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NSC - Q2 2018 Norfolk Southern Corp Earnings Call

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OVERVIEW:

Co. reported 1H18 net income of $1.3b and EPS of $4.43. 2Q18 net income was $710m and EPS was $2.50.

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PRESENTATION

Operator

Greetings, and welcome to the Norfolk Southern Second Quarter 2018 Earnings Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Clay Moore, Director of Investor Relations for Norfolk Southern. Thank you. You may begin.

Clay Moore - *Norfolk Southern Corporation - Director Investor Relations*

Thank you, Melissa, and good morning.

Before we begin, please note that during today's call, we may make certain forward-looking statements, which are subject to risk and uncertainties and may differ materially from actual results. 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.

The slides of the presenters are available on our website at norfolksouthern.com in the Investors section, along with our non-GAAP reconciliation. Additionally, a transcript and downloads will be posted after the call.

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

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Good morning, everyone, and welcome to Norfolk Southern's Second Quarter 2018 Earnings Call. With me today are Alan Shaw, Chief Marketing Officer; Mike Wheeler, Chief Operating Officer; and Cindy Earhart, Chief Financial Officer.

We continue to deliver record results as our second quarter financial highlights on Slide 4 clearly demonstrate. Income from operations was over $1 billion, an increase of 18% and an all-time record for any quarter in our company's history. Net income was $710 million, up 43% over the prior year. And earnings per share was $2.50, a 46% increase. Our second quarter operating ratio was 64.6%, a 230 basis point improvement from last year and the 10th consecutive quarter of year-over-year operating ratio improvement. All of these measures were second quarter records for Norfolk Southern.

Halfway into the year, our strategy continues to deliver improved financial performance. We have produced first half records for operating income, operating ratio, net income and earnings per share. Income from operations for the first 6 months was $1.9 billion, a 14% increase over the prior year, and our operating ratio improved 180 basis points. Net income for the period was $1.3 billion, and earnings per share was $4.43.

As we handled near-record volumes, we continue our focus on deploying resources to improve service and remain committed to improving network performance for our customers. 2.5 years ago, we laid out our 5-year operating plan and highlighted a number of aggressive yet achievable goals. Since then, we have consistently delivered record financial results. And today, we are more confident than ever that we will hit our targeted OR of less than 65% by 2020.

Importantly, based on the significant momentum underway and the dedication of our team, we are on track to achieve that target ahead of schedule. As we've said before, given our operations and seasonality, we do not expect all our improvements to occur in a straight line. However, we have already significantly reduced OR and remain on track to achieve another year of year-over-year OR improvement for 2018. As we've said before, when we get to 65%, we won't stop there.

We look forward to keeping you updated on our progress as we continue to take action to strengthen our network and enhance shareholder value.

Now Alan will cover trends in revenue. Mike will provide additional color on the state of operations. And Cindy will detail our financial results. Then we'll take your questions.

Thank you. And now I'll turn the call over to Alan.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Thank you, Jim, and good morning, everyone. Second quarter 2018 marks the sixth consecutive quarter of year-over-year revenue growth with second quarter gains in revenue, volume and revenue per unit across all 3 of our business groups.

Merchandise revenue grew 8% in the second quarter with increased oil and gas drilling activity, driving volume expansion of frac sand and NGLs, along with strong growth in ethanol, fertilizers and crude oil. These increases were partially offset by lower automotive volume, improved pricing and higher fuel surcharge revenue raised RPU 4%.

Robust economic conditions and a historically tight truck market led to record-breaking revenue and volume in intermodal. In the second quarter, NS delivered a 20% increase in intermodal revenue, marking the second quarter in a row with record revenue growth. RPU was up 11% year-over-year with increased fuel surcharge revenue, strong pricing and positive mix. Given the projected demand for the NS intermodal product, the strength in the pricing environment is expected to continue.

Our coal franchise revenue increased 4% driven largely by sustained high overseas demand for U.S. coals. The 10% top line growth generated by revenue growth in all 7 of our commodity groups reflects Norfolk Southern's ability to deliver both pricing and volume growth and the strength of the economy.

Turning to Slide 7. We expect continued revenue growth in the second half of 2018. The economy is anticipated to remain strong throughout 2018 with increased consumer spending and industrial production, coupled with a tight truck market and elevated commodity prices. In addition, inventory rebuilds are driving increased demand for our services.

In merchandise, we expect continued strong demand in many of our energy-related commodities such as crude oil, frac sand and ethanol. We project sustained strength in intermodal in the second half as the truck market remains extraordinarily strong, aided by a robust consumer economy. This growth will be enhanced by the steady increase in e-commerce volume and anticipated inventory builds. Coal will be supported by strength in seaborne demand, with export volume anticipated in the quarterly range of 6 million to 8 million tons.

Utility volume, dependent upon weather and natural gas prices, is expected to remain between 15 million to 17 million tons per quarter. Pricing remains an emphasis and an opportunity, benefited by increased truck rates, higher fuel prices and tight transportation conditions across all modes.

We remain confident that executing our balanced long-term plan will allow us to capitalize on the growing economy, support our customers' growth and strategically invest for the future. Execution against this plan drove growth in the first half of the year that we expect to continue in the second. Our focus includes remaining flexible in response to changing markets, increasing our competitiveness with truck and most importantly, efficiently meeting the evolving needs of our customers to deliver value to our shareholders.

I will now turn it over to Mike for an update on operations.

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Thank you, Alan. Good morning. Today, I will update you on the state of our operation. We progressed with our service recovery plan during the quarter in which we grew our business, handled near-record volumes and achieved a record second quarter operating ratio.

