RAILROAD WEEK IN REVIEW
April 23, 2021

"This is the ultimate positive solution. Short lines hustle for local business. You'd think this would be a very positive thing. For those who want more service up there, having a short line work hard for two loads a week is a good thing. Watco has a good reputation with customers." — Tony Hatch on opposition to CN selling Wisconsin lines to Watco

"We're constantly focusing on truck conversions on the merchandise side of the business — metals and plastics and steel and cardboard, you name it —that today we move in a boxcar. That makes us more and more involved, working with the customer. We continue to win business in those areas because our service is equivalent to what they're getting in a truck. Reliability is trip plan compliance." — Jim Foote, CSX President & CEO

"The demand environment across most of our business lines continue to strengthen. And I'm frankly super excited about how this year is going to shape up to be. We continue to accelerate volumes with Maersk. The port of Saint John calls are ramping up and our exclusive Vancouver transload comes online here in Q3." — CP Chief Marketing Officer John Brooks

"We continue to make good progress on our efficiency measures as both locomotive and workforce productivity improved in the quarter. These improvements were driven by our continual evaluation and adjustment of our transportation plan." UP Chief Operating Officer Eric Gehringer

CSX kicked off Week 2 of the 2021 first quarter earnings call series. Before we get into the numbers, it is important to say I think CSX is now starting to put PSR to good use. CSX has become, as Howard Marks would say, a great company at a fair price, now 11 percent under the DCF-based intrinsic value, and I think listening between the lines of the official commentary supports that conclusion. But first, the numbers.

CSX moved 1.5 million revenue units, up just a point year-over-year, for total freight revenue of $2.7 billion, down three percent vs a year ago. Merchandise carloads — the sector short lines live on — slid six percent in both units and revenue. Coal dropped five percent in both carloads and revenue; intermodal units were up ten percent and generated 11 percent more revenue.

Other income —- storage fees for intermodal containers, penalties for shippers that did not meet volume requirements, etc. — increased 42 percent so total revenue dropped two points to $2.8 billion. Operating expense increased two percent, operating income slid seven percent to $1.1 billion, and the operating ratio worsened to a still respectable 60.9 from last year's 58.7. Net income was $706 million, down eight percent.

I always find the Q&A session more valuable than the prepared remarks because they provide invaluable nuance to the prepared remarks. Jim Foote's observations on the CSX progress in running a better, more customer-friendly railroad were particularly enlightening. He said CSX has increased velocity more than 30 percent by reducing both line-of-road congestion and creating excess capacity within yards to limit how long trains sit idle. Pushing dwell hours back towards previous record levels will turn cars faster and further reduce cars online.

He adds that CSX is doing the same amount of work today with 1,500 fewer locomotives with dramatically improved locomotive utilization and has increased the number of cars processed per hour worked by a third. This higher throughput is due a reduction in yard congestion as well as *more strategic upstream blocking* of cars. (Italics mine because it means short lines can start blocking for the distant node, as they used to say at Big Conrail.)

COO Jamie Boychuk says they are training and qualifying 60 to 90 new conductors a month, meaning they can add revenue carloads at little incremental cost and that the railroad is running well enough to free up 20-30 percent more capacity. Moreover, operating department heads are working closely with their marketing counterparts, "reaching out to customers and understanding where that flow is going to come from, which will require a few more train starts."

Canadian Pacific President and CEO Keith Creel began the earnings call with what he called the 11 truths — benefits — of the CP/KCS transaction. He followed that up with the l1 truths — downsides — of the CN counter-offer. It was all very compelling and powerful to listen to and one can only hope that reason will prevail.

First quarter posted 691,400 revenue units, unchanged, generating freight revenue of C$1.9 billion, down four percent. System RPU also fell four percent. The 16 percent grain gain masked somewhat the 14 percent decline in energy/chemicals/plastics (ECP) and four percent shortfall in metals/minerals/construction (MMC). Manifest carloads plus auto were up 70 basis points but were down six percent in revenue.

Total revenue was off four percent at C$2.0 billion, operating expense came down three percent, and operating income slipped seven percent to C$780 million. Net income leapt a whopping 47 percent as last year's C$211 million Other expense translated to a C$28 million gain this year. Fuel burn was down a point on flat gross ton-miles and CP continues to lead in the fuel-efficiency sweepstakes at just 0.958 gallons per thousand ton-miles.

Chief marketing officer John Brooks cited strength in both Canadian and US grain tonnage and expects "grain on both sides of the border to continue to deliver steady volumes as we move through quarter two." Potash declined as exports were hampered by expansion work at the Canpotex Portland facility. ECP carloads excluding crude oil increased six percent on LPG; crude will come back slowly in the second half. Both paper and lumber are looking up, and CP has added 125 center-beams to the fleet. Excluding frac sand, MMC carloads were up.

