RAILROAD WEEK IN REVIEW

January 29, 2021

"Our view is that Kansas City Southern has the largest and most tangible set of growth opportunities compared to its Class I peers (refined products, cross border intermodal, new metal facilities coming online in Mexico, etc.)" — Allison Landry, Credit Suisse

"While the recovery remains uneven across the markets we serve, we are pleased by the momentum in volume demand that grew during the fourth quarter and continues to grow. We are increasingly optimistic about 2021 and we are reinstating our full-year financial outlook." — JJ Ruest, President and CEO, Canadian National

"Increasing the blending of different kinds of traffic on the same train supports minimizes additional train starts. We improve car velocity by blocking cars for the most distant possible destination, reducing yard costs by minimizing handlings." — Cindy Sanborn, COO, NS

"It was a phenomenal quarter overall. We delivered fourth quarter revenues of C$2 billion which was an all-time quarterly record, operating ratio of 53.9 and adjusted EPS growth of 6%, an industry leading performance." — Keith Creel, President and CEO, Canadian Pacific

Kansas City Southern reported fourth quarter revenues of $693.4 million, down five percent, "primarily due to lower volumes related to a protest-related service interruption at Lazaro Cardenas, lower fuel surcharge, and fluctuations in foreign currency." Revenue units decreased three percent in spite of double-digit gain in chemicals/plastics and grain. Thank the oil patch for the downside — 31 percent in frac sand and 36 percent in crude oil.

Operating expense improved 13 percent, operating income improved 11 percents the OR was 62.2. a 548 basis point improvement. Operating income rose 11 percent. Net before taxes (tax credits make YOY comps meaningless) $166 percent, up 14 percent. Free cash flow after capex but before dividends was up 29 percent to $668 million. Return on equity was 14 percent.

The most impressive part of the KCS story is, to me at least, the Precision Scheduled Railroad progress. Unlike other Class Is, where PSR seemed to be mainly a cost-cutting tool, KCS is actually using it to run a better railroad, thereby enhancing what Warren Buffett calls "durable competitive advantage."

On the call, Sameh Fahmy, EVP Precision Scheduled Railroading, spoke of their process. The 2019 Phase I was to emphasize velocity, asset take-outs, creating a "sense of urgency" and growing the top line by improving the service proposition. The 2020 Phase II increased train length and tightened up resource management. (And all this was done while "running trains and servicing customers in the middle of the worst pandemic that humanity has seen in the last 100 years.") Next,

> Phase III is about reaching out full potential by leveraging service and driving growth. We want to maintain the trains' lengths; we want to even increase it by probably another 5%. And at the same time we want to regain the velocity that we have seen in Phase 1. And the way to do that is to remove the limitations that we have been facing in Q4 in particular, because we have been essentially testing the limits and hitting the constraints.

The current 2021 outlook calls for double-digit revenue growth with a sub-58 operating ratio. Strategic investments in the property south of the border — expanding intermodal capacity, double-tracking certain line segments, adding CTC in single-track territory, and others — bode well for the coming year. It will be a delight to watch.

Canadian National Tuesday afternoon. Total revenue increased two percent to C$3.7 billion on 1.6 million revenue units, up seven percent, propelled by double digit gains in Grains/Fertilizers and Intermodal. System RPU dipped four percent with negatives in all commodity groups but Automotive. Two-thirds of total revenue came from the merchandise carload sector, second only to CP's 71 percent.

Operating income increased 16 percent to C$1.4 billion as operating expense was five percent lower; the operating ratio shed 461 basis points to 61.4. Fuel expense dropped 25 percent as the price per gallon dropped 28 percent. Gross ton-miles were up nine percent on two percent more gallons consumed. Not surprisingly, the fuel burn is at an industry low — 0.9 gallons per thousand gross ton miles. Consider: train length up two percent, dwell down a point, train weight and train length up two percent.

On the call, James Cairns - Senior Vice President, Rail Centric Supply Chain, said, "The carload franchise finished the year strong setting several new records in December. He cited in particular grain, potash, heavy crude oil, propane, and STCC 24 forest products. For 2021 Cairns expects growth in grain, potash, export propane, lumber, and transloads — the export plastic bagging facility on the Alabama Export Railroad short line in Mobile Alabama is of particular note. STCC 26 paper remains soft.

CN forecasts mid-single digit RTM growth, pricing "above rail inflation at a minimum," bringing railroad railroad technology to bear on enhancing the customer experience, and maximizing dollar in per dollar out — precisely the "durable competitive advantage" I've been on about. Concludes Ruest, "CN is a long-term investor play focused on sustainable profitable growth." Couldn't agree more.

Norfolk Southern was next up. Total revenue for the quarter fell more than four percent to $2.6 billion on 1.8 million revenue units, down 1.2 percent. Merchandise carloads fell five percent to 546 million; the biggest bite was chems, down 18 percent. Merch revenue was down five percent as well. Norfolk puts petroleum products in chems and, looking at the AAR Week 52 car count, chems by itself was down nine percent. The Petroleum Products category sank 30 percent.

Operating expense fell eight percent, mainly on comp and fuel. Operating income was up two percent and the OR was 61.8, a 248 basis point improvement. Net income was essentially unchanged at $671 million. Cash from operations decreased seven percent to $3.6 million, capex fell 26 percent to $1.5 billion, and free cash flow increased 14 percent to $2.1 billion.

NS is holding the line on carload pricing. Even though merch carloads decreased by five percent, merch RPU was unchanged at $2,845. More money, less work. That's why merch revenue dropped only 4.7 percent while carloads dropped 4.9 percent. Note too that in the full year numbers NS uses "adjusted" figures that take out the effects of a $385 million "locomotive rationalization" charge and another $99 million "related to an equity method investment", which they never fully explained. Like Warren Buffett, I distrust "adjusted" results and EBITDA because they distort the total cost of doing business.

Canadian Pacific brought up the markers Thursday, with what I think is a *very* strong story. Revenue units increased four percent to 727,800 while total revenue slipped three percent to C$2 billion, thanks to a six percent RPU reduction. (I'm not saying they're buying the business, but when the customer sees a non-competitive rate you have to do something, and the best prospect for business tomorrow is a customer today.)

There were double-digit volume gains in grain, potash, fertilizers, and automotive; even forest products was up four percent, taking merch group carloads up three percent. CP generates more than 70 percent of its total freight revenue from the merch carloads sector, more than any other ClassI road. A third of the carload volume is in grain, 22 percent is in the "energy, chemicals, plastics" (ECP) group, 15 percent is in metals/minerals/construction — MMC for short — so there's 70 percent of all carloads, all carrying decent revenue/variable cost ratios.

Operating expense dropped eight percent, creating a four percent gain for operating income to C$928 million, and an OR of 53.9. Reported net income was C$802 million, though adjusted for a tax gains and other items, it was $683 million, up four percent from a similarly adjusted $656 last year. (Here, "adjustments" are allowed because otherwise it would be an unreasonable 21 percent gain in the net.) CP has managed a handsome silk purse out of this sow's ear of a year.