RAILROAD WEEK IN REVIEW
May 7, 2021

“The backbone of North Dakota’s economy is agriculture and over 80% of North Dakota’s grain moves to market by rail. North Dakota grain shippers are in a captive rail market, which limits competition and our options for market destinations. A CP-KCS combination should provide CP grain shippers expanded access to markets across the United States, Mexico, Canada, and even internationally. The bid by CN would effectively end any opportunity for market expansion for North Dakota CP grain shippers.” – North Dakota Grain Dealers Association in CP press release, May 3

“CN has received more than 200 additional letters in favor of CN’s proposed combination with KCS with the STB. This brings the total number of support letters CN has received to more than 600 in just over a week since its proposal was made public, far exceeding the number of letters that Canadian Pacific has received in over five weeks.” CN Press Release, April 29

“With eight straight quarters of margin improvement, it seems that BNSF remains less focused on market share gains these days. So, the competitive dynamic with UP remains favorable in our view. Meanwhile, Warren Buffett noted at Berkshire Hathaway’s annual meeting over the weekend that BNSF is not interested in bidding for KCS at such a high price.” — Scott Group, Wolfe Research, May 3

“We want to unleash the strength of the Union Pacific franchise, along with our improved service product, to reach more customers, integrate more deeply into customer supply chains, and grow carloads in a meaningful way.” — Kenny Rocker, Union Pacific EVP Marketing & Sales

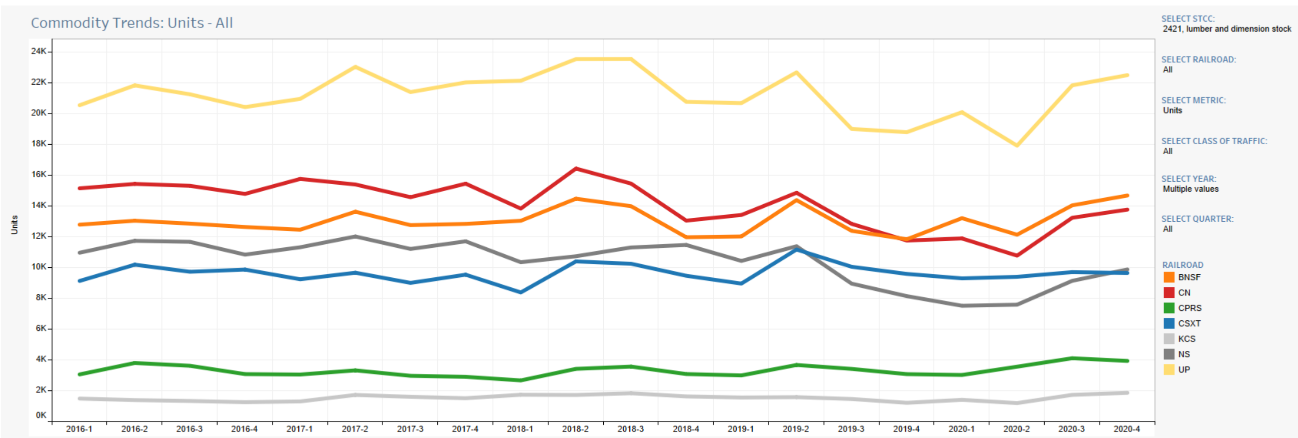
BNSF first quarter revenue units increased four percent to 2.4 million, mainly on a 15 percent consumer products (intermodal and auto) gain; freight revenue was off a point to $5.1 billion. RPU dropped five percent, though merch carload RPU gained 90 basis points on the 2.5 percent ag uptick. (Note that auto is about four percent of the total units ascribed to the consumer group.)

Total revenue lost 30 basis points to $5.4 billion, yet operating expense was trimmed two percent, yielding a four percent uptick in operating income — $1.9 billion. Net income rose five percent to $1.3 billion and the OR shed a point to 65. Clearly, Katie Farmer’s focus on Getting to Yes with the customer (WIR October 2, 2020) is paying off.