Turning to Slide 9. We are pleased with the increasing efficiency of our operations. An all-time quarterly train length record helped drive record crew productivity. Specifically, we handled 6% more volume with just a 1% increase in crew starts. In addition, we were near our quarterly fuel efficiency record. All of these factors combined to help drive a record second quarter operating ratio.

Moving to our operation on Slide 10. Our reportable injury ratio was up sequentially, but our serious injury ratio improved 10%. The safety of our employees and the communities we serve continues to be our top priority and where we focus a lot of attention.

We are also taking significant steps to improve our service levels. Our service composite performance as well as train speed declined sequentially, but we improved on dwell, which is encouraging. We are more fluid in the south since resumption of hump operations at Chattanooga, which was idled in 2017. To continue to improve service, a portion of the hump was reactivated on May 17 to keep pace with near-record carloads. This hybrid model, which calls for the humping of local traffic while still utilizing block swaps for true traffic, gives us the best balance between service and efficiency.

In addition, we are increasing our hiring to handle our strong growth. Our train and engine hiring target is now 1,800 for the team, an increase of 700 over our initial plan, which will result in a net of approximately 300 qualified conductors from now until the end of the year. In the interim, we are continuing to utilize our temporary transfers and a rapid deployment Go Team initiatives in our areas of need.

On the locomotives side, our DC to AC conversion program is paying dividends by giving us more powerful and reliable locomotives at a lower cost. We have received 75 of these units, and an additional 50 will be coming online this year. In the meantime, we are temporarily supplementing our fleet with leased locomotives. 130 of these units are on the property and pulling freight, and another 25 are due this quarter. As our velocity improves, additional locomotive capacity will also be created.

In closing, beyond simply improving our current service levels, our plan will allow us to handle continued growth. As our resources continue to come online, our operational improvements will accelerate. We are committed to enhancing service performance and are confident we are taking the right steps to drive meaningful improvement of our service metrics in the second half of 2018.

I will now turn it over to Cindy who will cover the financials.

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Thank you, Mike, and good morning, everyone. Let's take a look at the second quarter operating results, starting on Slide 12.

This quarter, we delivered record financial results. As Alan discussed, we had strong revenue growth of 10%, which helped drive all-time record income from railway operations up over $1 billion, 18% higher than last year. We also achieved a record second quarter operating ratio of 64.6%, improving on last year's results by 230 basis points.

Just as a reminder, 2017 results have been recast to reflect the required reporting reclassification of certain pension and post-retirement costs.

Slide 13 illustrates the changes to operating expenses. In total, operating expenses increased by $107 million or 6%.

Let's take a look at the details, starting with fuel. Fuel rose by $82 million primarily due to higher prices, which added $71 million. Consumption was up 5% over the prior year relative to the 6% increase in shipments.

Purchased services and rents increased $38 million or 10%. Equipment rents expense rose $14 million, the result of higher volume-related costs and slower network velocity. Purchased services increased $24 million, largely a result of transportation and engineering-related activity and higher intermodal volumes.

The materials and other category decreased $9 million or 5%. This quarter included $20 million of rental income associated with operating property, which you'll recall is now included in this expense category. This was partially offset by approximately $5 million of increased locomotive material usage primarily due to an increase in locomotives and service and $4 million of higher remediation -- environmental remediation expenses.

Finally, compensation and benefits decreased by $13 million or 2%. A favorable Supreme Court ruling was issued in June related to employment taxes withheld on stock-based compensation. As a result, we recognized $31 million benefit for this refund of employment taxes paid on equity awards for prior years. Reduced headcount levels saved $17 million over the same quarter last year. Headcount was approximately 550 positions fewer than in the second quarter of 2017 and up about 100 sequentially as we've increased our T&E hiring while continuing to decrease headcount in other areas. Consistent with the first quarter, lower health and welfare rates also resulted in savings of approximately $9 million versus last year. Incentive compensation was $34 million higher than in the second quarter of 2017 as we have continued to achieve strong financial results during the first half of the year. Overtime and recrews increased compensation and benefits by $13 million. Finally, with respect to headcount, we expect average headcount to continue to trend sequentially up slightly in the last half.

And moving to Slide 14. You can see that our strong operating results resulted in an 18% increase in income before taxes and contributed to record second quarter net income of $710 million, up 43% year-over-year. Diluted earnings per share also set second quarter record at $2.50, a 46% improvement.

So wrapping up our financial overview on Slide 15. Free cash flow for the first 6 months was a record $990 million, and over $1.1 billion has been returned to shareholders, up 47% compared to last year through the repurchase of 4.8 million shares of our common stock for $700 million and $408 million of dividend payments.

Thank you for your attention. I'll turn the call back to Jim.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Thank you, Cindy. As you can clearly see, we are well positioned for success as we look forward to the balance of the year. Volumes on our network remain robust at levels that we have not seen in over a decade, and we are adding resources to improve service for our customers. Our strong performance this quarter enables us to continue our progress toward our goals to generate shareholder value. We are confident in our long-term prospects for success and the strength of our franchise as we continue to execute our strategy.

With that, thank you for your attention. And we'll now open the line for Q&A. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Jason Seidl with Cowen and Company.

