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NSC - Q1 2016 Norfolk Southern Corp Earnings Call

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OVERVIEW:

Co. reported 1Q16 revenue of $2.4b, net income of $387m and diluted EPS of $1.29.

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PRESENTATION

Operator

Greetings and welcome to the Norfolk Southern Corporation first-quarter 2016 earnings conference call. At this time, all participants are in a listen-only mode and a question-and-answer session will follow the formal presentation. (Operator Instructions) As a reminder, this conference is being recorded.

I'd now like to turn the conference over to your host, Ms. Katie Cook. Thank you, Ms. Cook. You may begin.

Katie Cook - *Norfolk Southern Corporation - Director of IR*

Thank you, Chris, and good afternoon. Before we begin today's call, I would like to mention a few items. First, the slides of the presenters are available on our website at norfolksouthern.com in the Investors section. Additionally, transcripts and downloads of today's call will be posted on our website.

As noted in our disclosures found on slide 2 of our presentation, please be advised that during this call, we may make certain forward-looking statements. These statements are subject to a number of risks and uncertainties, and our actual results may differ materially from those projected. Please refer to our Annual and Quarterly Reports filed with the SEC for a full discussion of those risks and uncertainties we view as most important.

Additionally, keep in mind that all references to reported results, excluding certain adjustments, that is non-GAAP numbers, have been reconciled on our website in the Investors section.

Now, it is my pleasure to introduce Norfolk Southern's Chairman, President, and CEO, Jim Squires.

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Good afternoon, everyone, and welcome to Norfolk Southern's first-quarter 2016 earnings call. With me today are NS's Chief Marketing Officer, Alan Shaw; our Chief Operating Officer, Mike Wheeler; and our Chief Financial Officer, Marta Stewart.

We'll share our details of our strong first-quarter financial results with you momentarily, but let me begin by saying how proud I am of the men and women of Norfolk Southern who are so successfully executing our strategic plan. Their flexibility and initiative are driving shareholder value even in the midst of a challenging and ever-changing marketplace.

Turning to our results on slide 4, our team delivered a record-setting first-quarter operating ratio of 70.1%, 630 basis points lower than last year's first quarter. This performance was in the phase of weak commodities, a strong dollar, and coal volumes down 23%. Norfolk Southern's earnings for the first quarter were $1.29 per share, 29% higher than last year's $1 per share. Marta will go over the details shortly.

We were able to generate these results, thanks in large part to improved network performance. Mike will follow with an update on operations, but let me highlight here that our team increased the composite service measure by 23%, increased train speeds by 15%, and reduced terminal dwell by 14%. These strong improvements helped us control costs while enhancing the value of our product.

Better service is, of course, a prerequisite to growth and a foundation of our strategy. It is what allowed us to grow in the first quarter in markets like automotive and intermodal, even within a challenging macro environment. Furthermore, this focus on improved service helped to counterbalance weakness in commodities like coal and crude oil. Alan will share all the details of our topline results in a moment.

With respect to our strategic plan, and as noted on slide 5, our focus on strengthening Norfolk Southern is yielding results. We are now on track to achieve productivity savings of about $200 million for the full year, up from our previous target of $130 million. And we still expect to achieve a full-year operating ratio below 70.

Last quarter, we showcased a number of initiatives to rightsize our asset base. As this year progresses, we continue to explore and implement additional initiatives, including, as we announced yesterday, our reduced train operations at Knoxville Yards. By 2020, we expect to achieve annual productivity savings of over $650 million through cost reductions and labor, materials, fuel, and purchase services.

Our plan is dynamic, and our longer-term expectations include growth in both pricing and volumes. As previously noted, we are targeting 2.5% compound annual growth in pricing and a similar rate of growth in volumes over the five-year plan period. Our goal, as we have said, is a sub-65 operating ratio by 2020, accompanied by double-digit compound annual growth in EPS. Based on our strong first-quarter results, we are clearly moving in the right direction.

Our plan also provides for significant return of capital to shareholders. Over the past 10 years, Norfolk Southern distributed nearly $15 billion through share repurchases and dividends. This year, we plan to distribute $800 million through share repurchases while continuing a steadfast commitment to maintaining our dividend.

We have the right team in place. They have demonstrated their ability to perform. Delivering superior shareholder value is their abiding objective and mine. I have every confidence, as shown by our strong start to 2016, that this team will go above and beyond to produce results.

I will now turn the program over to Alan, Mike and Marta, who will provide more details on our 2016 results and outlook, and then return with some closing comments before taking your questions. Alan?

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

Thank you, Jim, and good afternoon to our audience. We appreciate your joining us today.

On slide 7, you can see that our first-quarter revenue declined 6% year-over-year to $2.4 billion. A majority of the decrease was attributable to lower on-highway diesel and WTI prices, which reduced fuel surcharge revenues compared to last year. The remaining decrease in revenue was due to a 23% decline in coal volume, driven by unseasonably warm weather and to the Triple Crown restructuring. Coal now represents less than 15% of our revenue, down from 29% in 2010.

Excluding the impact of Triple Crown, our volumes were relatively flat despite the declining commodity markets, due to our diverse portfolio and improved service product. Revenue per unit less fuel increased year-over-year for the third quarter in a row as a result of our pricing focus, which more than offset the negative mix impact from increased intermodal volumes and declines in higher-rated commodities.

