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NSC - Norfolk Southern Corp at Barclays Industrial Select Conference

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Brandon Oglenski *Barclays Capital - Analyst*

PRESENTATION

Brandon Oglenski - *Barclays Capital - Analyst*

All right. Well, good morning, good afternoon. I'm not quite sure what time it is. I think it's almost lunch, but thanks, everyone, again, for being at the Barclays Conference.

Up next -- well, by the way, I'm Brandon Oglenski, airlines and transport analyst, but I think a lot of you know that now. Up next we have Norfolk Southern, and joining us from the Company is Alan Shaw, Chief Marketing Officer. And, Alan, I think you've been at Norfolk for --

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Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Twenty-three years.

Brandon Oglenski - *Barclays Capital - Analyst*

Twenty-three years. Okay. And I know we have a lot to cover here, but you guys have had an interesting story the past couple of years here. We've literally just had Keith Creel from CP onstage, and, as a lot of folks in this room probably know, CP did make a public offer for your company last year, but you guys did come through with your own plan and obviously made a case that maybe mergers weren't the easiest thing to push through the regulatory environment. So I know we definitely want to talk probably a lot about what the new plan is for Norfolk and the path forward.

But just to give some folks some context, your business today is greater than 20% intermodal, right, (inaudible) strength of the franchise. And coal is still another 15% of revenue. But then you do have auto is about 10% and metals another 10% to 12%. So we'll talk a lot about the business mix.

But just to also give some folks some context, if you went back maybe a decade ago, Norfolk was viewed as one of the better railroad stocks. Obviously you guys had a leading margin position at least within the US carriers.

But the industry has improved quite a bit, as well, so kind of for the East Coast carrier definitely matching what CSX is doing from a profitability perspective, but some of the West Coast and the Canadian carriers have improved returns and margins. So we want to talk about that, as well.

But before we even do that if we could just queue up the ARS questions. So, No. 1, for the room, do you currently own Norfolk? One would be overweight, two equal weight, three underweight, and four would be no ownership. That's pretty good ownership representation, actually, for this conference.

If you can go to Question No. 2, please, what is your general bias towards Norfolk right now: positive, negative or neutral? Pretty fairly balanced there.

And Question No. 3, please, in your opinion, through cycle EPS growth for Norfolk will be above peers, in line with peers or below peers? Okay.

So let's start off from there, Alan. Can I ask, are you guys just breathing a sigh of relief right now that Mantle Ridge is down at CSX and maybe not at Norfolk?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

No, we're not. We're completely focused on our plan. Our head's down. We delivered on the results that we said we were going to deliver on in 2016 in a very difficult environment.

This year we've got some tailwinds behind us, and we fully expect and know that we'll deliver on our operating ratio goals for this year. Ultimately we'll get to a sub-65 operating ratio by 2020.

It's a great plan, flexible, dynamic. The fact that we were able to deliver last year in a difficult truck and commodity environment shows our ability to proactively manage through change.

Brandon Oglenski - *Barclays Capital - Analyst*

Well, and I think one of the biggest challenges, and we shouldn't be too critical of this, for the East Coast railroads is the level of profitability of the coal business. And I think if we go back to your peak year you guys did maybe $3.5 billion in coal revenue, and today down closer to $1.5 billion, right? So you've lost $2 billion in coal revenue.

Can you talk to folks in the room and just explain the difference between the coal and non-coal businesses, and if there is a margin differential there, which I think historically we've always pointed to as being the better business for the railroad, and how that's been a significant headwind in recent history?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

So, our coal franchise is going to grow this year. We firmly believe that. You see natural gas prices are elevated above where they were last year. There is a little bit of headwinds associated with warmer weather in the South. And so we're seeing more growth in the North than we are in the South. So that'll have an impact on our RPU.

As you know, our utility north shipments tend to be a shorter length of haul than our utility south. That's going to be balanced by the fact that our export coal franchise is doing very well, supported by the increased demand for seaborne coke and coal.

So we had talked on our call about 17 million to 19 million tons for the quarter for utility coal. It's probably going to be closer to that 17 million-ton mark. However, we also talked about 3.5 million to 4.5 million tons for export, and we'll exceed that in the first quarter of this year.