Jason H. Seidl - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Alan, I think you mentioned that pricing is both an emphasis and an opportunity for you. I was wondering if we can dive into that opportunity part. Is the opportunity continuing to be on some of the truck competitive business in both intermodal and merchandise? Or are there other areas, too, that we should be focused on?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes, Jason, good point. It is an opportunity for us going forward as I have talked previously about the cadence of pricing. The tight -- we felt like the tight truck market would lead to improvements in pricing well into 2019, and that's precisely what we're seeing now. And you can see that reflected in our numbers with a 20% improvement in intermodal revenue and an 8% improvement in merchandise revenue. The truck market is exceptionally tight. Inventory levels are still very low, and the consumer economy and the industrial economy are doing well. So there's a high demand for our services, and it creates a very good pricing opportunity for us.

Jason H. Seidl - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay. Next, follow-up question is going to be for Michael on productivity. Can you talk about productivity in the back half of the year? What we should look for? I mean, you just posted an all-time record in train lengths. Is that going to continue? Or are we going to start to plateau? And what are some of the other areas that we should look for, for the NS to show improvement in 2 half '18?

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Yes. So we continue to focus on train length. Obviously, you have to balance that and the terminals with getting trains in and out of there. So train lengths will continue on. That's a good news story. The other thing is as the railroad continues to get better, and we've seen the road slowly continue to get better, we'll have productivity in locomotives because we'll be shedding the locomotives and not needing as many of those, and that relates in the lower cost for locomotive maintenance. Recrews will go down. Overtime will go down. All those things that come out as the railroad continues to get better. So that's -- those are the things that will come out as we continue to make the railroad faster. But there's also other initiatives we continue to work on. But right now, our focus is on service restorations, but still initiatives in the pipeline that are always on our mind.

Operator

Our next question comes from the line of Matt Reustle with Goldman Sachs.

Matthew Edward Reustle - *Goldman Sachs Group Inc., Research Division - Senior Equity Analyst*

Just looking at intermodals specifically in pricing there. It remained strong, but it didn't flatten out relative to the first quarter. I was wondering if you can talk about some of the dynamics there, particularly with mix, international versus domestic, but if you're still seeing tailwinds domestically into the back half of the year where there's potential for reacceleration in that pricing.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes, Matt, we certainly are. We just effectively finished a bid season on some of the shorter-term business and the more transactional, and we're very pleased and encouraged by the results of the great increases we got there. If you look at our pricing year-over-year within intermodal, it was higher than -- in second quarter than it was in first quarter, and it improved with each month as we move through the second quarter. So as I stated before, our contract structure and the general pricing environment gives us a lot of confidence on our ability to continue to secure price in truck competitive business well into 2019.

Matthew Edward Reustle - *Goldman Sachs Group Inc., Research Division - Senior Equity Analyst*

Great. And just to follow up in somewhat related terms. I know it's hard to differentiate between tight trucking market and what we have going on with fuel prices. But I'm wondering, are your customers talking to you about the higher fuel prices? And do you see an opportunity where some of these market share shifts you can actually hold on to as trucking capacity comes to the market? Is there any way to think through that in terms of what's sustainable here from some of the volume growth you've seen from the tight trucking market?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes. I think there's some structural changes in the trucking market that are irrespective of fuel. One of them is the growth in e-commerce. In 2004, U.S. e-commerce sales were about $71 billion. Last year, they were about $453 billion. You got ELDs and hours of service, and initially, the impact of those was greater than what was originally expected. And then lastly is labor. It's been almost 10 years since the last recession, so there aren't a lot of truck drivers on the sideline waiting to get back into that market.

Operator

Our next question comes from the line of Justin Long with Stephens Inc.

Justin Trennon Long - *Stephens Inc., Research Division - MD*

So maybe to start with a couple questions on the OR. Jim, you made the comment that you're on track to achieve that sub-65% OR target ahead of schedule. I'm curious if we should translate that into pulling that forward a year. Do you think that's achievable in 2019? And then more near term, the last few years, you've seen a sequential improvement in the OR in the third quarter. Is that same seasonality your expectation this year? Just curious if you think, directionally, that's where we go or if there's anything that would prevent that from being the case.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Well, we certainly do expect to have a lower operating ratio year-over-year for the full year of 2018. We've said that since the beginning of the year, and that still is our expectation. Longer term, our goal remains the sub-65% operating ratio by 2020 or sooner, and we're making excellent progress on that with our outlook for this year. And so we are in the middle of long-range planning and a redefinition of some of our long-range goals, and we'll be back to talk about that some more at a later date. But that's certainly a necessary and appropriate thing, given the progress that we've made on our long-range plan -- our current long-range plan, thus far. As far as the seasonality is concerned within the year, you do have some of that in each year. I wouldn't expect this year to be different in terms of the usual seasonal pattern. But as I did say, we expect the full year operating ratio, certainly, to be lower.

Justin Trennon Long - *Stephens Inc., Research Division - MD*

Okay, that's helpful. And secondly, just given some of the recent macro headlines, I was wondering if you could share the percentage of your business that you feel is exposed to international trade. And within that number, could you talk about the geographies or commodity groups where you see the most uncertainty with some of the recent news that we've seen on tariffs?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes, Justin, basically, our percentage of volume and revenue associated with international trade pretty much approximates that of the U.S. economy. It's effectively 20% to 30%. Digging into that, which you asked about geography, Mexico is a very modest amount. Canada is a little bit more, but it's still less than 5% of our revenues. The big-ticket items are international intermodal, export coal and international merchandise business. As we take a look at trade skirmishes and potential trade war, we don't see much of an impact at all in 2018. It will be longer than that for supply chains to readjust.

Operator

Our next question comes from the line of Allison Landry with Crédit Suisse.