As you can see on slide 8, merchandise revenue increased 2% in the first quarter of 2016 with a 3% increase in volume. Volume grew in all business groups, except chemicals, which was impacted by decreased crude oil shipments. Automotive volume was up 18% in the quarter, exceeding North American vehicle production growth of 5%, with relatively easy comparisons from last year.

We do not anticipate year-over-year growth to continue at this level. Comparisons will become more difficult as the year progresses. For the year, we anticipate growth to be better aligned with North American vehicle production, which is now projected at an annual growth rate of 1.4%. Coil steel and plastics benefited from automotive production, while housing and construction activity drove growth in aggregates, cement, and lumber.

Turning to intermodal on slide 9, overall volume was flat, notwithstanding the impact of the Triple Crown restructure. Excluding our Triple Crown subsidiary, intermodal volume increased 6%, with a 15% increase in international business resulting from our network reach and service. Domestic growth, excluding Triple Crown, was impacted by the inventory overhang that we discussed last quarter, though volumes improved sequentially each month as a result of service gains.

Lower volumes of higher-rated Triple Crown freight and lower fuel surcharge revenue decreased intermodal RPU by 12%. However, excluding the impact of Triple Crown and fuel surcharges, intermodal RPU increased 1%, as pricing initiatives offset the negative mix associated with increased international volume and truck capacity.

Moving to the coal market on slide 10, utility coal met our previous guidance of 15 million tons for the quarter, a decrease from last year due to warm weather and low natural gas prices. Exports slightly exceeded our guidance of 2.5 million to 3 million tons for the quarter. Other challenges continue to be -- continue in an oversupplied global market. We maintain our previous export guidance through 2016.

Excluding fuel, revenue per unit increased 3%. RPU was positively impacted by $10 million in liquidated damages in the first quarter, as rate increases were offset by unfavorable changes in the mix of business.

As referenced on slide 11, warm weather in our service territory continued through March, resulting in stockpiles well above average levels. We expect this impact to extend into at least the fourth quarter, and anticipate utility volumes continuing at the first-quarter pace until stockpiles return to target levels, assuming normal weather patterns.

Concluding with our outlook on slide 12, coal volumes in 2016 will be impacted as utilities work down the stockpiled buildup resulting from the warm winter. Low oil and gas prices have significantly reduced rig counts and drilling activity, which will negatively impact our volume of crude by rail as well as natural gas drilling inputs, including frac sand and pipe.

The Triple Crown restructure will dampen intermodal volume for the rest of the year. Longer-term, our improved service product, combined with increased regulation in the trucking industry, provides stronger growth opportunities for domestic intermodal. Additionally, international intermodal volume benefits from our alignment with shipping partners adding capacity to the East Coast.

Our pricing outlook is favorable, reflecting the value of our service product. Our lower on-highway diesel and WTI prices, and associated fuel surcharges, continue to affect topline growth; that impact has greatly subsided.

We focus on growth by providing a service product the market values, while negotiating market-competitive prices. This quarter, our improved service levels especially benefited intermodal and automotive, and allowed Norfolk Southern to aggressively manage through the changing economic environment.

While executing against our strategic plan, we are enhancing shareholder return by successfully operating a network that efficiently and fluidly handles a diverse portfolio of business, and strategically inserting NS as a valued component of our customers' supply chains, which will generate greater opportunities for growth, even as individual markets fluctuate.

Next, Mike will describe operational improvements that have reduced our costs and enhance the value of our products.

Mike Wheeler - *Norfolk Southern Corporation - EVP and COO*

Thank you, Alan. I am pleased to announce that we are continuing to operate at high service levels while also making significant strides in our cost reduction initiatives. Thanks to the commitment and focus of our employees on executing these key drivers of our strategic plan.

The following results are a validation of NS employees' hard work. Let me begin with one of our core principles on slide 14, which is safety. While our injury ratio saw a slight uptick in the first quarter, as compared to the same period last year, we have actually seen a 5% improvement in our injury count. However, this was more than offset by a reduction in hours worked. We also achieved a reduction in the number of serious injuries, resulting in an improvement in our serious injury ratio.

Turning to service, on slide 15, you can see we are maintaining the high service levels we delivered in the fourth quarter. We have achieved this while aggressively and successfully pursuing cost-reduction initiatives, which is something we committed to on our last call. We remain confident we can continue to keep service at a high level while we focus on identifying and implementing further cost reduction initiatives.

As you can see on slide 16, our speed has continued to improve, which has aided our asset utilization. We are continuing to operate at our historic highs on this key metric. Dwell increased from the fourth quarter, due in part to seasonal impact, but we were significantly below first-quarter 2015. We are encouraged that our overall velocity, as measured at the car level, is near our previous record levels.

Taking a look at our resources on slide 17, we continued rightsizing our workforce in the first quarter to match the business levels. These reductions occurred in all the operating departments. We had 1,300 T&E employees furloughed at the end of the quarter, along with 450 non-T&E employees. We are in the process of recalling approximately 500 T&E employees to prepare for seasonal volume increases and to cover attrition; although for the full-year, we are ahead of our plan for headcount reductions, which Marta will update you on later.

