RAILROAD WEEK IN REVIEW

July 23, 2021

"I see the STB's interest in service level and recovery and resource commitments as certainly predating the executive order. And I know — from interactions that we've had with the STB, as well as the comments, the Chairman Oberman has made publicly — that that will continue to be a very heightened focus." —Pat Ottensmeyer, President and CEO, KCS

"Manifest carload growth was a key driver of our sequential and year-over-year improvement in volume with a 23 percent increase in lumber, driven by continued record commodity pricing, record propane volumes up over 20 percent, and a better than 150 percent increase in frac sand versus last year." — James Cairns, SVP, Rail Centric Supply Chain, CN

"We have kept our yards and terminals open and freight moving throughout the recovery and we will continue taking the necessary steps to add resources and increase fluidity in order to help customers meet their own growth targets this year despite the ongoing supply chain disruptions." — Jim Foote, CSX President and CEO

"Right now, we're really not seeing substantial problems hiring labor. We've got a couple of issues with very different skill sets — most of those are in our non-agreement workforce, like data scientists or machine learning scientists… Taking somebody out of a locomotive and putting them on the ground makes it a job that stays at home and turns it into shift work. — Lance Fritz, President and CEO, UP

KCS kicked off the 2Q2021 earnings season Friday. Freight revenue increased a whopping 39 percent to $712 million. Manifest carloads at 281,200 increased 30 percent, pushing that category of freight revenue up 39 percent to $578 million. System RPU gained seven percent to $1,218; manifest RPU gained seven percent to $2,054.

Several commodity lines turned in strong double-digit gains — Chemicals and refined petroleum products 37 percent, metals/scrap 24 percent, grain 23 percent, ores/minerals 11 percent; frac said and crude oil each more than doubled. Reported operating income plummeted to a $432 million loss, due solely to the $721 million in "merger costs;" without the merger fee it's $289 million, up 60 percent.

That fee will be refunded by CN at a later date but accounting rules stipulate the charge is to be taken as an operating expense in this quarter. The reported operating income number is according to GAAP. As a general rule I don't pay any attention to non-GAAP numbers but I think in this case the reported ops income seriously distorts the good work KCS has done strengthening the franchise. Thus the non-GAAP number shows a truer picture what the railroad is really doing.

The operating ratio before merger fees was a respectable 61.4, down 377 basis points year-over year. Reported net income was a negative $378 million; the net without the merger cost hit is $189 million, a near double. Cash from operations slipped three percent to $507 million; free cash flow after capex was $257 million, down 22 percent. There were no share buy-backs.

Ottensmeyer began the call saying they expect to see double-digit revenue growth this year, building on Q2s impressive results with a 60 OR this year, dropping into the 50s beyond. The quarter posted a 30 percent GTM increase but fuel burn in gallons per thousand GTMs hardly budged. There has been a commitment to keep all gateways open on commercially reasonable terms, and provide greater price transparency, specifically through rule 11 rates, through those gateways to satisfy any potential competitive concerns that might arise.

As is, KCS took maybe a 200 basis point hit to RPU thanks to network congestion, including car hire, crew positioning, elongated transit times, and incremental costs from resources KCS put in place to improve service and support future growth. Additionally, there was significant growth in lower RPU commodities like those related to energy.

CFO Mike Upchurch filled in some of the blanks, noting that two-thirds of Mexico's demand for refined petrol products is via imports, and most of that's coming from the U.S. over KCS, half in unit trains, half of it in manifest. Automotive took a $50 million hit from the chip shortage, though the OEMs are saying that issue will begin to subside in the fourth quarter.

The call concluded with Ottensmeyer's outlook for the rest of the year and 2022. "We expect the demand environment to hold up quite well as key macroeconomic factors, feedback from our customers and new business opportunities continue to give us confidence in delivering superior growth." As I see it, merger activities have been a bit of a distraction, buy they didn't get in the way of what KCS does best: creating customers and building long-term relationships.

Next up was CN Tuesday after the close. CN handled 1.5 million revenue units, up 14 percent; merch carloads including automotive were up 10 percent to 678,000. CN posted significant gains in mets/mins, automotive, petroleum/chemicals, and forest products. Freight revenue increased 14 percent to C$3.5 million while system RPU was unchanged, though grains/ferts dropped six percent and coal RPU dropped 20 percent.

Operating income increased nine percent to C$1.3 billion; after backing out last year's C$785 million charge against the loss on the sale of assets. The adjusted OR was 61.6 vs. 60.4 a year ago. Adjusted income without the equipment loss was C$2.4 billion, up five percent. Free cash flow was C$1.3 billion after capex, down 55 percent as there was no capex a year ago.