Allison M. Landry - *Crédit Suisse AG, Research Division - Director*

Let's see. So I wanted to understand how you make the decision to take on incremental intermodal business, specifically in the environment that we're seeing right now, which is capacity-constrained. And you obviously have a lot of different traffic that's competing for the space on the network. So curious to know how you evaluate intermodal and specifically, whether it's based on its OR or ROIC.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Well, it's both. We're certainly looking at the OR and the ROIC of that business, along with the others, as we add traffic to the network. We are -- as you know, we have a multi-channel strategy, and we work closely with our various channel partners to determine optimal levels of traffic on the network. And so that's a partnership with our channel partners. And we're looking to take advantage of the capacity that we do have and to grow where we can, certainly with an emphasis on volume growth but also pricing in this environment.

Alan, do you want to add anything to that?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes. Allison, we work closely with our customers and also with our operating team to make sure that we've got the capacity to handle the growth. If it's generating good incremental returns for Norfolk Southern and our shareholders and we have the ability to do it, we'll bring it on. You've also seen us close a couple of lanes this year where we weren't generating the returns that we needed to. So it's a balanced approach. It's a great market for us. We've -- we have improved the incrementals within our intermodal franchise over the last couple of years. And this year, we've been able to deliver 20% revenue growth.

Allison M. Landry - *Crédit Suisse AG, Research Division - Director*

Okay. And just following up on the capacity comments, you mentioned you do have capacity. Are there -- is that sort of in an -- on an overall basis for the network? And if you had to think about it in some of the big corridors, could you maybe parse out where the capacity utilization is on some of the major lanes?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Sure. Well, as a general proposition, we have more capacity on the northern region than we do on the southern region of our network because we're largely double tracked in the north but not in the south. Now that said, with the uptick in commodities volumes, there's plenty of traffic up north as well as down south right now. So capacity and capacity utilization are a dynamic equation in our business. We do believe that as the network picks up speed that we will generate capacity, and that we will, thereby be even better positioned to take on more growth.

Operator

Our next question comes from the line of Chris Wetherbee with Citi.

Christian F. Wetherbee - *Citigroup Inc, Research Division - VP*

Jim, a couple of questions ago, you had a comment about sort of the long-term planning and sort of implied or sounded like you might be considering making some updates at some point. I guess, I just wanted to sort of explore that a little bit further. When you think about it, will that be in the context or the scope of everything, including OR targets and beyond? Or how do you think about that, I guess, in terms of what you might be sort of reviewing or what the time frame might look like?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Our next long-range plan will certainly be a combination of financial targets, just as our current plan is. It will continue to emphasize operating ratio improvement. That's important to investors. And we've said all along that we never plan to stop at 65%. We'll continue to push past 65%. But it's a balanced plan. We're looking to grow as well. And increased return on capital, that will be a part of our long -- our next long-range plan as well. The process is underway. We're working hard, focused very intently on developing our next long-range plan, given the progress that we have made under our current plan. And we'll be back to talk to you later in the year about our progress in that planning exercise.

Christian F. Wetherbee - *Citigroup Inc, Research Division - VP*

Okay. That's very helpful. Appreciate it. Then just a quick follow-up on service cost. I apologize if I missed it, conflicting calls this morning. But did you quantify what the actual service cost was in 2Q relative to what you incurred in the first quarter, maybe how that looks in the back half?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Sure. So we did incur service costs in the second quarter. They did come down a bit from the first quarter given the additional volume on the network. That absorbed some of the costs -- extra costs we allocated to the volume growth. But we did incur some service costs, and service is not where we want it to be and where our customers expect and deserve it to be. So hard at work on that. Mike went through some of the things we're doing. With that said, we did make excellent improvement in margin with the lower operating ratio, and we were able to deliver a lot of the growth we experienced to the bottom line.

Operator

Our next question comes from the line of Tom Wadewitz with UBS.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

I wanted to ask you about, I guess, a couple of specific items and the kind of comp and benefit and maybe how that affects OR. You had a $31 million payroll tax benefit in the quarter. You had $34 million higher incentive comp. So those 2 seem to offset each other, I guess, in the quarter, or roughly so. How do you think about these 2 items going forward? It sounds like payroll tax might be onetime, but I'm not sure if you faced a similar headwind down incentive comp in the third quarter. So I think really, how do we think about that and how that affects comp and benefits per worker in third quarter, fourth quarter.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Cindy?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Sure, Tom. In terms of the employment tax refund, you're right. It's basically sort of a onetime item. It refers back to prior years, so I wouldn't expect there to be any benefit of that, really, too much going forward. On the incentive comp, that's really based on the results of the company and the business. We had strong results in the first half, so that resulted in an increase in our incentive comp that we recognized in the second quarter. I will remind you that last year, we had a similar increase in the incentive comp in the third quarter, so the timing was a little bit different. So as we go further into the year, it will all depend upon what the business results are doing. And it could go up. It could go down. It could stay the same. But it will be highly tied to the results of the business.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Okay. But the comparison is easier, I guess, in third quarter because you accrued more last year. Is that what you're saying?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

There -- you're right. There was a large accrual in the third quarter of last year.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Okay. Great. And then just, I guess, for the follow-up question, if -- I might have missed this. I was on another call earlier. But Jim, where do you think we're at in terms of the network investments and improvement? It seems like you've seen stabilization and some improvement in dwell time and things -- and velocity. Are you kind of past value and you got room for -- to ramp further? Or just how do you think about your kind of confidence in the path forward on the network metrics?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Yes. Well, I think we are making progress. We've seen a modest uptick in train speeds, thus far, in the third quarter. Terminal dwell is still too high, and we need to push train speeds back up to that 23, 24 mile per hour zone and bring dwell down accordingly. Now behind the scenes there, we believe we're seeing some improvements. Just a couple of the things that we watch, car counts within our major classification yards have generally been within yard capacity for the last month or so. We watch the inbound-type lines for the major classification yards very, very closely. And those have been manageable. That's an indication of the network fluidity. And the overall active trains out on the network, that peaked probably a month, 1.5 months ago. That's come down. So that's a good sign. Still too many cars online that really has not come down, so we're managing that right now, trying to get cars online down to a more normal level. So all in all, I think the network is running better. It's -- it has stayed fluid throughout, and the traffic is moving. Customer service, not where we want it to be, though, not where our customers expect it to be, so we're still hard at work on making improvements.