On the locomotive side, aided by our high velocity and the execution of our strategic plan to run a more efficient and profitable railroad, we continue to rationalize our locomotive fleet. In addition to currently storing high adhesion road locomotives, we have rightsized our yard and local fleet. A total of 150 units have been removed from this fleet, representing a 12% reduction.

We accomplished this without negatively impacting customer service levels. In addition, we plan to add 50 new locomotives in the second quarter, which will allow us to remove less efficient road locomotives from the fleet.

Now, on slide 18, the cost-reduction initiatives just discussed, coupled with our efforts to keep the railroad operating at a high-level, have resulted in significant productivity savings. Through the first three months of the year, we have been able to realize significant improvements in key areas.

Our 2.8% reduction in crew starts has outpaced our drop in volume, driven in part by our improvement in train length. That percentage is even higher when considering the sharp reduction in recrews, which, along with the drop in overtime, is indicative of a very fluid railroad. All of these together are driving improved productivity, as seen in the gross ton miles per T&E employee; so certainly, some positive results.

As Jim stated, this is indicative we are ahead of our $130 million productivity savings, and now expect $200 million in productivity savings for the full-year. Some of this was front-end-loaded due to the benefit of not having last year's weather and service costs in the first quarter.

On slide 19, I would like to update you on the status of our previously-announced additional cost reduction initiatives. We have ceased road operations on the West Virginia secondary as well as completed the consolidation of the Pocahontas and Virginia divisions. We also continued to make progress with the idling of the Ashtabula coal terminal, which should be completed in the second quarter.

As seen on slide 20, we have also consolidated our operational alignment from three regions to two. In addition to reducing regional supervision across all departments within operations, this initiative further streamlines our network, and improves communication and coordination across the railroad.

Lastly, on slide 21, we have also made significant progress with our yard rationalizations. We have been executing on this rationalization of our operation for several years, starting with the idling of Buckeye Yard in Columbus in 2009, continuing with Roanoke in 2013, and now, Knoxville, Tennessee.

As recently announced, we are idling terminal operations at our hump yard in Knoxville, effective May 1st. 130 positions will be impacted by this reduction in operations. The annual savings on this initiative is approximately $13 million. Our ability to realize these savings is due in large part to our expansion at our Bellevue hump yard and the capacity that has given us.

In addition, we have curtailed activities at many of our smaller yards. In all, we have reduced or rationalized yard operations at 25 locations across our system.

We see a lot of positive signs from our operation, and we will continue to execute our tactical and strategic cost control initiatives, and at the same time ensure we continue to provide a great service product to our customers.

Thank you. And I will now turn it over to Marta, who will update you on the financials.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

Thank you, Mike, and good afternoon, everyone. Let's take a look at our first-quarter financials, starting with operations.

Slide 23 summarizes our operating results compared to last year's first-quarter and, as Jim already mentioned, reflects a record-setting 70.1 operating ratio. As you know, the first quarter historically has the highest OR of the year, and so this result is very supportive of our anticipated full-year operating ratio, below 70.

Revenues, as Alan described, were down 6% in the quarter. However, this was offset by a larger decline of 13% or $264 million in expenses. The net result was an increase of $117 million or 19% in income from railway operations.

Taking a look at slide 24, the 13% decline in operating expenses reflects the aggressive efforts our team has taken to reduce expenses and control costs. Every cost category, except for depreciation, declined in the quarter. Let's take a closer look at each of the components.

Slide 25 depicts the significant drop in fuel costs. As you would expect, most of the decrease is price-related. In addition, consumption per unit improved, as gallons of fuel used declined by 4% on the 2% reduction in traffic volume.

Turning to slide 26, compensation costs were down by $60 million or 8%. As Mike discussed, our efforts to minimize overtime and recrews, combined with a lower overall headcount, resulted in $45 million of lower payroll. Commensurate with the reduced compensation base was a lower level of payroll taxes, which were down $13 million.

Additionally, we lapped the $11 million in cost related to last year's signing bonus, and have $10 million in lower pension expense. These items were partially offset by health and welfare rate increases of $15 million.

As shown on the lower left of the slide, our average headcount for the quarter declined by about 1,900 positions, both for the year-over-year and the sequential comparison. As Mike described, some of this is seasonal, and we now expect a full-year headcount reduction of 1,500 versus the 1,200 from our previous forecast.

Slide 27 details our Materials and Other category, showing a decrease of $52 million or 21%. Reductions totaling $42 million were due to a decline in all areas of material usage -- in locomotives, freight cars, and roadway. The largest drop was in locomotive materials, as a result of the 7% decline in locomotives in service.

In addition to the decreased number of locomotives, we greatly reduced locomotive overhauls, and strategically utilized parts from the fleet of DC locomotives that are slated for AC conversion. Additionally, fewer freight cars and the mild winter weather also contributed to lower material usage. For the remainder of the year, we expect the decline in materials to moderate to about a $10 million quarter-over-quarter favorable variance.

Moving on to slide 28, purchase services and rents were down $44 million or 10%, largely due to $34 million in lower Triple Crown costs associated with its much smaller operations. Additionally, expenses related to engineering and transportation services declined by $10 million, and equipment rents were down $3 million, notwithstanding the strong automotive volumes as velocity-related benefits offset these volumetric effects.