There's a lot of volatility there associated with exported, you see the volatility in the major index. But we feel good about our coal franchise going forward.

We've got a great network. We compete with truck. And there is a wonderful opportunity to pull more trucks off the highway in 2017 and beyond as we leverage the improvements in our service product and generate high-quality revenue.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. Coming back to coal real quick, it is probably better than average profitability on the network. Is that a fair statement to make?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Yes. What we've talked in the past is kind of incremental revenue to our network. Generally merchandise has the best incremental, highest incremental margin. But that's kind of a rule of thumb. It can be dependent upon where the business comes on, what kind of markets we're serving.

But we run a scheduled network with merchandise, so you add a couple of cars to a train that provide some incremental benefit. That's followed by coal, and then that's followed by intermodal due to some of the direct intra-terminal costs that we have in our intermodal franchise.

But we're very focused on improving the quality of revenue and the pricing in our intermodal franchise. And we feel like we're going to be able to do that this year as trucking capacity tightens, the economy improves. We've seen the inventory sales level has declined to the lowest level since 2014, and our service product is at a position where we can pull highway-to-rail conversions.

Brandon Oglenski - *Barclays Capital - Analyst*

Well, I definitely want to talk about the macro and what you guys are seeing in your book of business, but just to round out the conversation on coal, so this year we are seeing growth, but that's off of arguably too low delivery levels to domestic utilities last year, right? So should investors be thinking that with -- I'm not sure where natural gas is trading today, but --

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Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

$2.64.

Brandon Oglenski - *Barclays Capital - Analyst*

Well, even worse than $3.00. But let's say the outlook's right for $3.00 to $3.50 gas, which has been volatile, too.

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Yes.

Brandon Oglenski - *Barclays Capital - Analyst*

Is coal a business that you can maintain at this level, or should we be thinking this keeps going down 3% to 5% a year?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

So, we've guided on our earnings call that over our five-year plan we would have an increase in coal this year. Because, as you noted, it was abnormally low due to the winter weather last year. And, as you're aware, from February through May of last year natural gas averaged $1.88 per million BTU. That's not sustainable.

So natural gas is up. It's not up as much as we would like. It's up. It's supporting coal burn in our franchise.

We have a diverse portfolio in our utility market. About 50% of our volume comes from the Illinois Basin and the PRB. The other 50% comes from Northern App or Central App. After the growth this year we see it sustained, the volume sustained or declined slightly.

You know, another area where we're seeing a lot of strength this year is in metallurgical coal, in our metallurgical markets, as our integrated steel mills are a little bit more confident than they were last year.

As you know, steel prices for hot rolled coil steel are up about 60%. Capacity utilization in the steel market is up. And we're participating in changes to the supply chains in our integrated steel mills.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay, well, more on the macro, and we've been talking about the two-year industrial recession effectively we've had in North America. For sure that impacted rail demand, as well.

Are you seeing the recovery in your business right now that gives you a pretty bullish view of where we are, at least on industrial production, and maybe more broadly the economy? You touched on intermodal. But what can you tell our audience about where you think we are in the cycle?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

So, over the last couple of months you've heard a lot about sentiment and you've heard a lot about optimism and momentum. Now as the economic numbers are coming out you're starting to see some hard economic data that support strength in the economy.

And it's with the consumer, it's with consumer spending, it's with retail sales, it's with the latest jobs number. You're seeing the inventory to sales ratio come down to 135, whereas previously it had been up about 150, which limits trade and transportation.

You're also seeing it in energy investment, and you're seeing it in industrial production, most pronounced in manufacturing and in mining, which includes coal and oil and gas production.

So we're seeing some strength in the economy. It's kind of similar to what we had thought we would be seeing when we talked about our five-year plan on our call in January.

Brandon Oglenski - *Barclays Capital - Analyst*

And for the room's benefit, can you just help us out? What was the long-term growth trajectory of that plan, again?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Sure. So (over the four years) we guided to about 4% growth CAGR in intermodal, and merchandise would be about 2% growth CAGR, kind of along the lines of GDP.