Operator

Our next question comes from the line of Amit Mehrotra with Deutsche Bank.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Jim, Canadian National on their call last night, in an answer to the questions around long-term targets, talked about having OR targets that are the leader of the Class 1 pack, which I think was an effective way to communicate it, given volume, to some degree, is out of your control -- to a large degree, is out of your control. So I was hoping you could do the same thing vis-à-vis CSX. I understand that, in any given year, there could be differences for various reasons whether they're short term, midterm or long term. But over time, is there any reason that Norfolk should have a different return profile than CSX? And if you can just help us think about that from a structural standpoint, I think that would be helpful.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Look, margin improvement is important. We get that OR improvements -- consistent OR improvement is part of our plan. And in fact, we have lowered our operating ratio 10 consecutive quarters year-over-year, as you've seen. So we're very focused on operating ratio improvement. Ours is a plan with balance and [although] we also are looking to grow the top line. I wouldn't call ours a growth strategy. It's a strategy to improve return on capital that does include growth but also a healthy dose of margin improvement and capital efficiency as well. So we're going to continue to push on operating ratio. When we get to the current goal of sub-65%, we certainly won't stop there.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

So I don't want to put, obviously, words into your mouth, but if I can just think about it, meaning there's no real structural reason, but maybe you guys want to focus a little bit more on growth than maybe some of the other competitors out there. Is that a fair way of characterizing it? Or is that wrong?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

I will say, this is a terrific environment in which to grow. And we have been executing on growth by sending that growth to the bottom line, and that's how you get to the kind of operating income improvements that we put up this quarter. So I think, in our business, it is cyclical. You better jump on that growth opportunity when you have it, and that's what we're executing on right now. Productivity remains a consistent focus. It, too, is an important tool in getting the operating ratio lower and the bottom line up.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Sure. Let me ask one follow-up, unrelated to that, just more on the balance sheet. So Union Pacific, obviously, and then CSX have both expanded the balance sheet in recent quarters and returned more cash to shareholders, obviously, given the confidence in the business and the environment. Is this kind of assessment of the balance sheet within the scope of how you guys are evaluating your long-term plan, i.e. is the company -- is Norfolk Southern evaluating what the optimal comp structure is? Or are you kind of comfortable with where you are today? Just any thoughts there.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

We are examining capital structure, and we recognize that with the impact of tax reform, we have delevered to some extent. So that is certainly part of our planning process. We're taking a look at capital structure as well to operate.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Cindy, can you just update us on where the adjusted gross debt to adjusted EBITDA is at -- as of the last measuring point, just so we have apples-to-apples number and how you guys are thinking about it, how the credit rating agencies think about it as well?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Well, we have met with the credit agency -- both credit agencies, actually, this quarter. And we are committed to maintaining BBB+, Baa1 credit rating. And we want to stay sort of in the middle of that. And we are -- as Jim said, we are currently evaluating our leverage and whether we have some additional debt capacity. And we will continue to do that. So that's where we are right now.

Operator

Our next question comes from the line of Walter Spracklin with RBC Capital Markets.

Walter Noel Spracklin - *RBC Capital Markets, LLC, Research Division - Analyst*

Just coming back on the OR question. And Jim, I always thought that I understood that, and it did make sense that you want to have a balanced approach to operating ratio improvement with growth. What we've seen, however, is that you can have both, while there is an initial kind of disruption as you realign your network to achieve a structurally lower OR. But that disruption effectively goes away. We've seen evidence of it certainly with the Canadian peers and starting to see it with the U.S. -- or with the CSX. They're generating operating ratio of about a 500 or more basis point difference than you but still, in the case of, again, for example, CN CP, they're guiding to 5% to 7% growth, which is probably as much growth as you'd want. Isn't there a case here to take some short-term pain to restructure your operation a little quicker, take the service hit but then, on a go-forward basis, be generating the same growth rate at a much lower OR?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

First of all, we pay -- pay close attention to industry developments, and we're watching our peers and watch what's going on in the industry and open to any and all best practices in terms of operations or otherwise. And we are looking at operating our railroad differently in a variety of ways as well. Let me just give you a couple of examples. We are about to restructure our divisional and regional transportation leadership positions. So that's in an effort to streamline operations and push our strategic plan out to field level. Those frontline supervisors will have responsibility in the future, not only for transportation but for car mechanical operations as well, increasing their span of control and ability to influence the business. We are bringing our dispatchers into Atlanta. By the end of this year, we'll have everyone centralized, under prenegotiated implementing agreement, by the way. They're in Atlanta side by side with our network operations team, our locomotive control team, our service design team, and that's an industry best practice that we are embracing. And that's change for us. Something to be said for distributed dispatch in the field, but centralized dispatching is the norm these days, and that's what we're going to do as well. We are also working on simplifying our operating plan locally and improving our terminal operations, going through the network node by node, location by location and focusing on a local operating plan at each venue that we can execute well consistently. We're doing that in collaboration with our customers. They are very much a part of that planning process and executing a local service plan that works for them and works for us. So we're certainly not satisfied with the status quo of our operations, and we're pushing change in a lot of different areas. Right now, we are very focused on getting customer service back to where it needs to be, as I said. And we're going to add some conductor trainees this year. Mike gave you the numbers. Overall headcount was down significantly year-over-year. And labor productivity remains a very, very important objective. But adding T&E is the right thing to do when we have a growth environment like we have right now.