Brooks is upbeat for the rest of the year. "I see strong opportunity across all of our lines of business, and I remain very confident in the underlying demand environment. My sales and marketing team remains laser-focused on executing those specific marketing playbooks that build unique customer solutions and continue to generate that sustainable profitable growth."

Union Pacific Q1 revenue units were off a point to 1.9 million; there were 777,000 merch carloads, down five percent. Freight revenue dropped five percent to $4.6 billion and merch carload revs came down six percent to $530 million. Metals/minerals carloads decreased 16 percent and energy/specialized markets carloads were down 14 percent. Grain was up as you would expect — 16 percent. Forest products was also in the plus column to the tune of seven percent.

Total revenues dropped five percent to $5 billion, operating expense was cut three percent and operating income skidded seven percent to $2 billion for an OR of 60.1, up 110 bips. Net income decreased nine percent to $1.3 billion. Fuel burn was down four percent, but so were GTMs. No change in gallons per thousand GTM. Cash from operations decreased nine percent but free cash flow after capex increased six percent.

On the call, Kenny Rocker, EVP Marketing & Sales, said the increase in grain carloads was a function of greater export grain demand, yet fertilizers were down partly because of reduced export carloads. Energy & Specialized Markets — crude oil in particular — carloads decreased mainly on crude oil demand.

The forest products gain was due mainly to housing starts and rehabs, plus "brown paper" to support the trend toward direct deliveries as opposed to brick and mortar stores. Industrial chemicals and plastics took a hit from plant interruptions at the Gulf Coast producers. Metals and minerals volume suffered due to the adverse weather, slower demand for aggregates, and the drop in frac sand.

As for the rest of the year, Crocker cites continued export grain demand from China, a renewed biofuels trade, and favorable year-over year energy comps. The forecast is for "increased industrial production, and there are favorable year-over-year comps for energy market carloads, though there is still uncertainty with the speed of the recovery in those markets. Plastic volumes will also remain strong for us in 2021 as production rates increase."

The Canadian National counter-offer for KCS is a cash-and-stock transaction valued at $33.7 billion, or $325 per share, of which $200 is cash and $125 is for each CN share. This amount represents a 21 percent premium to the CP offer price and 27 percent upside to the current share price. CP offers $90 in cash and $178 in CP shares, total $268 for each KCS common share held.

CN argues that their offer brings significantly greater value, with more up-front cash and better growth opportunities of the combined company. The transaction does not require CN shareholder approval and CN "has confidence in our ability to receive all regulatory approvals required to close the transaction and capitalize on this opportunity."

Thursday morning CN President and CEO JJ Ruest wrote to KCS President Pat Ottensmeyer and the KCS Board, stating in part, "The CN proposal represents more incremental value per share of KCS common stock than that being offered as part of the proposed transaction with Canadian Pacific Railway Limited." He continues,

> Rather than acknowledge the clear and substantial superiority of CN's proposal for KCS shareholders, CP has sought to distract investors and attack CN's proposal with a variety of inaccurate and unfounded assertions. CP's claims are not intended to benefit KCS shareholders, but to advance CP's own interests and to deprive KCS shareholders of the full value for their shares.

CP responded in the strongest possible language, saying the counter-offer is "illusory and inferior, destabilizing, would reduce competition, and negatively impact shippers." Moreover, CP maintains that CN "has significantly underperformed over a decade, underdelivering against its own projections."

It seems to me that the KCS Board's first responsibility is to its shareholders, and the CN offer has to be more attractive. On the other, the competitive matters raised by both CP and its customers also must given due consideration. That being the case, I'm beginning to see some parallels with the NS/CSX split of Conrail (in which I played a part) some 20 years ago.

There were historical partnerships between NS and the former PRR properties, ditto for the historic relationships between and among the C&O, B&O, and NYC. So rather than get into a bidding war where NS had the stronger financial arsenal, it was agreed that Conrail should be split between the two along those lines. In those markets where mergers and track structures had changed the railroad landscape such that you could no longer tell who historically owned what, the Conrail Shared Asset Operation was created. And it worked.

Fast forward to the present case, I see KCS being split three ways: Shreveport north to CP, Shreveport east and the KCS side of the Meridian Speedway to CN, Shreveport to Dallas and south to Mexico, plus all of Mexico as a Shared Asset Area. I'm not suggesting this is the only way to split KCS between the suitors, but as a starting point for a discussion. I would welcome your comments and observations, but only under Office Car Rules — what's discussed between us remains between us. Any takers?