Turning to income taxes on slide 29. The effective rate for the first quarter was 35.5% versus 37.4% in 2015. A combination of small items, including a state tax law change and corporate-owned life insurance proceeds, slightly lowered the rate. For the remaining quarters of this year, we continue to expect a roughly 37% effective income tax rate.

Slide 30 shows our bottom-line results, with net income of $387 million, reflecting an increase of $77 million or 25%, and diluted earnings-per-share of $1.29, up 29% compared with last year. We're making solid progress and remain committed to continued improvement.

Wrapping up our financial overview on slide 31, cash from operations for the first three months was $879 million. Capital spending through the first quarter was approximately $400 million. Due to the reduction in traffic volume, we have revisited our capital plan and have modestly reduced our full-year capital budget from $2.1 billion to $2 billion even.

Turning back to cash flows, the improved operating cash and level CapEx resulted in free cash flow of almost $0.5 billion. With respect to shareholder returns, we repurchased $200 million of stock and paid $176 million in dividends during the quarter.

And with that, I thank you for your attention and I'll turn the program back to Jim.

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Thank you, Marta. Norfolk Southern has adapted to a challenging environment and delivered strong first-quarter results. The NS team remains focused on executing our plan to reduce costs, drive profitability, and enhance value for all NS shareholders. We are on the right track and showing tangible results.

And with that, we will now open the line for Q&A. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you, Jim. (Operator Instructions) Justin Long, Stephens.

Justin Long - *Stephens Inc. - Analyst*

Thanks and congrats on the quarter. The first question I had was, I was wondering if you could provide any expectation for the sequential progression of the OR throughout the year? You mentioned in the prepared remarks that 1Q is usually the highest OR of the year. So, I'm just curious if you think that typical seasonality will hold true in 2016?

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

So, Justin, as you properly observed, the first quarter is traditionally the highest operating ratio quarter of the year. And so, with our guidance for a sub-70 operating ratio for the full-year, we would expect to see declining operating ratios from here.

And now, with that said, we do certainly have some headwinds out there. The commodities landscape is anything but certain right now. And we are heading into some tough comps in the second quarter, some of the highest volume weeks of the year last year, and a variety of other areas as well. The revenue outlook is somewhat uncertain.

But we are confident that we can deliver. We are pulling out all the stops on costs, as you saw in the first quarter. And we intend to deliver sub-70 operating ratio for the full-year.

Justin Long - *Stephens Inc. - Analyst*

Okay. Great. And then maybe as my follow-up on pricing, I know you don't give details on core price, but I was wondering, first, if you could talk about how much of your 2016 pricing is locked in as of today? And then maybe just on a relative basis for that pricing that is locked in, how that stacks up to the level of increases you saw in 2015?

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

Hey, Justin. We've got about three quarters of our business for 2016 locked up right now with pricing. And I would say at this point, pricing is above the levels that we were seeing at this time last year.

Justin Long - *Stephens Inc. - Analyst*

Okay, great. I'll leave it at that. Thanks so much for the time.

Operator

Matt Troy, Nomura Asset Management.

Matt Troy - *Nomura Asset Management - Analyst*

Thanks for taking my call. Just a quick one. I think a couple quarters ago, people had asked about your decision to maintain WTI-based surcharges. You now said you are going to move in the last couple of quarters to on-highway diesel. Just wondering if you could frame for us roughly what percentage of your fuel surcharge programs are currently on the on-highway diesel framework? And what's the opportunity over what timeframe to migrate that? Thanks.

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

We -- Matt, we've gotten our WTI-based revenue from a little bit over 50% to somewhere between 40% to 45%, depending upon traffic mix.

Matt Troy - *Nomura Asset Management - Analyst*

Okay. And then my follow-up would then be just a simple question on pension. You said it was lower by $10 million in the quarter. I'm wondering if you could just dimensionalize for the year -- is that a good run rate? Should we expect pension expense to be about $10 million lower per quarter? Or do you have an annual forecast there? Thanks.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

Yes, Matt, you are correct. That pension trend set for the first quarter will continue for each of the quarters the rest of the year.

Matt Troy - *Nomura Asset Management - Analyst*

Great. Thanks, everybody.

Operator

Allison Landry, Credit Suisse Group.

Allison Landry - *Credit Suisse - Analyst*

So thinking about the improved free cash flow here in the first quarter, is there upside potential to the $800 million of share buybacks you alluded to? And then in terms of CapEx, you did take it down about $100 million. But do you see further opportunities to take that down even lower?

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Alison, I'll start. We are certainly working hard to adjust our CapEx as appropriate to keep it within limits to generate satisfactory returns. And that's why we have modulated our capital spending, both this year and last, downward in the face of declining revenue, relative to our original expectations for the year.

Marta, why don't you comment on the buybacks we've outlined today?

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

Okay. The buybacks are something that our Board reviews continually. Each time we meet with our Board, we look at that. We look at the free cash flow projection. And right now we are comfortable with the guidance that we gave of $800 million for the full-year.

Allison Landry - *Credit Suisse - Analyst*

Great, thank you.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

You're welcome.

Operator

Ken Hoexter, Merrill Lynch.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Jim and team, congrats on a great job. So, stepping back from the active events around the M&A, and you fought that back and a lot of weight on your shoulders to prove that you can achieve. So, great job out of the gate now that you can just focus on actually running the business.