Walter Noel Spracklin - *RBC Capital Markets, LLC, Research Division - Analyst*

Well, do you see anything more dramatic as just being too risky? If you take your number of hump yards on your system and cutting them by 70% or 80%, the kind of big -- bigger type of changes, do you see that as too risky to do at this point given the demand that you're seeing? Is that a good characterization or?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

A classification network that can provide good local service is one of the keys to growth in the merchandise network. So we have rationalized our yard network, and we'll continue to look at that, but it is important to maintain adequate classification capacity. And we closed a couple of hump yards, and we brought one back recently. So it's a dynamic plan. It's in the customer service and efficiency.

Walter Noel Spracklin - *RBC Capital Markets, LLC, Research Division - Analyst*

Okay. And just last question here on pricing. I know you don't guide to it, but is there -- it's a good time to be in freight transportation. You're seeing tight capacity across all modes, and that's leading to some standard price increases. Is there any reason why due to mix or contract types or whatever it might be that you wouldn't get the same same-store pricing as your peers?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Alan?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

This is a great environment for pricing. You see truck rates going up, contract 12%, spot rates going up, double that. So as I said, pricing is an opportunity for us, and it's an emphasis. And we saw our pricing year-over-year improved in second quarter relative to first quarter, and we saw our pricing improved as the quarter progressed. And we've said that our pricing will continue to improve as we move into 2019.

Operator

Our next question comes from the line of Scott Group with Wolfe Research.

Scott H. Group - *Wolfe Research, LLC - MD & Senior Transportation Analyst*

So I wanted to just try the margin one a little bit differently. So if you look over a 30-year period, your margin is 300 basis points better on average than CSX. Do you think your -- forget about what you're operating ratio target is and theirs. Do you think your network is structurally better than theirs?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

I like our network a lot, Scott. I think we have an outstanding network with a lot of potential for both efficiency and growth. We go a lot of places. We have great partnerships with our customers, with our channel partners. And we have a terrific opportunity to achieve greater productivity and growth. So I'll take our network any day. And I think we're going to continue to push on all fronts. We are very, very focused on our strategic plan and developing a successor to it. And that plan will include significant efficiencies, significant growth and as always, the focus on safety as well.

Scott H. Group - *Wolfe Research, LLC - MD & Senior Transportation Analyst*

Okay. And then just quickly for Alan. Can you just help us a little bit? Any way to think about the benefit of the WTI surcharges kicking in, in the third quarter? And then any color you can give us on how to model coal revenue per car going forward, just after -- if you think it will be higher or lower sequentially as we go into the back half.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Scott, so I'll take the fuel surcharge one first and remind you that we've been successful over the last several years of transitioning off of a WTI-based program to an on-highway diesel-based program, which, frankly, more closely follows the path of our expenses. So right now, over 2/3 of our base revenue is associated with an on-highway diesel-based program. About 25% is associated with WTI. And the majority of that is now in the money. There's a little bit of a lag associated with that, and so we saw that improved as the quarter moved on. More important for us is price, and we are very confident in our ability to secure price in this competitive and economic environment. With respect to coal, there's several moving parts in there. One is export. We had pretty strong growth in our export volumes in the quarter. It was up 21%. However, our met export coal, which, as you know, tends to be higher rated, was up 4%. So the predominance of that came through -- or the growth came through steam coal, which tends to be lower rated. And also, we had a little negative mix within our utility franchise. Last year in the second quarter, we were about 50-50 in terms of Utility North versus Utility South. This year, we were -- or 58% of our utility tonnage was in the north, which tends to be a shorter length of haul.

Scott H. Group - *Wolfe Research, LLC - MD & Senior Transportation Analyst*

Do you think those 2 things, just real quick, the more steam, there's met exporting more north or south, you think those continue in the back half?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

I think there's an opportunity to grow the Utility South franchise a little bit more than the Utility North going forward. Stockpiles are starting to come down, and there's been a lot of heat in the southeast. The steam and met is going to be highly dependent upon overseas demand. The forward curve for API 2 is moving up. The forward curve for the met coal overseas is moving down, but it's largely range bound, and we don't see any big catalyst for a shock there. Does that make sense, Scott?

Scott H. Group - *Wolfe Research, LLC - MD & Senior Transportation Analyst*

Yes, it does.

Operator

Our next question comes from the line of Brian Ossenbeck with JPMorgan.

