inventories, execution at our key terminals, and improved asset utilization are all having positive impacts. Specific areas of improvement include our border terminals, Monterrey, Sanchez, and Laredo, all showing marked improvement both sequentially and year-over-year." — Jeff Songer Chief Operating Officer, KCS

"We think absolutely we can grow [traffic levels] while becoming a PSR railroad. The end game is a consistent reliable service. Our customers want that and we're delivering. We've largely completed our initial transportation plan changes associated with Unified Plan 2020 and are well ahead of schedule." — Lance Fritz, Union Pacific President and CEO

CSX as usual was first up with Q1 results. Total revenue increased 4.8 percent to $3.0 billion on 1.5 million revenue units, unchanged from a year ago. RPUs gained 4.8 percent with mid-single-digit percentage gains in the ag & food, forest products, and minerals groups. Primary metals, pulp & paper, and lumber all had mid-single digit gains in carloads; non-metallic minerals & phosphates were off 19.5 percent.

Operating expense came down 2.1 percent, driving a respectable 16.8 percent operating income gain and whopping four point drop in operating ratio to 59.5. Below the line, net income was up 20.0 percent to $834 million. Free cash flow after dividends but before share repos jumped 54.7 percent to $625 million. Capex was 11.7 percent of revenues, down from12.8 percent a year ago.

Merchandise carloads including auto did surprisingly well, up 3.1 percent, with revenues up 5.6 percent and RPUs up 2.4 percent. On the call, Foote said he was "encouraged by the strong performance of our merchandise business, with growth across every market with the exception of fertilizer." Foote said the improved merchandise carload results came as a result of improved service levels.

Out on the railroad, velocity and dwell improved sequentially and year-over-year to reach record levels for the company. The number of cars on the property came down ten percent and GTMs per available horsepower increased nine percent. Fuel expense dropped nine percent and fuel burn dropped two percent on flat GTMs; fuel burn per thousand RTMs improved two percent to 1.08 gallons, closing in on the holy grail of 1.0 gallons per KGTM.

I think the sudden shock of rapidly applying Precision Scheduled Railroading principles at CSX is beginning to settle down. CFO Frank Lonego sums it up thus:

> Continued refinement of the operating plan and our ongoing focus on trip plan compliance led to year-over-year improvements in velocity and on-time arrivals. CSX operated significantly fewer active trains at higher-performance levels leading to reduced road crew starts and savings in ancillary crew costs, such as crew balancing expense, nonproductive re-crews and road crew overtime.
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> Shifting to the mechanical side, the active locomotive count was down 10 percent year-over-year and over 600 locomotives are currently in storage. The total active locomotive count is now down over 1,200 units since the end of 2016. The smaller locomotive fleet, combined with fewer cars online and freight car repair efficiencies, helped drive an eight percent year-over-year decrease in our mechanical craft workforce.

In sum, CSX is turning the PSR corner, generating more merchandise carloads at higher RPUs. Now if only they can get OT arrivals (64 percent) and departures (81 percent) under control.

Kansas City Southern has a new mantra: Service Begets Growth. And the first quarter results show how and why. Q1 revenue increased 5.7 percent to $675 million even though revenue units slipped 1.4 percent. The 6.7 percent RPU increase helped. Reported operating expense increased 22.5 percent to $515 million, dropping operating income by 26.7 percent to 160 million and an OR of 76.2, up ten points. That said, much of the negative change came about as the result of accounting changes in Mexico and other non-recurring events.

In the first quarter of 2019, reported operating expenses were $515 million. Excluding restructuring charges related to PSR initiatives, and including the Mexican fuel excise tax credit, adjusted operating expenses were $433 million, just 3.1 percent higher than 2018. That makes adjusted operating income $242 million, 10.5 percent higher than a year ago. The adjusted first quarter operating ratio becomes 64.2 percent, a 1.6 point improvement over first quarter 2018.

Reported net income in the first quarter of 2019 was $103 million, or $1.02 per diluted share, compared with $145 million, or $1.40 per diluted share in the first quarter of 2018. Changes flowing through and from the above events creates adjusted net income of $155 million and diluted earnings per share of $1.54, 18 percent higher than a year ago.