We feel like our automotive franchise, the US vehicle production has sort of hit a plateau, which is okay. It's going to be down about 3% this year, the latest forecast, though the January numbers, as you know, were pretty strong.

And then coal, as we've talked about at length previously, is kind of flat to declining slightly (after this year).

If you look at our numbers quarter to date (for total carloads), they're up a little bit over 5%.

But I do want to caution you and the audience that we were coming off a pretty easy comp. So we had a very sluggish start to our volumes last year in January.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. And more specifically on intermodal, it sounded like you're pretty bullish on the outlook there. What is the opportunity set for Norfolk? I think you guys have been outperforming your closest competitor.

There's a lot of discussion around pricing for rails right now, and I know investors are very keen to ask that question. So is it competition with truck? Is it competition with your closest rail partner? And what's the opportunity for Norfolk specifically?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

It's absolutely competition with truck. That is our primary form of competition. We want to take freight off the highway.

And it doesn't necessarily need to go into an intermodal container. It can go into a boxcar. It can go into a gondola. It can go into a hopper. It can go into a multilevel.

It's all predicated on leveraging the good service product that we have, improving the customer experience, getting closer to our customer with technology and transparency, and then leveraging that to bring in high-quality yields. We understand that we have to price above rail inflation and we have to bring in high-quality yields to support our business and our long-term shareholder value.

Brandon Oglenski - *Barclays Capital - Analyst*

Well, so, can we talk about that? And, by the way, I'm sure the audience knows if you want to email questions there's an email address here. My team will read them out anonymously. Or if you just want to ask one raise your hand. We'll get a mic to you. I don't see any right now, but go ahead and stick them up if you want.

Your plan, I think, by 2020, and correct me if I'm wrong, is to get to a 65 operating ratio, which would be a 35% EBIT margin, which I think is good from where you guys are. But given the fact that Union Pacific is targeting long term a 60 OR I think by 2019 or 2020 and a 55 OR beyond that, we have two Canadian railroads today that, granted they benefit a bit from FX and the translation of the margins that are sub-60 today, I guess a lot of investors would ask, just given changes that are going on at one of your close competitors, why not be more aggressive on the outlook?

Especially as volumes come back we're getting a little bit more growth in the network. Is there more that can be done on the cost side?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

We've got a great team working on a clear plan. And it's a balanced plan. It's a sustainable plan that drives long-term shareholder value through both productivity and growth.

And that is the key. We are going to focus on a service product that allows highway-to-rail conversions within the East. That's a unique aspect of our network.

And we're going to focus on pricing of that, bringing pricing discipline and high-quality yields. We're going to look for every opportunity to improve. We're going to look at every new idea.

You saw last year, our productivity improvements were about $250 million, which, Brandon, as you know, is about double what we had originally guided to. We accelerated that proactively as we saw that our markets were not materializing as we thought. I talked earlier about the very slow start to the year.

We also changed our capital plan twice midyear, pulling down capital by about 10%, very consistent with what we did in the second half of 2015. So we're looking through every avenue. It's part of our culture each and every day to try and improve both our pricing, our growth, our service and our productivity, and we're not going to stop at a sub-65 operating ratio.

Brandon Oglenski - *Barclays Capital - Analyst*

Well, can you talk about the service improvement? What are the metrics you guys are managing to? What are you looking to specifically improve? And how does that drive price and top line (multiple speakers)?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

So, broadly we talk to the investment community about the composite service metric, and that was above 80 for last year. And then individually with our customers we measure what's important to them.

The composite service metric is a wonderful network performance tool. We talk specifically to our customers of what they value.

It could be consistency, whether or not we're placing a car within the window of the original ETA. It could be availability, whether or not the intermodal container is on the chassis in Chicago when we told the customer to expect it. And so it's not a one size fits all. It's very targeted and very specific to each of the markets that we serve.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. Any questions? So, Alan, I guess on that something that we focus on quite a bit is labor productivity. And I think you guys are running, I don't know, 27% to 29% operating ratio of labor cost. And if you look at some of the railroads that, again, are at lower operating radios, that metric can be a lot closer to 20%, 22%.

And I know Jim Squires, the CEO, and we've talked with Marta, as well, your CFO, about headcount plans. I think you're around 28,000 employees right now.