Brian Patrick Ossenbeck - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

So just going back to the OR, always decent noise on that metric. But since it is a singular one, it gets a lot of focus. See if we get a little bit of clarity on maybe a cleaner rate for the quarter and looking in the second half of the year. So it looks like the employment tax has made 100 basis point help in the quarter. Just curious to see what the optics of fuel did to the OR. And then on gain on properties, it has become more prevalent in the railroad industry, in general, but can you just call out what they were in the quarter? They're down year-on-year and for the first half of the year, but is that the spot where we should expect them to stay for the rest of the year?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Yes, Brian. In terms of the fuel's impact on the OR, on revenue, we had 70 -- $72 million of incremental fuel revenue. The incremental fuel expense was about $82 million, so in terms of investment, both to operating income as well as operating ratio. In terms of the property sales, we really didn't have very significant operating property sales in the quarter. And those are -- they're difficult to predict from quarter to quarter. We've said that before. I will tell you that even though they were not significant in the second quarter, we continue to focus very strongly on looking at all of our properties. And if it's property that we don't need for the business, we're looking to monetize that. So we would expect to see operating property sales going forward. It's just hard to tell you exactly when they may happen because some of these things take a while.

Brian Patrick Ossenbeck - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Okay. And can you quantify, Cindy, the actual impact on OR from fuel in the quarter, just from an optic perspective because it's essentially passed through? But that sounds like it actually was a negative drag as well, if I heard you correctly.

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Yes, it's negative. Negative.

Brian Patrick Ossenbeck - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Okay. And anything on the -- can you quantify the basis point impact on OR in the quarter?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Well, if you look at fuel, if you look at just the price, the price part of fuel, so in revenue, price -- the price was about $68 million was related to price. On the expense side, it's about $71 million. So for on OR, it's about -- that's about 100 basis point impact.

Brian Patrick Ossenbeck - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Okay. Great. If I can just ask one quick question on capacity. STB is still monitoring service. Service is clearly improving a bit here. I guess, for Alan and Mike, how do you think about balancing the network? Can you continue to grow volumes at this clip without taking up CapEx? And just curious if there is conversation internally about needing to improve some of the operating resiliency, maybe cast a wider net with the infrastructure to capture volume growth, where it might tick up unexpectedly. Or do you think you can kind of vantage at these levels through higher headcount, pricing and some better efficiency to release some capacity into the back half of the year and into next year?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Brian, let me take a stab at that, certainly, the capacity CapEx question first. We have spent consistently in our capital budgets on capacity all across the region. So if you look back over the years, we have invested where we needed to invest to address capacity tightness at locations on the network, and we'll certainly continue to do that. We're going to try to be very thoughtful about that and very strategic with where we put that money. And that's important, for one thing, because these are long-term investments. And investments in infrastructure capacity are not a quick fix for any service concerns at the moment. So we have to be thinking years ahead when we make those capacity investments, where are the pinch points on the network that need to be addressed for the long term. So in the short term, network velocity and efficiency and customer service, really, are about injecting crews and locomotives into the network. And that's what we're focused on right now. We take a longer-term view of the capacity investments trying to find places on the network where we can make a real long-term difference by increasing capacity.

Operator

Our next question comes from the line of Ken Hoexter with Bank of America Merrill Lynch.

Kenneth Scott Hoexter - *BofA Merrill Lynch, Research Division - MD and Co-Head of the Industrials*

Alan, just to follow up on Scott's question there. Did you update your outlook on export coal volumes for the year?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes. Ken, I said 6 million to 8 million tons per quarter moving forward.

Kenneth Scott Hoexter - *BofA Merrill Lynch, Research Division - MD and Co-Head of the Industrials*

Okay. Thanks for that clarification. And then, Jim, I know you've got a lot on the OR, and you keep mentioning you know -- you watch peers, and you adapt. And I'm just wondering, with your peer now at 58%, I guess, if you adjust out 100 basis points impact from the comp and benefit gain, it's a 700 basis point differential. And so just where do you see the cost opportunities? Or is it the employment that you talked about? Is it the efficiency? How do you adjust? And then, I guess, on that point, Mike, do you feel like you need to bring in additional precision rail expertise into the management team to create some of that overhaul that maybe Walter was kind of questioning about?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Ken, as I've said several times, we certainly understand the importance of margin improvement. And we are pushing hard on the operating ratio, and we will continue to do so. Not stopping at 65%, but continuing to drive for lower operating ratios. That is a critical element of continued financial results for us. Ours is a balanced plan. We are looking for long-term growth in this franchise that we can pair with the margin improvements, just as we did in the second quarter of this year, to drive the bottom line. We -- as I said, we are open to all best practices, and we are certainly watching closely what goes on in this industry, all across the industry, and making a number of changes to our own operations, some of which I went through earlier. And we'll continue to do that. We -- part of our long-range planning process will definitely be to examine the operating plan we currently run and figure out ways we can run better.

Kenneth Scott Hoexter - *BofA Merrill Lynch, Research Division - MD and Co-Head of the Industrials*

No, I understand that. I think you've kind of went over a bunch of those points. I was just wondering, where do you see the opportunity to improve? You said you're looking at your plan. You might change and adapt and lower from the 65% in your next long-term plan. Just is it -- is there other particular areas where you see the exaggerated improvement? Is it the network operations? Is it employment? I'm just wondering where you see the biggest opportunities to adjust those changes.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Cost structure in our business comes down to people and assets. Certainly, labor productivity is key. Now right now, we're focused on ramping up T&E to get T&E back to where it needs to be to provide the customer service. But other areas within the workforce are coming down. And you will continue to see us focused on headcount. That's a big cost center for us. Network velocity spending the assets is a big part of cost structure as well, managing cars online, managing the number of locomotives you have out there pulling freight, managing all of the other assets we have. And we will continue to push on asset productivity, certainly, as part of this planning as well.

