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Norfolk Southern Corp. (NSC)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Norfolk Southern Corporation second quarter 2020 earnings call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce Pete Sharbel, Director of Investor Relations. Thank you, Mr. Sharbel. You may now begin.

Peter Sharbel

Director-Investor Relations, Norfolk Southern Corp.

Thank you and good morning, everyone. Please note that during today's call, we may make certain forward-looking statements, which are subject to risks 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.

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

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

James A. Squires

Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

Good morning, everyone, and welcome to Norfolk Southern's second quarter 2020 earnings call. Joining me today are Alan Shaw, Chief Marketing Officer; Mark George, Chief Financial Officer; and Mike Wheeler, Chief Operating Officer.

As we announced earlier this week, Mike will retire from Norfolk Southern on October 1, after a 35-year career of distinguished achievement. He will be greatly missed, and we wish him well.

When we began the search for our next Chief Operating Officer, we looked for an experienced executive who could lead our day-to-day operations and build on our successful implementation of precision scheduled railroading. We are proud to welcome Cindy Sanborn, one of our industry's leading operations experts, to the Norfolk Southern team. We look forward to Cindy joining the company on September 1.

With that, let's proceed to a review of our second quarter performance. Amid the global pandemic and ensuing economic disruption in the markets and communities we serve, the men and women of Norfolk Southern demonstrated their resilience in the second quarter. Our customers in virtually every segment shipped significantly lower volumes, with many changing their shipping patterns as they work to keep the supply lines open.

The automotive industry was particularly volatile, experiencing a rapid and almost total shutdown and then a subsequent restart and push to restock inventory, all within the same quarter. Norfolk Southern's business reflected that disruption. Revenues decreased 29%, leading to a decline of 43% in earnings per share.

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Our team rose to the challenge. We quickly adjusted network plans and resources in the short term, while advancing our long-term strategy to deliver shareholder value with several important achievements. First, Norfolk Southern employees are serving our customers and our country with excellence during a pandemic. The successful implementation of our TOP21 strategic plan and precision scheduled railroading, combined with the hard work and commitment of our employees, is producing results. We achieved record train performance, train speed, terminal dwell and shipment consistency. Many other service metrics were near all-time best levels.

Second, we managed our operations efficiently as shipping volumes bottomed out while ensuring we have strong operating leverage as business recovers. Year-over-year in the second quarter, our force levels declined by 20%, that's nearly 5,000 positions, while train size increased and fuel efficiency improved. These achievements enabled an operating expense reduction of 21% against a 26% decline in volume. We are a fast, fluid railroad ready to take advantage when volumes return.

Third, and perhaps most important, we kept our eye on our strategic objectives by attacking structural costs. We reduced our hump yard footprint in the quarter by idling two additional humps, bringing the total to four that have been idled over the past year. These actions create direct cost savings over the coming quarters and demonstrate our success in proving our TOP21 train plan to be nimble and adaptive to changing freight demand with fewer, more efficient major terminals.

Throughout all of this, we are taking comprehensive steps to protect the health and well-being of our people. All employees who can work remotely continue to do so. For employees whose responsibilities require them to work on site, we are following CDC guidelines.

I opened by lauding our team's resilience. While each one of these actions and achievements on its own has merit, when taken together and in the face of the unique disruptions of the second quarter, they demonstrate the determination of this team to forge ahead and take on any challenges necessary to create value for our shareholders.

I'll now turn the call over to Alan and the team to provide further details and commentary. Alan?

Alan H. Shaw

Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

Thank you, Jim, and good morning, everyone. Second quarter volume was greatly influenced by the dual shocks of COVID-19 and large declines in our energy markets. We remain committed to executing our strategic plan of long-term revenue and margin growth based on our excellent service product and market approach, both valued by our customers.

Our productivity, service and collaborative focus was most evident in our automotive franchise, where weekly volumes declined over 90% early in the quarter. We quickly pulled down our automotive train service and, as automotive production resumed, rapidly ramped up operations to effectively and efficiently serve our customers.

Our dynamic planning process and proactive collaboration with our customers produced this rapid restructuring of plan and assets. Our team remains committed to both maximizing profitable growth and improving our service offering as we emerge from the challenge of the pandemic.