But, earlier, Michael, you talked about recrews down about 51%. Just wondering operationally, is -- what are you changing in order to kind of achieve that? And what's structurally, when you take a step back? Obviously, you are shutting down a bunch of the different local networks that you've talked about and combining systems. But what operationally do you need to change? And is there more room to improve from those changes?

Mike Wheeler - *Norfolk Southern Corporation - EVP and COO*

Yes, Ken. Well, obviously, like we talked about last year, getting the right resources in place, crews and locomotives, and those are in place. And with that, we've been executing our operating plan very well. And that's allowed us to reduce the recrews and do all the productivity things we've seen, as well as all the high service levels we've provided.

So that's kind of the big driver of it. We've got the resources. We've got the right operating plan, and we are executing that operating plan.

Now, going forward, we've always said that we are going to continue to take a look at what opportunities are out there. You saw what we've announced yesterday. We continue to look, and we will, but we are always going to make sure that we protect the service product that we have, and keep that at a high level as we continue to reduce costs.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Is there I guess -- Jim, when you step back, is there a master plan of different buckets that, when you look at this [65] OR target, that you can tell us and walk us through it, at some point, whether it's train length, what you need to do on sightings, reduction on employees or locomotives that you feel needs to be done to get there?

Or is this kind of piecemeal, each time you improve, you just keep coming out with, oh, we can close this now. Or is there something master that you can kind of set targets on a little more specifically?

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Sure. And we have outlined some targets along those lines, Ken, to go with the annual productivity savings totaling more than $650 million by 2020. For example, we have said that we intend to bring employment down significantly with associated compensation and benefit expense savings by 2020. And that's a function of productivity, labor productivity initiatives across the board. But we also have targets for our locomotive fleet and for various other resources that will drive those productivity savings.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Is that something you are going to share with us, kind of targets and goals, so we can kind of watch you along the way? Or are they just more internal targets?

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

We will certainly update you as we move along, as we have today with regard to our labor targets. And Mike also got into the locomotive fleet size and efforts there to rationalize that asset.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Great. Great job. Thank you for the time.

Operator

Chris Wetherbee, Citigroup.

Chris Wetherbee - *Citigroup - Analyst*

I wanted to ask about the productivity, the $200 million upside from $130 million. Can we get a sense of how much was in the first quarter? It sounded like maybe some of it was a little bit both overdue to weather and some other favorable operating conditions. But just wanted to get a sense of sort of what was in 1Q, and then maybe how we can think about the cadence for the rest of the year.

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Yes, that's right, Chris. We entered the year with a running start. And we had some built-in favorability from the absence of weather and service-related spending in the first quarter of last year. And that boosted productivity in the first quarter.

We were also benefiting from other initiatives that we had kicked off last year, that give us a lot of momentum and energy entering 2016. And we're going to keep that going. We've revised upward, as we've said, the productivity target for the full-year to $200 million.

Chris Wetherbee - *Citigroup - Analyst*

So just trying to understand sort of how much of that $200 million might have been in 1Q and what we can expect for the rest of the year.

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

$200 million for the full-year is our new goal, as I said. Again, that was a bit (technical difficulty) in the first quarter. And Marta went through, for example, the run rate on mechanical spending relative to last year will lessen somewhat in subsequent quarters. So call it a fast start. We are going to stay at it. And for the full-year, $200 million.

Chris Wetherbee - *Citigroup - Analyst*

Okay. That's helpful. And then just thinking about sort of the headcount as we go forward, obviously you updated the target there. You know, that would suggest roughly flattish, maybe a little bit down or maybe a little bit -- yes, sort of up a little bit over the course of the rest of the year. And you just want to think, is that the right way to sort of think about how that cadence plays out after a seasonal uptick generally in volume over the next couple of quarters, but it sounds like you can handle that with the existing resources you have.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

So, our guidance, Chris, was that, for the full-year, we think we would be down 1,500. So, I don't know if you are looking at it sequentially or year-over-year. But the way to think about it is if you look at our last year average that we have in our financial data book, we think we are going to end the year 1,500 below that. Make sense?

Chris Wetherbee - *Citigroup - Analyst*

Okay, that's helpful. Appreciate it.

Operator

Scott Group, Wolfe Research.

Scott Group - *Wolfe Research - Analyst*

So, outside of the, what, $10 million or so of liquidated damages, is there anything else that you would call unusual in this quarter? And I guess I'm trying to go back to that first question about the sequential margin trend. Because we typically see -- I don't know, 400 or 500 basis points of margin improvement from 1Q to 2Q, and I don't know if that's a realistic expectation, kind of given the strength we saw in the first quarter.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

Well, Scott, let me reference you to something that Jim said about the weather-related. If you will recall last year, we had some weather and service-related costs in each of the first three quarters, but they were definitely weighted towards the first quarter. So, that was $42 million that we called out last year. So that is kind of the running start that he and Mike referred to.

So, that would tell you that we had more of a reduction in the first quarter than you would normally expect. Does that make sense -- with the $42 million of the $82 million was incurred in the first quarter of last year.

Scott Group - *Wolfe Research - Analyst*

Okay, so maybe we've got $40 million-or-so of lower-than-normal weather costs, and then a little bit of the liquidated damages to think about for the first quarter of this year? Okay.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

And the third item would be the materials that we highlighted that we had a materials year-over-year reduction of $42 million in this first quarter, but we're forecasting that will be just a $10 million reduction in the second, third, and fourth quarters.

