RAILROAD WEEK IN REVIEW

July 24, 2020

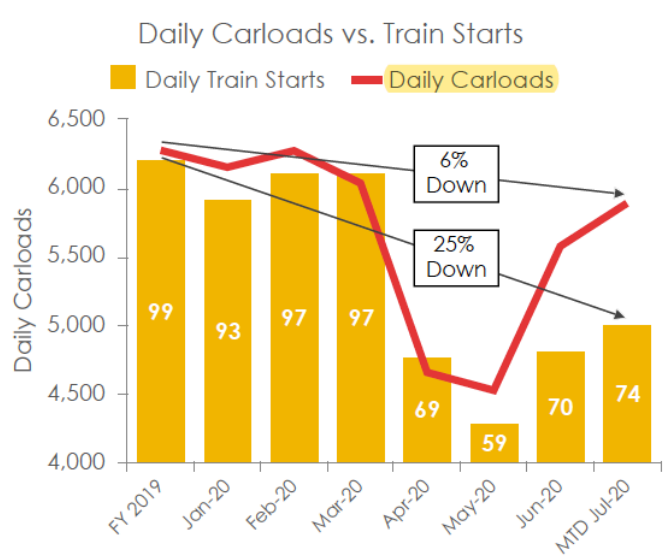
"We believe KCS possesses a unique growth story anchored by its Mexican franchise that provides above-average long-term growth opportunities among U.S. railroads. The completion of the USMCA trade agreement, combined with palpable benefits from Precision Scheduled Railroading (PSR) techniques and ongoing implementation, should afford multiple expansion, in our view. Strong Buy." — Raymond James

"In the second quarter of 2020, CN committed to a plan for actively marketing for sale certain non-core lines in Wisconsin, Michigan and Ontario representing approximately eight hundred and fifty miles."— CN July 21 earnings press release, Note 5.

The CP sales and marketing team is making more customer cold calls, sales blitzing territories on our network, building new relationships and finding outlets for our customers. That's the PSR culture that we have in the sales and marketing team." — John Brooks, Chief Commercial Officer, Canadian Pacific

Kansas City Southern kicked off the Q2 earnings season July 17 with a fairly upbeat report, all things considered. Revenue may have come down 24.5 percent as revenue units decreased 21.4 percent, but you have to take that in context. Here you can see how revenue unit volume tanked March-May and recovered rapidly in June.

This is why I think the YTD comps tell a more accurate story. Both revenue units and carloads were down nine percent year-to-date compared with the 2019 first half. And that with train starts down 25 percent!



To me, KCS has embraced the Precision Scheduled Railroad concept more fully than the other US Class Is. They're blocking for the distant node and putting everything headed in the same direction in the same train. That makes for fewer bigger trains but without the lag of intermodal trains waiting for mixed freights to clear, etc.

Strict adherence to carload trip plans means on-schedule arrivals and departures at class yards with all scheduled block swaps made. Here's how Sameh Fahmy, EVP for Precision Scheduled Railroading put it on the call:

> We know that when we get to the full volumes we'll be able to do it with 20 percent fewer train starts, 20 percent fewer crew starts, 20 percent fewer locomotives, 20 percent higher train lengths and nine percent better fuel efficiency than we did in February. We started consolidating trains mid-March, so, whether it's intermodal, automotive, manifest, grain trains, refined products, it doesn't matter.
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> We built tight windows for trains to arrive within that window and make the connection fast, so that we don't affect the dwell time and then get out of the yard before the next trains come in. And we did that without sacrificing velocity and without sacrificing dwell, so velocity has been up 37 percent year-over-year.

The result of this close operations planning and coordination is that second quarter operating income came down only13 percent; the 27 percent drop in ops expense more than compensated for the 23 percent revenue hit. The GAAP operating ratio improved 379 bp to 67.1. Year-to-date operating income increased 27 percent YTD and the OR shed 10 points to 63.3.

The PSR initiative is yielding significant results. Fuel efficiency in gallons/KGTM improved five percent and RTMs were 52 percent of GTMs. That also explains why income statement equipment rents dropped by 30 percent in the quarter and half. Fameh again:

> We are at about 70 percent trip plan compliance, which is equal or better than the pre-COVID time. Train lengths have increased significantly and train starts have come down by 25 percent with traffic only down by six percent. And that's why I was saying earlier that we believe that we'll maintain a 20 percent reduction in train starts when volume increases to pre-COVID levels.

Canadian National reported Tuesday after the close. The railroad delivered what CEO and President JJ Ruest called "resiliency during unprecedented economic times" on the call. Revenue units decreased 16 percent to 1.3 million with a freight revenue decrease of 19 percent to C$3.0 billion. Merchandise carloads dropped 22 percent, thanks to the 72 percent hit automotive took as that industry suddenly shut down. Grain/ferts saved the day being down three percent in carloads with revenue up a point.

Operating income was cut in half to C$785 million, though, absent the C$486 million charge for planned line sales in the US, operating income would have been C$1.3 billion, down 20 percent. The operating ratio as reported was 75.5, up 18 points; without the special charge the OR would have been 60.4, up 139 basis points.