But you do have the lowest GTM productivity, so gross ton miles. And sorry if we're getting too many acronyms for the room, but effectively a good measure of productivity for a railroad, right? You create gross ton miles.

Now, you do have the shortest length of haul, so we do need to put that on a curve. But I think even when we look at some of the better productivity metrics for the industry you guys are falling a little bit below. So do you view labor as a big part of that productivity and service piece as you look forward?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Yes, absolutely, Brandon. That's a very valid point. We have said clearly that of the $650 million in productivity savings about $420 million of that will be through compensation. So that is productivity.

Just last year we reduced our overtime by 38%. We reduced our re-crews by 28%. So we're working each and every day to improve labor productivity, locomotive productivity, fuel productivity and the utilization of all of our assets.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. But I guess if we put this all together you guys have guided to an improving operating ratio this year, right?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Yes.

Brandon Oglenski - *Barclays Capital - Analyst*

But the magnitude of that improvement we'll have to see at the end of the year. Is that right?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Yes. We said that we would not have a straight-line improvement year over year in operating ratio. It's going to improve this year.

We know it will. We fully expect that it will. We'll recognize that we had $250 million in productivity savings last year.

Those are sustainable, and we're going to build off of those this year. We just don't anticipate that we're going to have that level of productivity savings on top of that this year.

And also recognize, and I need to make this very clear, that the reduction in fuel prices last year particularly in the first half of the year, benefited our operating ratio. So you think about in the first quarter of last year WTI was about $33.50 a barrel, and now it's up 60%. On-highway diesel was up, was about $2.09 a barrel, so that is now up about 30%, 40%.

So all in all in the first quarter of last year our fuel surcharge revenue was down about $115 million, our fuel expense was down $114 million. Net-net, that's fine for EPS, but for an operating revenue, where the revenues are on the bottom, that was 150-basis-point tailwind to our operating ratio.

So, as fuel prices go up, even though that helps the rail industry as we compete primarily with truck, it puts more pressure on the operating ratio. Does that make sense?

Brandon Oglenski - *Barclays Capital - Analyst*

It does. I mean, we get it, because fuel is effectively a passthrough in this business, so as fuel cost goes up obviously your revenue and costs go up, likewise, but your margin (inaudible) comes lower.

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Well, the margin is effectively -- EPS is the same, net income's the same, but what it does is it hurts your ratio.

Brandon Oglenski - *Barclays Capital - Analyst*

Right.

QUESTIONS AND ANSWERS

Brandon Oglenski - *Barclays Capital - Analyst*

I think we might have an email question.

Unidentified Participant

Yes, so yesterday we heard from JB Hunt, which is an intermodal partner of yours, and they were a little less optimistic about the economic environment currently. Could you just talk maybe about given your focus on service and what you're seeing in the intermodal space, could you just talk about how you see the current domestic freight environment, and kind of what your outlook is in terms of that?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Yes, as we talked about, we're starting to see some economic data that shows there's better economic strength out there. The big assist and the big help, in addition to our service product, on a macro standpoint is going to be the implementation of electronic logging devices in December of this year.

And so we think as the year progresses truck capacity is going to tighten, and it'll also support our pricing plan as the year progresses. It'll be -- we fully believe we'll be in better shape toward the second half of the year than it is right now.

Brandon Oglenski - *Barclays Capital - Analyst*

And I guess on-truck capacity, do you have any other insight into kind of what's causing some of the persistent looseness in the market?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

It's tighter than it was this time last year. I think it's basically been a function of economic activity.

There has not been a lot of industrial production, a lot of manufacturing growth in the United States. A lot of that has to do with energy investment. And so that's been a headwind within trucking.

Also, the inventory levels were elevated for about a year and a half. And as those cleared, that put an impact on, a negative impact on supply chains. So now with inventory levels closer to normal, we feel much better about activity moving forward.

Brandon Oglenski - *Barclays Capital - Analyst*

And I guess along those lines, and, again, if you guys want to ask questions, just raise your hands. I don't want to miss anyone over here.

Unidentified Participant

We actually had another one just come in on email.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay.