Scott Group - *Wolfe Research - Analyst*

What's the change there?

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

That's the materials. We had some items in the first quarter that I called out in terms of locomotive overhauls that were greatly reduced, and some specific things we did with freight cars and locomotives in terms of using parts that is a first quarter-only item. So part of the materials reduction will continue, but a large part that we had in the first quarter will not.

Scott Group - *Wolfe Research - Analyst*

Okay. And then just in terms of headcount, so you are already above the 1,500 people you are talking about for the year, and I mean, we are not really seeing the seasonal volume upticks. Your service metrics are at kind of great levels right now. And then you just announced some additional closures yesterday or two days ago. So, I guess I'm a little confused why we are not raising the headcount target even more.

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Well, we do need to bring the folks back to cover attrition, and we need those folks to make sure we continue to maintain the service levels that we have. That's a key point. And we historically do see higher seasonal volumes in the second and third quarter than what we have in the first quarter. And that's expected to cover that as well.

Scott Group - *Wolfe Research - Analyst*

What are you assuming for volume growth -- not volume -- volumes in the second quarter?

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Well, we expect sequentially higher volumes in line with the usual seasonal pattern. Alan, why don't you break that down a little bit for Scott?

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

Scott, it will be down year-over-year, though, because as Jim noted, some of our greatest volume comps were in the second quarter of last year. We're going to continue to have headwinds in our coal market, which I've outlined. We will not have the level of growth in our automotive franchise that we had in the first quarter, due to the fact that we had some pretty easy comps in the first quarter of last year, and there are a couple models that are built at plants served by NS, which are effectively being taken off-line due to low demand.

So we are going to have some headwinds with respect to volume in the second quarter. But ultimately, service is driving more intermodal volumes for us. And Triple Crown will be a headwind for us into the fourth quarter of this year.

Scott Group - *Wolfe Research - Analyst*

Okay, thank you, guys.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

You're welcome.

Operator

Jason Seidl, Cowen and Company.

Jason Seidl - *Cowen and Company - Analyst*

You know the old saying you've got to walk before you run, and it looks like at least you guys are starting to jog. Just a question, sort of your physical plant going forward. I know, as one of the callers alluded to before, that you guys made some recent streamlining announcements. What in terms of maybe some track sales or maybe some track divestitures might be left here in 2016? And when should we expect more color on them?

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

We have previously announced a goal of short-lining, idling, or downgrading 1,000 miles of track this year. That remains our goal in terms of the track structure.

Mike, other thoughts on infrastructure-related rightsizing?

Mike Wheeler - *Norfolk Southern Corporation - EVP and COO*

No, we continue to look at it. We've got a lot of modeling that goes on to try and find where we can do that. And we think the opportunities -- we will do that. And we have some of those things you are talking about and on the table going forward that will be announced later on in the year.

Jason Seidl - *Cowen and Company - Analyst*

Okay, that's fair enough. Also, how should we think about coal next year? I know it's very negative now and all the other railroads are talking about massively high stockpiles, warmest winter on record. How should we look at it next year if we get more normalized weather patterns?

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

Jason, if stockpiles return to target by the end of the year, then coal volumes will be kind of close to where we were at a run rate last year, where we -- (technical difficulty) we were 17 million-19 million tons, is what we were looking at. And export is going to be highly dependent upon what happens with the overseas market. So --.

Jason Seidl - *Cowen and Company - Analyst*

Right, right. I understand that. So where are we now with stockpiles in your region?

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

Jason, they are about 100 days right now. And target I would tell you is probably about 60, dependent upon the geography. So, there's a lot of inventory overhang that needs to get worked through this summer in order for us to get back to target. So we are going to need a hot summer to support that coal franchise.

Jason Seidl - *Cowen and Company - Analyst*

I'll keep my fingers crossed for you. Well, listen, guys. I appreciate the time, as always.

Operator

Brandon Oglenski, Barclays.

Brandon Oglenski - *Barclays Capital - Analyst*

Thanks for taking the question. And, Jim, if you guys keep delivering earnings up 29%, some of those critical stuff from the past three months probably goes away pretty quickly. I just want to ask you, Marta, because you grouped in Materials and Other, and I think Purchase Services and some other line items. So can you go over the guidance for those two broad categories again as they are supposed to trend throughout the year?

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

Okay. Certainly. So, in Materials, we were down $42 million in the first quarter, but quarter-over-quarter for the remainder of the year, we think that's going to be down $10 million. Okay? And then in Purchase Services --

Brandon Oglenski - *Barclays Capital - Analyst*

Sorry, Marta. I just want to clarify. So, sequentially down $10 million? Or meaning year-over-year only?

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

Quarter-over-quarter -- year-over-year. So, second quarter of 2016 compared to second quarter of 2015 and so on, we think that will be down $10 million in Material. And then with Purchase Services and Rent, the predominant reason for the reduction there was the reduction in Triple Crown services.

