RAILROAD WEEK IN REVIEW

October 23, 2020

"The headline story for this quarter is specifically our ability to hold the PSR-driven efficiency improvements and cost savings generated over the prior year and a half. Volumes and revenues experienced a truly unprecedented roller coaster ride, with the steep decline in the second quarter and then the very sharp recovery in growth during the third quarter." — Pat Ottensmeyer, President & CEO, KCS.

"We've got a high speed camera system that's going to do train inspections. It's capable of producing full body resolution images at train speeds up to 70 miles an hour. And it's safer. It's a more efficient way to analyze the train. And we've already proven that we can detect 87 percent more defects than traditional manual inspections." — Keith Creel, President & CEO, CP

"Q3 was a quarter of sequential recovery. The recovery is underway since the month of July. The operating matrices are improving. We brought many of our employees back to active service, and we added train starts. And kudos to the entire team for producing a 59.9 operating ratio." — JJ Ruest, President & CEO, CN

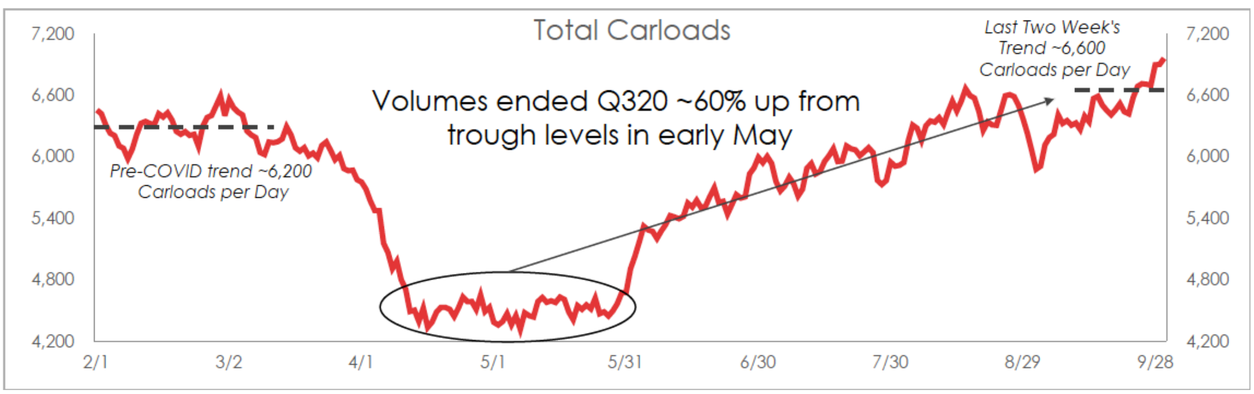
Starting this quarter I'm changing the emphasis to carloads and commodities and away from earnings per share, share counts, and below the line items. Over the past quarter of a century WIR readership has become predominantly non-Class I railroad owners and operators, and they live and breathe commodity carloads. The WIR mission is not only to relate what's happening and why, but also how to use present trends to stay ahead of likely future trends. I'm doing KCS, CP and CN this week; next week I'll dive into CSX, UP, and NS.

Kansas City Southern third quarter revenue units declined 3.6 percent to 577,600 vs. a year ago. Merchandise carloads including auto (48.3 percent of total units) dropped 7.0 percent. On the plus side, the STCC 28 chemicals and STCC 29 petro chems combined were up 4.7 percent and represent 16.3 percent of total units. Everything else was down with double-digit hits in metals, ores & minerals, frac sand (-62.3 percent!), crude oil, and automotive. Utility coal was off 14.8 percent while intermodal rose 1.7 percent. RPU was off 8.8 percent

Total revenue dropped 11.8 percent to $660 million, operating expenses came down an impressive 16.7 percent, and operating income slipped just 3.7 percent to $272 million for an operating ratio of 58.8, a 3.45 point improvement on last year's 62.3 OR. Below the line there was an $8 million foreign exchange gain and the income tax provision came down nearly $30 million so the net income to the railroad increased 5.3 percent to $190.2 million. That's how you get net income up while operating income is down.

From the 10-Q, a model for the rest of us: “As revenues declined in the second quarter of 2020, the Company responded quickly and implemented a variety of cost-saving measures and accelerated Precision Scheduled Railroading (“PSR”) initiatives by further consolidating trains, which increased train length and reduced crew costs. For the three months ended June 30, 2020 and September 30, 2020 operating expenses decreased by 27 percent and 17 percent, respectively, compared to the same periods in 2019, due to lower fuel price and consumption, fewer headcount and hours worked, decreased restructuring charges, and savings related to PSR initiatives.“

Chief Commercial Officer Mike Naatz said on the call that even though Q3 revenue was down YOY, revenue declines were worse than volume slippage. Lower fuel prices and FX together accounted for most of the RPU drop. However, the problem with quarterly comps is you miss what was actually going on. KCS brought back a lot of volume quickly, totally masking the flat volumes in April. Thus Q3 revenue units saw a 30 percent sequential increase.