The Q&A on the KCS combo was most helpful. The comments of Ruest and others were direct, confident, and to the point. There was no hemming and hawing on the call. Asked about the effect of the Biden Executive order on the KCS action, Chief Legal Officer Sean Finn said the CN-KCS combo meets the Board's desire for "a fair, open, and competitive marketplace." In his

words CN is “looking at how do we ensure customers have more choices rather than fewer. And the Executive Order has some very strong comments we can build on.”

And I think the big take-way is in JJ’s concluding remarks: “Everything we filed and all the commitments made in terms of how we want to do this combination actually was done before the Executive Order came out. We did our homework.”

CSX had its turn Wednesday afternoon. Capitalizing on the sorry results of 2Q2020, CSX pushed freight revenue up 32 percent to $2.8 billion on 1.6 million revenue units. Merchandise carloads including automotive jumped 21 percent to 656,000 units. Twelve of the 18 AAR categories saw increases, led by chems, primary metals, STCC 24 wood products, and both scrap lines (waste and ferrous). All but metals posted RPU increases.

Operating income more than doubled to $1.7 million thanks to the RF&P sale to Virginia for $367 million. Here’s where I take exception to GAAP. That reduction of operating expense creates an uneven picture of how CSX is really performing. But taking it out still produces operating income of $1.3 billion, still up a respectable 62 percent. The reported OR was 43.4; take out the property credit and it’s still a solid 56 even, down 12 points for the year.

Net income including the property sale was $1.2 billion, another double. Operating cash flow increased 10 percent to $2.4 billion and free cash flow after capex but before dividends was $1.6 billion, up 19 percent.

On the call Foote said carload trip plan compliance was 69 percent, but gave no further details. He also said yard dwell was down to ten hours, and that gives me pause. My understanding of dwell time is it’s the number of hours between a car’s arrival in the receiving yard and its leaving the departure yard (unit trains and intermodal jobs don’t count). On-time arrivals were 67 percent against 78 percent on-time departures. But what really gets me is that CSX’ 10 hour dwell is half what we see on the other Class Is. And nobody brought it up in the Q&A.

On the other hand, the Q&A did gin up some commentary on service lapses related to crew availability. Foote had said in January that they needed 500 more qualified engineers and conductors and were hiring accordingly — even over-hiring to accommodate the usual six or seven percent attrition rate. For his part, COO Jamie Boychuk says that even though they have “a couple hundred” new faces running trains, they’re going to need at least that more and soon.

My over all impression is that CSX its getting its arms around the dual challenges of adapting an old-school railroad to more modern ways and doing it in the midst of the COVID turmoil. I think they’re well on the way toward better trip plan compliance as more crews and capex create a more fluid CSX. (Keep in mind TPC for feeder lines starts and ends at the interchange.)

Union Pacific rounded out the week's calls Thursday. Once again, a tone of confidence pervaded the call. There was the sound of new ice breaking (see Fritz quote above) and a strong outlook for the carload side of the house. Merchandise carload commodities all registered gains — mostly double-digits — during the quarter, making the sector up 16 percent to 846,000 units. Putting that in context, the total revenue unit count increased 29 percent to 2.1 million. Total freight revenues increased 29 percent to 5.1 billion while RPU increased six percent with increases in every commodity.

Within merchandise, grains, food/refrigerated, industrial chemicals/plastics, metals/minerals, forest products, and energy/special markets (crude oil and LPG) posted double-digit carload gains. Lumber and paper-related commodities were both up double digits. Even coal gained six percent on higher natural gas prices and demand for both domestic and export coal.

The 2021 revenue unit outlook calls for gains across the commodity spectrum, though the upward rate of change may be slowing in coal demand and auto production. Which tells me the regional railroads depending on merchandise carload volume ought to be OK.

The railroad is running better, creating a more desirable product for customers. Because 2020 was an aberration in the general scheme of things, UP did a series of 2Q2019 comps for a more accurate presentation of "normal" results. In that vein, fright car velocity and trip plan compliance for both carload and intermodal increased, though the TPC numbers in the 70s show there is yet more work to be done here.

Operating income jumped 50 percent to $2.5 billion as ops expense increased 17 percent against the 30 percent jump in total revenue to $5.5 billion; the OR printed at a cool 55.1, down six points. Gross ton-miles increased 22 percent against an 18 percent increase in fuel burn. Fuel efficiency (GTMs/gallon) slipped three percent to a still enviable 932. Net income increased 59% to $1.8 billion.

Finally, with respect to TPC, UP measures trip plans for shortline and regional railroad customers to and from the interchange. As UP moves to decrease unplanned events that cause TPC to deteriorate, the smaller railroad community can add its own interchange on/off times to the UP trip plan days. Customer dwell — actual placement to release event — can be a major factor in feeder railroad dwell times and must be managed accordingly.

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