So that was $34 million of that decline. And that will continue at that level for the -- at approximately that level for the second and third quarter. In the fourth quarter, it will be about half of that, because recall that we downsized Triple Crown in the middle of the fourth quarter of last year.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay, got it. That's helpful. Thank you for clarifying. And I guess I'm going to slip one more question in, if you guys don't mind. So, Jim, what can you leverage on the service side now that it appears you have your cost structure a little bit better than where it was last year? Service does appear to be improving for Norfolk. When markets come back, what's the plan on the marketing side? Because we've talked a lot here about the cost side.

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Sure, absolutely. We are well-positioned to grow as commodities rebound and other markets recover from inventory overhang. And that's the great benefit of having service at the current level. It sheds cost and it positions us for growth. So we are very confident that we can grow into this level of service and will, just as soon as business picks up.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay, thank you.

Operator

Rob Salmon, Deutsche Bank.

Rob Salmon - *Deutsche Bank - Analyst*

Marta, with the benefits from the Knoxville closing, it sounded like, if I heard you correctly, it's about $13 million on an annualized basis. Are there any costs that we should be thinking about in terms of that will be incurred in Q2 and in anticipation of the savings that we should be modeling in?

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

No. No. You are good with that $13 million that Mike talked about. Again, if it's going to be effective May 1st and the $13 million is annualized. So, roughly half of that we'll realize this year with a midyear implementation.

Rob Salmon - *Deutsche Bank - Analyst*

Right. All right that's helpful. And then with regard to the train length, I saw that increased about 2.5% on a year-over-year basis. Is that predominantly driven by the growth that we saw in terms of traffic in your merchandise network? Or was this kind of more broad-based and that's kind of not a fair apples-to-apples comparison?

Mike Wheeler - *Norfolk Southern Corporation - EVP and COO*

No, you are exactly right. The -- our intermodal and the unit trains stayed at very high levels, but the growth was in the merchandise section. In fact, that section grew 6%.

Rob Salmon - *Deutsche Bank - Analyst*

Okay, that's helpful. And how should we think about the cadence looking at from here? Are there incremental initiatives that should allow further growth? Or is the growth going to come from the volume eventually picking up?

Mike Wheeler - *Norfolk Southern Corporation - EVP and COO*

I would say both. We'll be able to handle the volume growth onto the train network. The other thing is we continue to have initiatives looking at where we can build big trains, particularly between terminal and terminal, including more use of the distributed power technology. And we're doing more and more of that, and big trains, terminal-to-terminal, where it makes sense.

Rob Salmon - *Deutsche Bank - Analyst*

Okay. And are there any goals that you are willing to share in terms of targets for the back-half of the year at this point?

Mike Wheeler - *Norfolk Southern Corporation - EVP and COO*

No, not at this time.

Rob Salmon - *Deutsche Bank - Analyst*

Okay, thanks for the time.

Operator

David Vernon, Bernstein.

David Vernon - *Bernstein - Analyst*

Just a question for you on some of the intermodal pricing and the outlook for intermodal rates, both in the sort of immediate and near-term. It looks like the RPU ex-Triple Crown and fuel surcharge grew at about 1%. and I'm just wondering kind of what your expectation is in the context of that pricing above inflation, what we should be expecting in that core intermodal rate?

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

Well, David, recognize that that that 1% growth had a negative mix component from flat domestic and a 15% increase in international, which tends to be shorter haul and have a lower RPU of 40-foot boxes -- (inaudible). So, let's strip that mix, and we had pricing and intermodal that exceeded rail inflation, and pricing and intermodal that drives sufficient shareholder returns to allow it to compete for capital.

David Vernon - *Bernstein - Analyst*

So you are not seeing any pressure there from any temporary looseness in the truck market on the intermodal rates?

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

To be sure, truck capacity is limiting probably the level of increase that we could get, but it's not causing rate decrease.

David Vernon - *Bernstein - Analyst*

Okay. And then maybe just as a quick follow-up. Obviously, Jim, this is a pretty amazing sort of inflection point in the sequential productivity. And I guess as you think about kind of the outlook, obviously you are going to be delivering more. But should we be thinking this first quarter is the -- like you said, a running start and is going to be kind of the peak for the rate of change in productivity going forward? Or are you also holding some things back for later in the year?

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

Yes. No, I think that's a fair assumption. We frontloaded some of the productivity gains. As I said, we had a very fast start to the year with a lot of momentum and energy, based on the plans that we made and the things that we did last year to position ourselves for it. So yes, we have the pedal to the metal and that's where it's going to stay.

David Vernon - *Bernstein - Analyst*

All right. Well, a 70 OR in the first quarter is truly impressive and great results, guys. Thanks.

Operator

Tom Wadewitz, UBS.

Tom Wadewitz - *UBS - Analyst*

I echo the other commentary. Very strong results, obviously. Let's see, can you comment a little on the kind of look on markets where -- I know you said that the second quarter comps are more difficult volume-wise. But as you look at things, I guess macro variables changing and so forth, where might you be most optimistic that you could see some improvement in markets?

Would it be in steel with some of the actions that might take place, that might help the domestic producers? Would it be -- where might you actually see a little more optimism looking beyond maybe the tough comps here in the near-term?

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

Tom, we talked about the coil steel benefiting from the automotive market. And as you alluded to, the recent tariff activity has improved steel pricing and steel capacity utilization. So there are some aspects of the steel market that are performing well. Within our metals and construction, of course, is frac sands, and we are going to have a pretty significant decline there, due to decline in drilling activity, as is pipe.

