RAILROAD WEEK IN REVIEW

April 26, 2019

"I'm one that believes that a normal three year economic cycle turn is a good turn. It's good for both the customer and the railroad to be able to plan. It doesn't lock us into or out of bad economics. We're looking at some very surgical rifle-shot investments to create additional capacities that allow us to absorb some of the situations that we experienced through the winter. — Keith Creel, Canadian Pacific President and CEO

"Two key pillars of the new operating plan will be expanding the use of distributed power, which utilizes locomotives on the head and middle of the train, as well as driving more unit train business to manifest. We are increasing the merchandise train speeds from 50 miles an hour to 60 miles an hour — which is the speed intermodal trains currently run — so we can continue to commingle networks." Norfolk Southern COO Mike Wheeler

"PSR is nothing more than what many industry observers call "vulture capitalism," and with good reason. Hedge fund investors swoop into a company and drive down operating costs in order to wring out every possible dime in profits, but don't share those profits with the workers who created them. They buy back stock to pump up the price, and when they run out of cash, they borrow against the company's assets to buy back more stock and pump up the prices some more." — Dennis Pierce, National President, Brotherhood of Locomotive Engineers and Trainmen, Railway Age Newswire, April 21

Canadian Pacific had a difficult quarter, to say the least. On the call Creel said, "The period saw one of the coldest winters in the century with temperatures 20 percent to 30 percent colder than what we experienced last year. The record freezing temperatures and snowfall affected supply chains across North America as well as the fluidity of our network."

Moreover, the fatal February spiral tunnels derailment (DP grain train with 112 covered hopper cars and three locomotives — head end, mid-train, and bringing up the markers) made coping with the conditions that much more difficult. Creel adds that the incident led into what became one of CP's toughest months and quarters. GTMs dropped to the lowest level in eight years.

The quarter's 635,600 revenue units were off by two percent year-over-year, operating income gained less than a point to C$543,000, and the operating ratio gained 180 bips to 69.3. Still, average system RPU rose nine percent; freight revenue was C$1.7 billion, up six percent; reported net income before items was $434 million, up 25 percent; and free cash flow after capex, dividends, and before share repos increased 32 percent to C$98 million.

The "ECP" group (energy, chemicals, plastics) led the charge, up six percent in carloads and 23 percent in revenue (not-FX adjusted). Chief Commercial Officer John Brooks cites "record volumes of LPG, plastics and refined products." On the other hand, volume deltas in bulk products — grains, ferts, coal — were generally negative, though forest products registered a two percent gain in carloads and was up 11 percent in revenues (not FX adjusted). Says Brooks, “We continue to drive asset utilization on our CP center beams and boxcars, offering greater service reliability to key markets for our forest products customers.”

While the first quarter had its challenges, the second quarter is off to a very good start. The first three weeks of this quarter have both Canadian and U.S. grain trending up double digits. Potash and sulfur continue to gain and and Canpotex has sold out through the end of June. Crude by rail volumes will gradually ramp through the end of the year, thanks to increased demand.

There was surprisingly little operations commentary, per se, though Creel said in his opening remarks that “Our commitment to precision scheduled railroading enabled a strong recovery from the first quarter challenges and gives us a solid foundation moving forward.” CFO Nadeem Velani conceded that

> Revenue growth was muted and significant expenses were incurred, most notably through higher casualty costs, which fall under the purchased services line predominately. This resulted in a Q1 operating ratio increase of 180 basis points to 69.3%. Had it not been for the challenges we faced, we would have expected mid single-digit volume growth similar to January and an OR in the mid-60s.”

For my own part, I find the quick recovery from the winters’ trials, the coming into fruition of the marketing initiatives we heard about at the September shortline meeting, and the recent acceleration of volume and operating trends up and to the right are all good signs. There seems to be no reason why CP can’t deliver an operating ratio starting with a five going forward.

Norfolk Southern made substantial strides in strengthening the franchise in the first quarter. This was one of Norfolk’s strongest quarterly calls. Chief Commercial Officer Alan Shaw was particularly forceful and energetic in his remarks, showing revenues up five percent on flat carloads with most merch categories down but with a five percent average RPU increase.

Revenues of $2.8 billion came on gains in every commodity group but chems and coal, the former dragged down by a six percent drop in crude oil; the latter came on a 12 percent drop in export coal and a seven percent cut in domestic met coal. Operating expense held at $1.8 billion, unchanged, producing a 16 percent operating income increase to $966 million and a 66.0 operating ratio, down 3.3 points.

Below the line, net income jumped 23 percent to $677 million. Cash from operations increased eight percent to $881 million, capex rose 22 percent to $467 million, but free cash flow after capex and dividends slipped 19 percent to $184 million. Share repos ate $500 million, however.

Chief Operating Officer Mike Wheeler's slide on service & productivity metrics gives us more detail on how the Service Delivery Index is calculated. The measure is "the on-time delivery performance of our scheduled shipments. It is a customer-facing metric, which measures shipment consistency [in terms of plan] adherence for general merchandise traffic." Sounds like trip plan compliance to me. Now we only need to know whether the trip plan for a shortline car starts and ends at the shortline customer at at NS interchange. Surely it's a question for the next NS shortline meeting.

I'm a little worried about the commercial direction NS is taking. Shaw said on the call that the revenue results "highlight our focus on testing the limits of market based pricing, allocating resources to opportunities with the greatest return and reducing network complexity to develop a valued service product we execute every day." My concern is that the single-carload business is fragmented and labor-intensive, perhaps not offering "the greatest return." Here's why:

You gather carloads from many places with many local freights and crews, build trains based on the distant node, and, at that distant node, break them down into many local freights and crews delivering carloads to many places. You've got a batch process on the core trains and a custom process on the locals. How to square the two?

Hunter once told me you run the same local plan every day so the power and crews are where you need them the next morning. Yes, it's messy. But running freight trains is a carload business and the best way to run it is to do the same thing the same way every day. Then customers can rely on you to show up as advertised and you can rely on customers to have their loads or empties ready for your scheduled arrival.

So when I look at Norfolk's Week 13 carload report to the AAR and see ten of the 18 commodity groups with negative year-to-date carload deltas, I'm concerned. Seeing revenue up and carloads flat to down means Norfolk is getting paid more for doing less. Does this bode ill for the single-car merchandise sector that is the livelihood of short lines? Or does it imply another round of NS branchline spin-offs?

Notwithstanding my questions regarding trip plan compliance and merchandise traffic mix, there is no doubt that NS produced record quarterly results in railroad freight revenue, merchandise carload RPU, operating income, operating ratio, net income, and per-share earnings. Shares gapped up six points in three days, so the Street was clearly impressed. Based on the formal remarks on the call and the Q&A response frankness, I'm sure this Thoroughbred is off to the races for 2019.