Revenue ton-miles were off 18 percent against a 20 percent decrease in gross ton-miles. The railroad burned through 22 percent fewer gallons, increased GTMs per gallon by 2 percent, and once again hit an industry-wide best for fuel-efficiency: 0.88 gal per thousand gross ton miles.

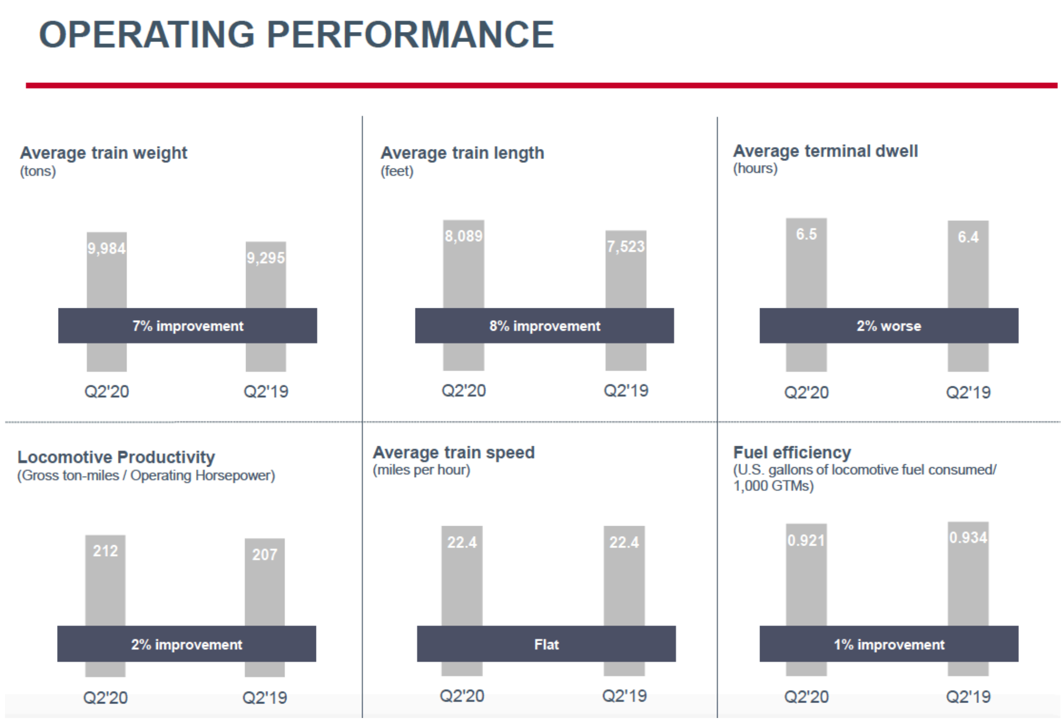
Commodity highlights include record quarterly amounts for Canadian grain, West Coast propane, and wood pellets. To support the grain surge, CN is adding 1,500 more high-capacity hoppers for the next season. The new hoppers will allow CN to move 20 percent more wheat and 40 percent more canola using the same power/crew mix.

Wood pellets in particular generated record year-over-year gains, of which some 15 percent has come from expansion projects across British Columbia and Alberta. Propane producers with the CN/Prince Rupert routing get easier access to the best net-back markets in Asia. The CN lumber franchise started to recover late in Q2 with price per million board-feet down by roughly 40 percent April-June and the outlook for eventual recovery to pre-COVID levels.

I think Consumer Supply Chain SVP Keith Reordon, SVP - Consumer Product Supply Chain, sums up the CN position most eloquently: "CN's reach and network scale, the diversity of service offerings, plus the structural and capacity improvements that we and our customers are making, will produce mid to long-term growth for our carload franchise." Surely the door is open for shortline contributions.

Canadian Pacific showed once again the benefit of staying close to your customers. Revenue units were off 12 percent to 631,000, freight revenue slipped nine percent to C$1.8 billion, but RPU gained 3.1 percent, best of show so far. Carloads gained in grain, potash, and sulfur/ferts; forest products revenue increased four percent on a five percent volume drop, while energy/ chems/plastics revenue decreased just one percent though carloads were off 28 percent.

Once again, CP is hitting all its operating Key Performance Indicators spot on:



Operating expense decreased by 12 percent on significant savings in comp & benefits, fuel, materials, and rents/car hire. Operating income was off six percent, though the OR took off 139 basis points to a respectable 57 even. Net income declined 12 percent to C$635 million.

As you know, I'm big on Going to See the Customers. So is John Brooks, per the above quote, and the superior revenue/revenue story even in these unsettled times proves it. Said he on the earnings call,

> The next several weeks will present challenges as it relates to comps, given our strong industry-leading performance last year, but the volume environment continues to improve. As we look forward, we will continue with our disciplined approach to picking our partners, executing our playbooks, enabling us to outperform the industry.

And so it is that I see Canadian Pacific uniquely suited to do just that, and in so many words has told the shortline and regional railroad community that CP welcomes their initiatives and partnership.

CSX chimed in after the bell Wednesday, Union Pacific reported Thursday, and NS wraps up the railroad earnings call season next Wednesday. I'll comment on each in next week's WIR. BNSF reports as part of the Berkshire quarterly, which I'm guessing will be August 1. Thus you'll have to wait for WIR August 7 for them. WIR Extra members will of course get summary observations with my charts and their presentation slides as they happen.