I would tell you that once the retail and wholesale inventory levels normalize, we see a lot of opportunity in that consumer base market because of our improved service product. And even with pressure on corporate profits now, shippers are looking to shift to intermodal because it still is a lower-priced option than truck.

Tom Wadewitz - *UBS - Analyst*

So what's a reasonable timeframe to see the volumes look a little bit better? Do you think they can grow later in the year? Or is that just hard to tell?

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

It's going to be wholly dependent upon what happens with commodity pricing. The pressures in crude oil, frac sand and coal, and then what happens with the retail and wholesale inventory levels.

Tom Wadewitz - *UBS - Analyst*

Okay. And then just a short follow-up. On the comp and benefits, can you give me any sense of how to model that year-over-year looking forward, Marta? Does that change because incentive comp is more of a headwind or different? Or do you think it's kind of down for work or year-over-year the next several quarters?

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

I think you keyed on the one thing that's going to be different in the second through fourth quarters. In my prepared remarks, I talked about three things and they are going to continue.

And just to summarize those, that's headcount -- it's going to continue but at a moderated level, as we've already discussed. The inflation that we had guided to at 3.5%, and you saw the $15 million in health and welfare -- that's going to continue. The pension, as someone else asked a few minutes ago, that's going to continue.

But the one thing that is going to be different in the second, third, and fourth quarters is the year-over-year headwind from incentive comp. Because as you will recall, last year in the first quarter, we had been accruing at a beginning-of-year bonus accrual level. But as the year went along and we didn't meet expectations, we had reversals of those accruals.

And so each of the quarters last year had year-over-year incentive comp reductions. And so depending on how our performance is the remainder of the year, you will see headwinds from that item.

Tom Wadewitz - *UBS - Analyst*

Okay, great. Thank you for the time.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

You're welcome.

Operator

Tyler Brown, Raymond James.

Tyler Brown - *Raymond James & Associates, Inc. - Analyst*

Hey, Jim, I just wanted to ask you a little bit about the opening of the Bellevue hump yard and the Inglewood flyover from last year. So, first, are you guys seeing the returns on those projects that you expected?

And then two, I'm just curious if those projects have been instrumental in the ability to close Roanoke and Knoxville hump yards, and even if they've been a key driver on productivity?

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

No doubt about it. The Bellevue capacity and throughput has facilitated asset rationalization elsewhere on the network, including at the terminal level and elsewhere as well. And certainly the flyover has helped with our meats in and out of Chicago. So yes to both.

Tyler Brown - *Raymond James & Associates, Inc. - Analyst*

Okay, great. And then I am curious, have you -- at this point, has rationalizations impacted schedules or transit times at all on the intermodal side, and maybe positively or negatively?

Mike Wheeler - *Norfolk Southern Corporation - EVP and COO*

No, no. We are continuing to run at the high levels that we've had in the past. So they've all -- it's all been good.

Tyler Brown - *Raymond James & Associates, Inc. - Analyst*

Okay, great. No, great quarter. Thanks, guys.

Operator

Ben Hartford, Robert W. Baird.

Ben Hartford - *Robert W. Baird & Company, Inc. - Analyst*

Marta, can I circle back on the incentive comp discussion? Did you provide what the headwind was in the first quarter, if there was any, in terms of IC?

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

It was approximately flat in first-quarter.

Ben Hartford - *Robert W. Baird & Company, Inc. - Analyst*

It was? Okay.

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

If you do look, I think -- if you do look at the full-year of last year, it was a year-over-year, $150 million, but it was all in the second, third, and fourth quarters.

Ben Hartford - *Robert W. Baird & Company, Inc. - Analyst*

Okay. So will there be catch-up in the -- in 2Q, 3Q, 4Q for the first quarter? Or was there just none for some reason, even though this might be the quarter's strength?

Marta Stewart - *Norfolk Southern Corporation - EVP of Finance and CFO*

It's more of a year-over-year thing, Ben. So, the first quarter of last year, we had an incentive comp accrual. And then this first quarter of this year, we had a roughly similar amount. As you move into the remainder of the year, the issue will be the year-over-year comparison.

Ben Hartford - *Robert W. Baird & Company, Inc. - Analyst*

Got it. Alan, I guess maybe your view on international intermodal and then SOLAS (Safety of Life at Sea) and the container weighing discussion, what is your take in terms of potential pull-forward of international intermodal ahead of the implementation mid-year? And what type of effect do you expect if and when that is implemented?

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

Ben, we've heard the theory that that could cause some volumes to be pulled forward, but as we've talked to our customers in the shipping lines, we haven't seen any activity to that regard.

Ben Hartford - *Robert W. Baird & Company, Inc. - Analyst*

Any concerns? I assume there are concerns, but any changes in behavior that you see from shippers preparing for that potential implementation?

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

Nothing meaningful.

Ben Hartford - *Robert W. Baird & Company, Inc. - Analyst*

Okay, thank you.

Operator

There are no further questions at this time. I'd like to turn the conference back over to management for any closing remarks.

Jim Squires - *Norfolk Southern Corporation - Chairman, President and CEO*

All right, thank you very much for your participation in today's call.

Operator

Ladies and gentlemen, this does conclude today's teleconference. We thank you for your time and participation. You may disconnect your lines at this time, and have a wonderful rest of your day.
