RAILROAD WEEK IN REVIEW

July 26, 2019

"We continue to see positive trends in all metrics. Reductions in line-of-road equipment failures, modifications to our service design, and reduced train starts have all helped to a system fluidity. We are more than doubling the expected PSR cost benefits for the full-year 2019." — Jeff Songer, Chief Operating Officer, KCS

"You can have a regime where people don't take risks, but then you'll miss things, maybe important ones. You can be right in the small, but if you're not right in the large, it can be a big mistake." — Former New York Fed President Bill Dudley in Bloomberg

"Did Brookfield see GWR as a pure infrastructure investment (stable, say mid-single digit returns/hands-off style), or will it view this more as a private equity investment (investing with an aim to provide something — capital/expertise/directional change — to improve results and achieve double-digit returns)?" — Tony Hatch in Progressive Railroading

"The benefits of TOP21's reduced circuity and improved velocity are already apparent, as we can now serve the majority of our customers with more predictable transit times and fewer assets to move their freight." — Jim Squires, President & CEO, Norfolk Southern

Kansas City Southern second quarter revenue units were unchanged at 570,000. Freight revenues increased four percent to $678 million as average revenue per unit increased four percent to $1,190. The chemicals and petroleum group was the best performer with revenue units up 18 percent and revenue up 19 percent. Frac sand took the biggest hit, down 33 percent in volume and 36 percent in revenue. Total revenue increased five percent to $714 million.

Operating expenses increased 16 percent including a $51 million restructuring charge. Operating income was $208 million, down 15 percent year-over-year. As a result, the operating ratio was 70.9, up nearly 7 points year-over-year. Granted, the drop in the operating income and unfavorable change in operating ratio came about as a result of changes in tax laws related to the Mexican fuel excise tax — the adjusted operating ratio is 63.7. (Personally, I don't like to use non-GAAP numbers because, after all, the excluded costs are a cost of doing business and should be included in the year-over-year comps.)

Below the line, net income dropped 13 percent mainly as a result of the charges noted above. Reported EPS came down 11 percent to $1.28. Absent the two million share buyback, EPS would've been $1.26, down 13 percent.

KCS has been making remarkable strides in its PSR initiative -- reducing the active locomotive fleet, reducing the system freight car holdings, and consolidating trains to reduce train-starts. Still to come: doing more with velocity/dwell/train length, eliminating delays in Houston, at the border, and in the Mexico yards, and getting rid of mechanical failures (unplanned events) in both frequency and duration.

Even though KCS took second quarter hits in both revenue and revenue units, Chief Marketing Officer Mike Naatz presents a positive view of second-half commercial results. Chemical/petroleum, ag/minerals, and automotive – 60 percent of revenue – are looking favorable for the balance of the year; industrial/consumer, 20 percent of revenue, is a neutral. The only negatives are in energy and intermodal.

KCS shares have been trading in a narrow range since mid April. The high was $125; the low was $111. Shares closed Friday in the $120s. I think if KCS can follow through with the task it has set itself for the second half we should see $125 and better before the end of the year.

Canadian National reported record quarterly revenues of C$4.0 billion, up nine percent, on 1.5 million revenue units, up two percent, with system RPU up eight percent to C$2,444. Ops expense was up eight percent, leveraging an 11 percent operating income gain to $C1.7 billion. The operating ratio came in at 57.5, a 70 basis point improvement. Net income was C$1.4 billion, up four percent; GAAP earnings per share increased six percent to C$1.88.

The commercial effort is now split into "Rail Centric Supply Chain" (carload) and "Consumer Product Supply Chain" (intermodal and auto). The SVPs in charge are James Cairns and Keith Reardon, respectively. Carloads and revenue ton-miles were both up two percent; intermodal revenue was up 15 percent (thanks to the addition of the TransX intermodal product) while units grew less than a point. Automotive vols increased four percent and CN has "line of sight on future new business."

Coal carloads increased four percent, but revenue grew only one percent, as CN's Canadian coal export franchise offset the current weak U.S. coal market. Canadian grain revenue was up 11 percent and export grain tonnage is now up two million tons year-over-year. US grain revenue was up 21 percent, mostly from exports.

Looking ahead, Cairns said on the call, "We still see volatility in a few markets including grain, lumber, U.S. coal, and crude oil" with the crude oil somewhat dependent on the Alberta government. Fundamentals for crude oil remained strong for the second half of 2019. And "uncertainty around the ban of canola exports in China will push a larger-than-expected grain carry-over into the new crop year."

He adds that a new expanded West Coast export plant will fully absorb the added train capacity, now able to move more grain products than there is current demand, and will allow CN to move record volumes into new crop year. In forest products, "full impact of BC mill closures and production curtailments will be a headwind for the forest products volume for the balance of 2019. We are rightsizing our fleet and resources accordingly."

As for what's next, CEO and President JJ Ruest sums it up most eloquently:

> Operating metrics are at PSR railroading level and we are in position to have good results going forward. In just the last four weeks, revenue ton-miles are running at a six percent growth rate. In the next three years, we are aiming for low-double digit diluted EPS growth, normalizing our capital intensity, producing a high-50s operating ratio with ROIC in the range of 15 to 17 percent.

Norfolk Southern wrapped up the week Wednesday with total revenue $2.9 billion, up 90 basis points, on 1.9 million revenue units, down 3.8 percent. Merch carloads were down 2.6 percent with the only plus sign in ag products. That was all grain, up ten percent. Of 18 commodity groups reporting, ten were down. RPU was up five percent for merch carloads and total railroad. The OR was 63.6, off a point year-over-year.

Elsewhere in the merchandise sector, såteel volumes dipped eight percent due to tariff impacts and lower steel prices while pipelines ate into NGL vols. Intermodal vols dropped four percent on increased truck capacity, higher inventories and Midwest flooding. Reduced domestic volume was partially offset by the seven percent gain on the international side.

The 2019 outlook is for more crude oil to the northeast, a projected three percent increase in light vehicle production, and an improved environment for aggregates. Finished steel products will likely continue to suffer due to weak demand, tariff impacts, and low commodity prices. Intermodal will finish the year slightly ahead of 2018 vols; coal will continue to decline.

Train performance, terminal dwell, shipment consistency, and velocity were the best on record for any quarter. However, COO Mike Wheeler's ops slides are underwhelming. Slide 10 shows 2019 goals but no actual 2019 year-to-date numbers. Slide 11 tells what they did, but there's nothing on any benefits from any of it. Slide 12 shows road train starts down, which is good as GTMs were down 3.5 percent (RTMs down 3.9 percent).

Below the line, net income was up 1.7 percent; eps was up eight percent AFTER they bought back 17 million shares, otherwise up 1.7 percent, same as net income. Free cash flow after capex and divs was $515 million, down 12 percent. Year-to-date NS has spent a cool $billion on stock repos while balance sheet long-term debt is up $516 million. Net debt now stands at 73 percent of equity and Moody's rates NS paper Baa1, "lower medium grade," two levels above non-investment grade. Color me disappointed.