Moving to slide 6, second quarter revenue declined 29% year-over-year. These declines were affected by volume impacts of COVID and low energy prices, the latter of which also impacted fuel surcharge revenue. The first half

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of the quarter had dramatically different results than the second, in which we saw an 8% sequential improvement in volume as the economy started to reopen.

Our continued focus on yield is evident with all three business groups improving revenue per unit, excluding fuel, a year-over-year gain we have delivered for 10 consecutive quarters. Decline in fuel surcharge revenue and a changing business mix composed of a greater percentage of intermodal volume, lowered overall revenue per unit.

Merchandise volume declines were most pronounced in the automotive franchise as automotive volumes declined more than 60% quarterly amid April and May production stoppages throughout the industry. Decreases in this market rippled to adjacent products such as steel and plastics.

Nearly every market was hurt by pandemic shutdowns, energy prices, consumption decreases or a combination of these items. Food products were greatly influenced by closed restaurants and other points of sale. Low energy prices drove declines in all of our energy markets, including utility coal, frac sand, crude oil, natural gas products and scrubber stone.

Intermodal revenue fell 19% in the second quarter, driven by lower levels of consumer demand in response to the pandemic. As the economy reopened, intermodal volume improved as demand for our services grew and truck rates increased. Domestic volumes rebounded as the quarter progressed due to the need to quickly rebuild inventory, while international remained pressured. The increased use of e-commerce and essential goods led to more transloads and domestic equipment.

Our coal franchise continued to face pressure this quarter, with revenue declining 55% year-over-year, a result of sustained low energy prices and the global pandemic. Utility volumes declined 67%, as load in the industrial and commercial markets deteriorated and coal generation faced intense competition from low natural gas prices. The overall coal decline was slightly offset with an RPU gain of 3%, reflecting volume shortfalls and changing mix.

Moving to our outlook on slide 7, we believe the recent volume growth trajectory will moderate with future gains at a slow and uneven pace from June levels. A high degree of uncertainty exists, state and local government reaction to increased COVID cases will have a major influence on the speed and shape of the economic recovery. The growing number of such cases and fiscal policy will impact our outlook to the extent that both influence the strength of consumer demand and labor availability, with the latter having an effect on production.

The consumer is active with high retail sales figures reported for June and durable goods spending close to pre-pandemic levels, increasing the need for transportation services. In the trucking sector, spot rates have returned to pre-COVID levels and are currently at the highest point of the year during this inventory replenishment cycle, a positive near-term signal for intermodal and truck-competitive merchandise markets. These markets rely heavily on the consumer, where the impact of government stimulus, potential shutdowns, and unemployment will be key drivers in the continued recovery.

Intermodal will benefit from new product development, such as the recently announced newer services that strengthen the link with our best-in-class channel partners, enhance our interline service offerings, and allow Norfolk Southern to secure even more business moving from the Southeast to the Northeast. These products create value for our customers while utilizing the capacity dividend generated by our efficient and faster network.

Although the manufacturing economy is lagging the consumer, we are seeing a solid rebound in automotive, where volumes quickly started improving at the end of May, with continued strength through the third quarter as inventories rebuild. We expect energy to remain depressed. Continued low natural gas prices and unfavorable

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crude oil spreads are creating additional headwinds across all of our energy markets. Export coal is expected to continue to be negatively impacted by the worldwide pandemic and geopolitical tensions.

Our expectations are tempered with the ever-present uncertainty surrounding COVID-19 and fiscal policy. This quarter was marked with a sharp difference between the first six weeks and the last. We understand that our volumes will fluctuate as our customers and their customers are impacted by potential future state and local restrictions in response to increasing COVID infections.

Despite these conditions, our strategy is clear. We will continue to improve our revenue quality and service product, delivering services that allow our customers to compete and succeed while utilizing fewer resources.

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

Michael Joseph Wheeler

Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.

Thank you, Alan. And thank you, Jim, for those kind words.

The second quarter saw an unprecedented amount of operating change as we ceased hump operations at two yards and responded to major volume shifts, with a keen eye towards making many of our crew start reductions permanent. We continued to execute at a high level while pressing forward with our transformation and managing through the challenges of the pandemic.