Kenneth Scott Hoexter - *BofA Merrill Lynch, Research Division - MD and Co-Head of the Industrials*

So just -- if I can just follow up on that, right, because the biggest differential, I guess, is when you talk about the employees, right? I mean, it's a significant differential in terms of number of employees. So are there -- when you look at the network structure, do you have to -- that's why I was asking, do you need to bring in additional precision rail expertise to make that monumental change or to assist in the change in order to get those large employment kind of cost differentials out of the network?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

I'm very, very confident in our operations team and their ability to drive productivity while laying and maintaining a foundation for growth. So I think we're in great shape as a team. We're always open to outside practices and outside perspectives, and we do bring those in from time to time. So I think we've got a good plan, and we're going to continue to pursue it.

Operator

Our next question comes from the line of Bascome Majors with Susquehanna Financial Group.

Bascome Majors - *Susquehanna Financial Group, LLLP, Research Division - Research Analyst*

Rail running season is almost over. If there's been 1 consistent analyst question for you guys or the management team is just it's some version of why can't you put up results more like CSX'. And while that's already been asked several times today, Jim, I'm curious if you could speak for management and the board on your longer-term strategic response to the changing competitive landscape in the east. Into that, I mean, in management's view is what CSX' management team has accomplished over the last 1.5 years, is that driving short-term profits at the expense of long-term growth? And I guess, the natural extension of that is, do you think your shareholders will be better served over the next 2 to 3 years by the current strategy versus a more aggressive push and just some of the operational changes that your peer has made?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

We are pushing very aggressively on all fronts to drive results for shareholders. So we are approaching every day with a sense of urgency and enthusiasm about our performance and a desire to get better every single day. So as I said, we are always open to best practices. We're watching the industry. We're doing things differently ourselves, driving for shareholder value. So I'm very confident that we're on the right track, and that we are going to pursue a balanced plan that includes both efficiency and growth. And we'll produce great results for shareholders, as a result.

Bascome Majors - *Susquehanna Financial Group, LLLP, Research Division - Research Analyst*

So -- I mean, does that suggest that while the CSX moves have been very effective in the short term that you think that, that strategy purely pushed in that direction is -- could be damaging long term? I'm just kind of curious what the board's perspective is.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Well, we believe in our plan. And our plan is a balance of efficiency and growth, as I've said several times this morning. That really is the right formula, in our view. You do need to make the investments for growth. You do need to have a certain level of resources available, particularly in times that are conducive to growth, like these times. So while we are definitely focused on productivity going forward, right now is the time to make sure that you have the workforce in place to handle the business, so that you can grow when that's possible. So I think our plan will be the right plan for our shareholders in the future.

Operator

Our next question comes from the line of Brandon Oglenski with Barclays.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP & Senior Equity Analyst*

So Jim, not to pepper you with another one here versus your competitor. But I do think it's important when you think about the cost structure of someone you're going to bat against, especially with competitive contracts. We know it's not that much overlapping business in the east but definitely some jumpoffs here. And just looking at the metrics, at least optically, it does appear that CSX has the right formula here with much lower labor cost and higher velocity in the past year. So -- I mean, what -- do you have any concerns going forward that, wow, we might actually be quite uncompetitive from a cost structure and a service perspective as we look out into 2019 and 2020?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

We are very focused on cost structure as well, and cost structure is critical in our business. We are an asset-intensive, resource-intensive business. And you have to mind those resources every day. So sweating the assets and making sure that we have the right level of people and other resources to get the job done is critical in our business. And we'll continue to focus on that. Very focused on cost structure. You also have to make the investments in order to grow, though. So we're going to make those. We're going to continue to keep the people on, the staff that we need to generate that growth and support great customer service, so likewise for all of the other resources we employ.

Operator

Our next question comes from the line of David Vernon with AllianceBernstein.

David Scott Vernon - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

And I will not ask about operating ratio. I would like to know a little bit, Alan, about something that is going right. You guys are outgrowing the market in domestic intermodal by a factor of 1, 1.5., and you're getting a little bit better price. What are you guys doing right in the domestic intermodal business right now? And how should we think about how sustainable that could be over the next, call it, 12 to 24 months?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes, that's a great question. We've got the best intermodal franchise in the east. And to pivot off of what Jim said, we've made investments in this intermodal franchise over time, and that is bearing fruit for us and for our shareholders. And that's why we've been able to deliver 20% growth in intermodal on each quarter this year. And our confidence remains very high on our ability to execute going forward. Our customers want to continue to do business with us and are very excited about the growth prospects in this economic environment moving forward. So we're in great shape with our intermodal franchise. We've improved price. We've improved the margins on it. And we're benefiting from the investments that we've made in recent years to support this growth and provide a service product.

David Scott Vernon - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

Is there anything you can help us understand kind of from a top-down level? Will -- we spent some time with the intermodal schedules, but if you were to think about kind of how your transit times compare versus other transit times in the marketplace, like how big of an advantage is there? And do you see any risk? Or is there -- are there some structural things that you guys have that allow you to keep that transit time advantage in the schedule?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Yes, we've got a great network between Chicago and Eastern PA and then down to Atlanta. Our primary form of competition is truck, and we're able to leverage the tight truck market into 20% growth. We're also doing that in our merchandise network. And recognize that our merchandise revenue was up 8% in the second quarter. And if you combine our growth rate and merchandise and intermodal, we outpaced the growth rate and truck volume over 300 miles in the first half of this year. So it's -- we've got -- we have a great franchise, whether it's intermodal, coal or merchandise. And we're competing very hard, very aggressively against truck, and it's delivering results.

Operator

Mr. Squires, there are no further questions. I'll turn the floor back to you for any final comments.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Well, thank you very much, everyone. We appreciate your time and attention this morning.

Operator

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.