RAILROAD WEEK IN REVIEW

April 30, 2021

"In sum, the Transaction appears to fall neatly into the Board's rationale for adopting the waiver in the first instance. The Board has considered the objections filed by those commenters arguing the waiver for transactions involving KCS should not apply to this Transaction, and finds... more compelling the reasoning offered by Applicants in their reply that the waiver in the current merger rules is applicable to this Transaction." — STB Decision, April 23

"This is a win for CP, in our view, given that this move by the STB de-risks the bid by the Calgary-based railroad to some extent. Indeed, this move validates CP's position that the combination is one that is more likely to get approval from the STB. CN has stated that under their proposal, the new merger regulations will be used, a move undoubtedly taken by them due to their size and the admission that there is some overlap with KCS that needs to be addressed." — Jason Seidl, Cowen & Co., April 26

Kansas City Southern today announced that its Board of Directors has unanimously determined... that the unsolicited proposal received from CN... could reasonably be expected to lead to a "Company Superior Proposal..." KCS statement, April 24

"We believe we can close the transaction on new rules or old rules. We've taken the position from the outset that, first, this transaction should be reviewed by the new rules, and second, our 500 or more support letters recognize that under the new rules, we can get this transaction approved and closed." — JJ Ruest, President & CEO, Canadian National, April 26

Canadian National first quarter revenue units increased seven percent to 1.4 million, mainly on a 23 percent jump in intermodal boxes; carloads including automotive dropped three percent. Freight revenue was unchanged at C$3.4 billion, in spite of a 14 percent gain in intermodal traffic. Merch sector revenue was down four percent to C$2.3 billion. Still, carloads ex-coal and intermodal brought in 68 percent of all freight revenue on 68 percent of revenue ton-miles. The OR was 62.5, down 327 basis points.

Total revenue decreased a mere 30 basis points to C$3.5 billion. They took operating expense down *five* percent, leveraging a nine percent gain in operating income, C$1.3 billion. Net income was off four percent to $974 million thanks mainly to a doubling in the income tax set-aside. Cash from operations slid 19 percent to C$952 million but trimming capex a bit put free cash flow after capex but before divs at C$540 million.

There was a telling exchange about competition towards the end of the Q&A. CN argues that the KCS transaction is about innovation, creating new products and services, and competing vigorously to connect more buyers with more sellers. With a larger network than CP, CN says it can connect to more destinations through existing gateways. However, as I look at the map I see a number of locations where the CN and KCS both serve the market; take out KCS and that option is lost to the customer.

Asked about "customer overlap" (going to one serving railroad from two), Chief Operating Officer Rob Reilly confirmed the most two-to-one instances are between Baton Rouge and New Orleans. They represent less than one percent of the combined railroads' network and there are workarounds, he says.

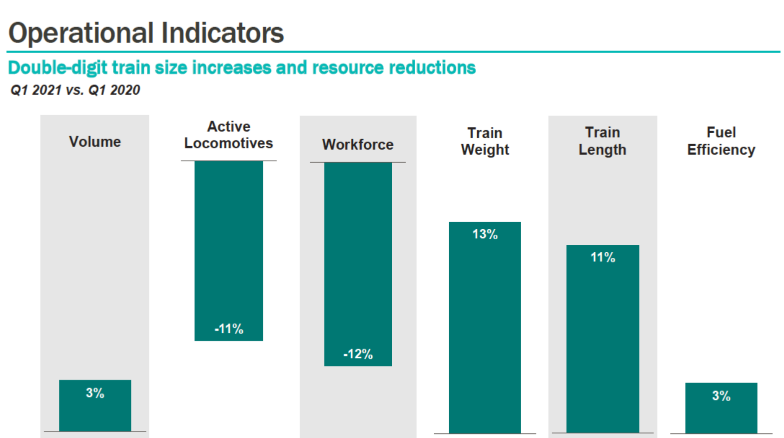
He added that there are many major markets with no overlaps — Jackson (??? KCS and CN/IC both there), East St. Louis, Springfield, Mobile. Here again, a closer look at the map is required to identify potential four-to-threes and three-to-twos. Then there are short lines that connect with CN and can reach destinations beyond via KCS or another player. Take KCS out of the mix and you've gone two-to-one.

Norfolk Southern brought up the Earnings Call markers on Wednesday. Freight revenue increased less than one percent to $2.6 billion on 1.7 million revenue units, up three percent. Merchandise carloads slipped three percent; revenue was off four percent.

Of the 17 merchandise carload commodity groups in the AAR report for Week 13 (April 3) eight showed percentage gains. Of the largest commodities in terms of carloads, chemicals (18 percent of merch carloads) were off three percent. Second-place metals (12 percent of merch carloads) increased seven percent. System RPU fell two percent; merch carload RPU fell one percent.

Operating expense came down three percent on reductions in all line items but depreciation; operating income rose seven percent to a $billion even (I'm using non-GAAP numbers here because last year's $385 million write down for excess locomotives sold is terribly distorting under GAAP). Net income increased just 60 basis points to $673 million. Free cash flow after capex but before dividends increased 27 percent to $750 million.

The operating results were impressive. NS handles three percent more revenue units with fewer locomotives and personnel while increasing train weight and length.



On the call COO Cindy Sanborn noted that even though revenue unit volume saw considerable variability in the quarter, efficiency gains did not.

The existing train network now has enough flexibility to absorb the ups and downs and NS could absorb the variables by adjusting train length, train weight and power to keep the trains running to plan. Maintaining power to weight ratios and using more distributed power units to do so was a key factor. And as a result NS moved more freight with fewer resources compared to what that tonnage would have required a year ago.

Though AAR train speeds and dwell times are on the mend, they only measure the Big Picture and do not measure performance of the manifest freights that actually serve the customer. Until that becomes more reliable and consistent, the railroads, in the words of a recent NEARS shipper panelist, become less "relevant." And without a healthy and sticky customer base, all the effort to run a more efficient core railroad comes to naught.

The North Eastern Association of Rail Shippers (NEARS) pulled off its second virtual session this week and it was a rousing success. To me, one of the most important features is the collection of speakers representing railroad customers, and Tuesday's Veolia presentation was spot-on. At issue was the company's chemicals division specializing in supplying hazmats and TIH commodities to the refining and metals industries, to name two.

Denise Kopko, SVP for North American operations, works with all the Class Is and says the progress made in safety and reliability in her 30 years managing supply chains has been remarkable (used to be having 60 percent of loads arriving within three days of plan was considered good). But more work needs to be done.

She runs a fleet of some 1,000 covered hoppers as well as a large number of trucks and a handful of barges. The time-sensitive stuff goes by truck and train. She says 90 percent of trucks arrive per plan; rail cars not so much, and missed switches are her biggest headache. Not only is material delayed, but also the demurrage bills add up as cars are constructively placed for want of space. Bunching between OD pairs is a major culprit.

Worse, rates keep going up as service becomes more erratic—talk about negative value added. So, thanks to the combination of higher freight rates, higher demurrage fees, and longer trip cycle times for her fleet, she has to start looking for other options. That's why railroad managements need to spend less time on head-counts and operating ratios and more on first-mile, last-mile consistency and reliability. Thanks, Denise, for your candor.