Moving on to slide 9, which again shows continued improvements in train speed and terminal dwell, setting or tying all-time records for us this quarter, our operation benefited from the network fluidity that came with dramatically lower volumes. We were able to adjust our operation in line with our customers, again, setting records in train performance, shipment consistency, and plan adherence. These milestones came as we further reduced assets and employment while taking advantage of the lower volume environment to reconfigure our network operations.

Moving on, slide 10 is the update to our service and productivity metrics for the year, which you have seen in previous quarters. All of our metrics are showing improvement on a year-to-date basis, reflecting both our continued progress and the effect of the pandemic.

Our service delivery index measures shipment on-time performance indexed to 2018. We were already at our 2021 goal in the first quarter and continued to improve in the second quarter, which will enable us to meet or exceed our goals over the rest of the year. We continue to provide a service product that meets or exceeds our customers' expectations.

Extreme volume swings challenged both T&E and locomotive productivity during the quarter. We reduced both T&E employment and active locomotives during the quarter to the lowest numbers on record, but those changes slightly lag the reduction in volumes. We improved our year-over-year train weight by closely matching the train plan to volume changes and being careful about when and where we added additional service as business returned. Train length grew even more than train weight.

Matching the plan to volumes helped us realize an increase in fuel efficiency to a second quarter record by maximizing the returns on the investment in energy management and PTC technology.

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Finally, we easily surpassed our cars online goal, setting new records in the quarter that were driven down in part directly by lower volumes and in part by our record train speed and dwell metrics that kept cars moving towards destination. As in past quarters, this includes cars that were both active and stored awaiting upturns in business.

Moving on to slide 11, this is our sixth consecutive quarter of accelerated crew start reductions. I am exceptionally proud that our operating team was able to respond so quickly to the sudden and severe pandemic-induced volume drops. We will continue to use both tactical and structural changes to keep our cost structure controlled and flexible as volume changes.

Prior to the pandemic, we advanced through Phase 3 of the TOP21 program. We are continuing to optimize our train network and rationalize our yard network, even while setting the stage for positive operating leverage as volumes rise. Implementing TOP21 enabled us to cease hump operations at Linwood and Bellevue. Continued progress comes through long-term structural changes in our asset base, improved service levels, and rising productivity metrics following proven PSR principles.

Moving to slide 12, we seized the opportunity to use the second quarter business drop to craft a better plan for when traffic returned. As this graph shows, we reduced crew starts in line with business reductions. But as traffic comes back, we are fully optimizing our train capacity based on our current business mix instead of simply just restoring previous train starts.

Slide 13 shows how well Norfolk Southern is positioned. In the second quarter, we closed one of our two locomotive heavy repair shops and ceased hump operations at two of our large yards, Linwood and Bellevue, making a total of four hump yards eliminated in a year's time. Our structural network changes are emblematic of our willingness to transform the way we operate in the pursuit of efficiency. We aggressively continue to look for additional opportunities to reduce our terminal footprint.

We can and will do more to reduce our resource and investment needs. But we are also capitalizing on the return of traffic from historic lows by adding back trains more slowly than returning traffic. As traffic does come back, we are much more willing to mix traffic types on whatever trains have capacity and can meet service standards. Generating this kind of operating leverage during a rise in traffic is very powerful, and we are committed to maintaining that leverage.

Now I will turn it over to Mark, who will cover the financial results.

Mark George

Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

Thank you, Mike. Good morning, everyone.

On slide 15, you see the key financial measures. As Alan shared, while RPU ex-fuel for each commodity was favorable, adverse mix and declining fuel surcharge revenue created headwinds, leading to overall revenue being down 29% on volume being down 26%. Operating expenses were down 21% in the quarter, with each cost component driven lower, led by fuel as well as employment-related costs.

As we signaled in May, we weren't able to completely mitigate the sudden and dramatic volume declines with dollar-for-dollar expense reductions, and this led to operating income being down $455 million while the operating ratio increased 710 basis points. Despite the 43% decline in operating income, free cash flow for the quarter declined by half that rate or 22%. So it remained more durable and contributed to a record free cash flow during the first half of the year of over $1 billion.