Unidentified Participant

So, I guess, in the context of Hunter potentially getting the CEO role at CSX, and if you were to target a sub-60 OR, how much of the business could potentially be at risk, and how does that change the calculus of your strategy going forward?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

I don't want to speculate on what may or may not happen within Jacksonville and what that does to the industry. I can tell you that we're going to look for opportunities each and every day to drive shareholder growth, and we're going to look for pricing opportunities, and we're going to look for every opportunity to add high-quality revenue that fits within our franchise and where we can leverage our improved service product. And we're going to continue to look for new ideas to focus on our productivity and our asset utilization.

Brandon Oglenski - *Barclays Capital - Analyst*

Well, coming back to the market side, your customer base, we've talked a lot about at this conference the past day and half just unleashing the animal spirits, all right? We've obviously had a big change in D.C.

Have you seen that with your customer base? I mean, are people excited about the potential reforms that we could see from a tax perspective? Has Norfolk thought about a border adjustment tax? Is that a net positive for your company?

And are your customers talking about these things? Is it creating more opportunities or more risk? I know it's a lot of unknowns right now because we have no certainty out of D.C.

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Yes, at this point it's all theoretical, isn't it? I will tell you, though, as I talk to our economic development partners and I talk to our own industrial development group the level of activity in our project pipeline and our economic development partners project pipeline is at a two- or three-year high. So that's a pretty good indication.

More broadly I'll tell you that Norfolk Southern prefers public policy that lowers corporate income taxes, incents manufacturing and production within the United States, incents consumer activity within the United States.

We're a trade company. We work with many, many of our customers who participate in international trade. And so we're monitoring the situation closely. At this point it's ill-defined.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. Can we queue up Question No. 4 here for the audience? In your opinion, what should Norfolk do with excess cash? The first couple of questions are -- or first responses are M&A, share repurchases, dividends, debt paydown, internal investment. Share repurchase has taken a pretty large share there.

But from your perspective, where would you like to see the capital budget at Norfolk? I mean, I know you guys have a lot right now tied up in PTC and obviously a very large maintenance budget, but are you incrementally excited to raise maybe the capital you're putting at risk here because of some of the things you're seeing come through the development pipeline?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

No. We've got our capital plan for 2017. We're going to wait to see what happens with markets before we proactively adjust it. I doubt that we're going to be potentially adding capital to our plan for 2017.

Our capital deployment is pretty clear. It's focusing on safety and service and maintenance of the assets, targeted growth opportunities that we believe deliver high-quality yields and high-quality returns to our shareholders. It's dividend payback ratio of about 33% over the long term of our earnings. And then it is share repurchases. And this year we've announced -- our Board has announced about $800 million at share repurchases.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. Could we queue up Question No. 5, please? In your opinion, on what multiple of 2017 earnings should Norfolk trade? Obviously rail equities have done pretty well here recently. Kind of right where we're trading today.

And, lastly, Question No. 6, what do you see as the most significant investment issue for Norfolk Southern: core growth, margin performance, capital deployment or execution and strategy? Growth and margin performance.

And I guess just to round this out, Alan, because we are about out of time here, but when you look forward to the plan, what's the biggest component, again, to delivering on those shareholder targets by 2020? Is it the growth in the system, and as we get a better environment for growth is Norfolk going to potentially deliver ahead of schedule? Or what's the opportunities, what's the risks as you see it?

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

I'll tell you, there's three major tenets of our long-term plan, and everybody at Norfolk Southern understands this. It's a combination of delivering safety and service. It's productivity. And it's growth. And they all feed off each other.

We're not going to -- we can grow because we have a much better serviced product, and that's going to drive better utilization of our assets and better network performance and better service. So they all work together in conjunction to provide that operating ratio of sub-65 by 2020.

And I'll tell you, the end is fixed. Our goal is fixed. We're going to get there. How we get there, the means, are flexible and dynamic, as we showed, in 2016.

Brandon Oglenski - *Barclays Capital - Analyst*

All right, Alan. Well, I do approximate you coming down to Miami and participating here.

Alan Shaw - *Norfolk Southern Corp - EVP and Chief Marketing Officer*

Thank you for the invitation.

Brandon Oglenski - *Barclays Capital - Analyst*

Thanks.