I have to give KCS high marks for the recovery. Though GTMs were off 9.3 percent, fuel burn was off 12.6 percent, a big contributor to the 41.7 percent YOY drop in fuel expense. The 30.2 percent drop in cost per gallon also helped. Fuel efficiency of 1.24 gallons per KGTM needs work, however, given its peers hovering around and under the dollar per KGTM. Free cash flow after dividends and share repos was $81 million, double what it was a year ago.

Canadian Pacific checked in Tuesday morning with 659,000 revenue units, down 7.4 percent, generating C$1.8 million, down 5.7 percent; system RPU managed a 1.8 percent gain to C$2,763. Merch carloads (all but coal and intermodal shed 3.8 percent on volume but RPU gained 1.3 percent. Grain and potash were the real winners with units up 16.8 and 20.1 percent respectively with revenues up 11.7 and 12.8 percent respectively. Chief Commercial Officer John Brooks said on the call that these two trends will continue, and that merchandise volumes excluding frac sand will continue.

Total revenue came in at $C1.86 billion, up 5.9 percent; operating expense fell 2.3 percent and operating income was off 10.4 percent. The OR gained 2.1 points to 58,2, still a highly respectable number. Below the line, net income was off 4.4 percent to C$598 million. Fuel burn dropped 8.0 percent on GTMs down 7.9 percent. Fuel efficiency held at 0.93 gallons per KGTM.

As you can see, CP is maximizing carloads and resources to good effect. That system RPU gained two points tells us customers are seeing added value in the CP product.

The year-to-date RTM mix is interesting. Intermodal accounted for 16.6 percent of RTMs and 20.7 percent of revenues; coal was 11.8 percent of RTMs but just 7.4 percent of revenues. Merchandise carloads including auto produced 69.5 percent of RTMs and 71.9 percent of revenues. Tells me merch is holding its own while intermodal is largely subsidizing the loss of coal revenue and tonnage. The outlook for Q4 per the just-filed 10-Q calls for "volume as measured in RTMs to be down low-single digits."

Canadian National was next up with its Q3 results, reporting 1.4 million total revenue units, down 5.9 percent, generating C$3.2 million, down 10.2 percent. Merchandise carloads including automotive were off 9.2 percent, revenue slid 12.0 percent, and RPU was C$2,256, down just 4.5 percent. Merchandise carloads were 47.1 percent of total units moved with metals/minerals being the largest part of the mix.

Operating expense actually came down 7.9 present thanks largely to a 33.0 percent reduction in fuel expense, consuming 11.7 percent fewer gallons even though GTMs fell 8.6 percent. The 25.6 percent drop in fuel price per gallon helped, as did the 3.4% improvement in gallons per KGTM — 0.85, an industry best.

Jim Cairns, SVP, Rail Centric Supply Chain, runs the merchandise carload side of the house. Said he, grain continues to be "a bright spot" with record carloads in Canada and improving volumes in the US. The next crop year will. be even better — CN and customers are investing in more high-payload cars; by the end of next March the grain fleet will be more than 4,200 cars.

CN is the "dominant player" in Canadian forest products and is preparing for more carloads, having "brought back all the lumber cars that were in storage and we recently added 500 additional lease cars to meet spot demand at auction prices." There is increased demand for wood pellets as a green fuel alternative and there will be more propane export volume through Prince Rupert. Crude, frac sand and refined petroleum products, were the weak outliers in Q3.

Chief Operating Officer Rob Reilly talked about how CN has coped with the rapid volume recovery in Q3. They've brought back crews, returned cars and power to service, reduced the number of yards and servicing facilities, and combined three dispatching offices into one in Edmonton. Train length is up six percent, train weight is up four percent,and car-miles per day are up 25 percent.

The subject of 45G came up on a recent Zoom call with a few shortline friends. In a follow-up e-mail one of the participants wrote, "The tax credit is valuable to us in that we actually put the credit back into track. I think it is needed as the railroad industry is a private enterprise operating for the public good and competes with other transportation systems that are heavily subsidized. On the other hand, to portray that shortline railroads in general are all broken down and falling apart is just terrible public perception as we all try to grow our businesses.

"We are working on applying for a state short line grant. A friend who has some experience in these matters offered to help us out, but in his first draft of the application he made it sound like we are falling apart and without this grant we would go out of business. I had him rewrite the grant request to show that we are upgrading track to handle increased traffic, which will result in getting more trucks off the road. I was reminded of an old track guy who told me, 'If you don't have enough traffic to generate enough revenue to maintain the line, you don't have a railroad.'"

How true.