Six of the 17 AAR merch commodity lines reported increases. Most significant are grain (23%) and iron/steel scrap (29%), though the broader metals group was off 7% in carloads.Yet the tea leaves point to better days ahead for the construction sector. On Monday Raymond James Research said it was “raising our out-year estimates to reflect the bullish tenor of the debate over federal highway funding” and cited “already strong residential construction trends.”

And if that isn't enough, Barron's last week confirmed that "depleted inventories" of available homes pushed prices higher in February. The article concludes, "investors can expect the frantic run in home prices to continue." Which in turn means builders can charge more for new houses and still absorb the high cost of lumber, now well north of a grand a thousand board-feet.

BNSF is particularly well-positioned for this. While UP is the clear winner in terms of carloads, BNSF and CP are essentially tied for second place. My waybill sample tables suggest BNSF gets



$4,000+ per lumber carload, and BNSF reported 82,000 loads in 2020 — that's a cool $328 million, roughly six percent of their reported 2020 industrial sector carload revenue. They were up two percent year-over-year in 1Q2021, and at a run-rate pushing 90,000 cars.

Of the seven North American Class Is, BNSF reported the highest Q1 revenue and the highest number of revenue units. Though not first in operating income gains, BNSF was up four percent to UP's down seven percent. BNSF merch carloads were down four percent to UP's down five percent. And it continues. March revenue units were up an industry-leading 20 percent, and up 27 percent year-to-date.

And, speaking of KCS, a reader who follows such things tells me, "A huge amount of business -- almost all of BNSF's Mexico trade -- crosses the river at Eagle Pass, about 100 miles southwest of San Antonio. Back when, there was a train a day each way on the Eagle Pass branch. Now it's like 16 a day. BNSF obviously gets to Eagle Pass on UP trackage rights."

Right. They get off their own ex-Santa Fe Galveston line at a place called Caldwell, some 60 miles south of Temple. From there it's a straight shot to San Antonio and on to Eagle Pass. No wonder the Buffetteers weren't particularly worried about the KCS transaction.

The message of the Union Pacific Investor Day program Tuesday afternoon was quite clear. CEO Lance Fritz said, in essence, the demand for freight transportation is huge, and the more tools we have to meet customer supply chain needs, the better. As you will see, it was a railroaders' presentation for people who understand railroads. All the materials and videos are here, and let me add a few of my own observations made during the three-hour session.

The operating presentations were impressive enough, but here I want to focus on freight volumes and revenues. Kenny Rocker, EVP Marketing and Sales, posits a four-prong attack to gain new *profitable* commodity carloads. First, to "transform the sales culture" to a more consultative, problem-solving approach via closer personal interaction with customers. Second, to grow with PSR by leveraging its "solid service product" to generate increased customer value.

Third, to "advance the customer experience" through technology that gives UP a Unique Selling Point (USP) that differentiates the UP offering from the competition's. It goes back to the old saw that quality is in the mind of the customer, and higher perceived quality through the USP generates newer and stickier customers. Fourth, Rocker wants to expand the UP network reach by becoming a vital part of customer supply chains, thereby expanding the UP's geographical footprint.

It is here that the UP's non-Class I railroad relationships play a critical part. All four of Rocker's commercial goals — new business, a more creative sales approach, enhancing the USPs of Union Pacific service, and more supply chain involvement — are part and parcel of what the feeder network does best. Let me suggest you take a look at the bulk and industrial source maps (slides six and eight in Kenny's deck) to see what comes from where and how you can take part.

UP acknowledges that revenue and volume growth have lagged over the past few years. How much? In CAGRs, according to my calculations, over the past five years 2016-2020 revenue units have fallen 1.7 percent, revenue by 40 basis points, and operating income grew just 1.5 percent. The OR came down 3.6 points and net income increased by less than five percent.

CFO Jennifer Hamann says that in order to address this lag, their goals for 2022-2024 are to increase revenue units by a three percent CAGR, keep pricing increases at a rate that exceeds core inflation (also three percent?), attain incremental margins in the mid- to high-60 percent range, and achieve EPS growth in the low double-digit CAGR range.

All in all, the Investor Day experience was enlightening, to say the least. The direction UP is heading is quite clear, as are the ways customers, communities, and connections can benefit.