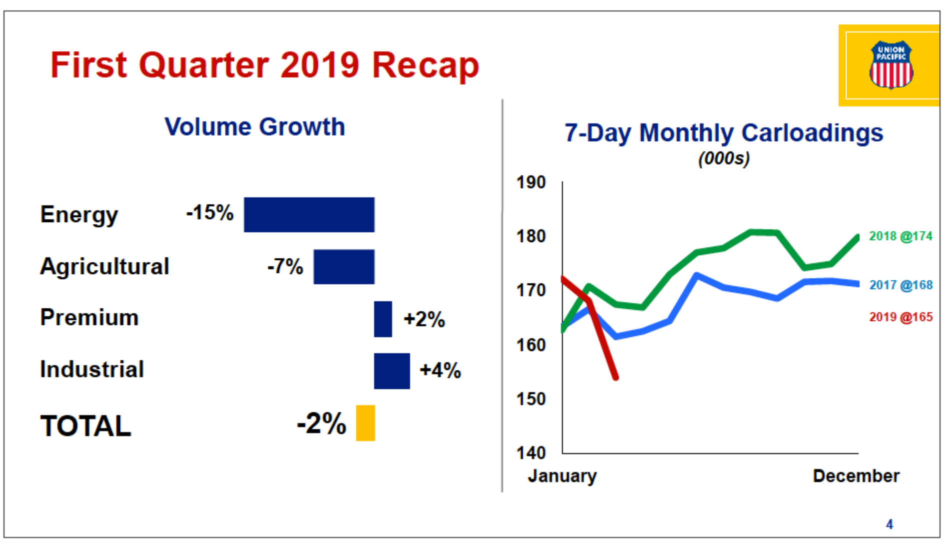
Revenues for the first quarter of 2019 increased in four commodity groups, led by a 20.7 percent increase in chemicals and petroleum due to refined product shipments to Mexico. Agriculture and minerals grew by 8.4 percent, driven by improved network cycle times. Energy and industrial/consumer products grew 5.4 percent and 2.4 percent, respectively. These increases were partially offset by revenue declines in automotive and intermodal of 3.7 percent and 12.1 percent, respectively, due to auto plant shutdowns and teacher protests.

KCS has a very disciplined and targeted approach to asset management and railroad scheduling. They've enhanced the AAR Velocity metric with Gross Velocity to measure not only average train velocity between end points, but also transit hours, thus capturing all time spent at intermediate locations between a train origin and destination (including all crew changes, terminal dwell, delays, and incidents). Rod Case's Unplanned Events, in other words.

Sameh Fahmy, newly-tapped EVP Precision Scheduled Railroading, says first quarter velocity and dwell improved by 11 percent and 5 percent respectively. There's been a focus on yard ops, pinch points, mutual pre-blocking with connecting roads, the reduction of the loco fleet by some 100 units, and shop closures.

The commodity outlook for the rest of the year sees strength in 70 percent of carload markets including chems, petroleum, automotive, metals, forest products, and intermodal. Less sanguine are the outlooks for ag, minerals, and intermodal. Still, KCS has given a superb account of themselves and I'm convinced they are in a stronger position than ever.

Union Pacific rounded out the week's calls. Total revenue, $5.4 billion, slipped two percent on 2.1 million revenue units, down two percent (chart below) with industrial products — roughly a third of all units — up the most. Monthly carloadings plummeted to a new low, as snows in the upper midwest and PNW plus floods in the plains states took a serious toll on just about every measurement UP uses.



Ag products saw grain, grain mill products and food/beverage off seven, eight, and ten percent respectively, largely on reduced exports and the effects of winter storms. In the energy group, coal and frac sand took 14 and 45 percent hits respectively offset by an 18 percent crude oil and STCC 29 increase. Auto carloads were down three points on slowing car sales (see previous WIRs) whereas domestic intermodal was down and international was up.

The industrial products sector is where it gets interesting. As the most varied commodity group of the portfolio, it contains everything from soda ash, metals, industrial chemicals, and plastics to aggregates and both forest products STCCs. There were gains in construction materials (housing and highways), plastics (cheap feed stocks and more sources along the Gulf Coast), and drilling pipe (frac sand may be down thanks to local sourcing but the Permian still needs pipe). The 2019 volume outlook sees ag gains in ethanol and boxcar foods, more crude oil and less frac sand, more plastics, steel, and other industrial raw materials.

The railroad is running well, by and large. Even as total revenues slid two percent, they took three percent out of operating expense, producing $2 billion in operating income and a 63.6 OR. Quite an accomplishment. The severe weather cost UP 1.6 OR points in lost revenue and added ops expense, though 2.4 points were added back through a payroll tax refund, fuel savings, and core ops improvement. Below the line, UP generated net income of $1.4 billion, up six percent. Cash from operations gained three percent to $2 billion, free cash flow after capex and divs came at $581 million, up 37 percent.

Chief Operating Officer Jim Vena showed how the Unified Plan 2020 disciplines reduced yard dwell, increased freight car miles/day and GTMs/available horsepower, and improved trip plan compliance by two percent (still more work needed here — only 62 percent of loads are trip-plan compliant). Trains are running 500 feet longer than they were in Jan, work has been slowed at Brazos, the Hinkle and Pine Bluff humps were closed, and the relatively new Santa Teresa terminal just west of El Paso splits and combines trains to increase train length west of there.

To short lines experiencing service wobbles, I can only say close the loops with your UP contacts to document what's happening where and what you are prepared to do — pre-block, shorten interchange on/off intervals, eliminate the need to constructively place cars, etc. I know doing so works because I've seen good results with all the Class Is and their shortline partners. As Chief Commercial Officer Kenny Rocker says, the business is out there. All we need do is go get it.

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