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On slide 16, you'll see that the quarter was free of any significant unusual items, although the EPS compare versus last year does benefit from the absence of a non-operating impairment charge that was recorded in Q2 2019. So while the reported EPS eroded by $1.17, the contraction from core operations is actually $1.25.

Moving to slide 17 and operating expenses, you'll see they were driven down by $385 million or 21%. Certainly, fuel savings were a large contributor with roughly half of that savings, driven by the sharply lower prices. $74 million of the reduction was from lower consumption due to the decline in GTMs, but also another solid quarter of fuel efficiency gains, which was 3% this quarter and is now 4%, year to date.

We drove comp and ben down $126 million, or 18%, as employment was reduced by nearly 20%, or 5,000, year over year, and down 5% versus 1Q. It's important to note that as we pressed forward with structural resource reductions in the quarter, we did maintain forces on extra board status that would be required to serve in the event of a sudden surge in volume, which is exactly what happened in June, where volume sequentially increased 12% from the May level, with no adverse service disruption.

As Mike touched upon, we prioritized this approach as complementary to our strategic plan's focus on best-in-class service without the cyclical variability in reliability that has plagued the industry historically. You'll note $20 million in savings from managing tightly our overtime, as well as recrews which were down 50%. In line with what I had signaled during the quarter, comp and ben per employee was sequentially down by a modest amount.

Moving over to purchased services and rents, this was down 11%, with purchased services itself down 13% driven by lower intermodal and automotive facility costs associated with the volume decline. Material costs are down $20 million, thanks in large part to reduced maintenance costs associated with our mechanical realignment, as well as initiatives surrounding the locomotive and rail car fleet rationalization. The lower other costs of $11 million benefits from our constraint of travel and other discretionary items. Gains from the sales of operating properties this quarter was negligible, similar to last year.

You'll recall last quarter, I provided a window into how you should think about these expense categories from a volume variability perspective, given the onset of what we knew would be a volume shock here in Q2. I indicated that we would be able to reduce roughly 50% to 60% of our costs with volume. In Q2, the 21% reduction in costs, or 16% if you exclude the anomalous fuel price benefit, was exactly in line with that 50% to 60% guidance I had given.

On slide 18, we look at the full P&L and here you'll see that other income, net, of $49 million is $27 million better than prior year. This favorability is driven by the absence of last year's $28 million asset impairment charge, along with a $25 million year-over-year increase in COLI returns. This favorable return was partially offset by headwinds from lower non-operating property gains as well as transaction costs associated with the debt exchange that we completed during the quarter. Lastly, the modestly lower effective tax rate in the quarter of 22.1% was driven by the COLI returns I just mentioned, which are not subject to income tax.

Moving to slide 19, for the six months ended June 2020, our free cash flow was a record at $1.023 billion aided in large part by fewer capital additions and timing of income tax payments. Property additions in the first half were $735 million, $244 million below 2019 levels, and we're on a run rate to be at our target of $1.5 billion for the year, which will be a 25% reduction from 2019 spend levels.

With our cash generation and liquidity profile, we were able to continue to distribute cash to shareholders, maintaining our dividend, while moderating share repurchase activity. In the quarter, we repurchased 1.3 million

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shares, roughly $200 million. As of now, we have over $1 billion of cash on hand, with less than $100 million of debt maturities in the next year. So we are in a comfortable place in case the recent market stabilization that we are enjoying falters.

I'll just wrap with a comment on the outlook. While we can't be certain of the volume shape in the back half, as you heard from Mike, we are taking this opportunity to make significant structural changes to our network, while also driving further efficiencies into the train plan. These actions ensure that we are well positioned to leverage the volume recovery. And that in any scenario, we are moving forward with transforming our cost structure.

Jim?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

Thank you, Mark.

In summary, we are committed to driving our operating ratio down and still have a goal of 60%. We have a full-court press on productivity initiatives to ensure that our cost structure improves while also capitalizing on the operating leverage that we are achieving.

Thank you for your attention and we'll now open the line for Q&A. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now be conducting a question-and-answer session. [Operator Instructions] And our first question is from the line of Chris Wetherbee with Citi.

Chris Wetherbee
Analyst, Citigroup Global Markets, Inc.

Q

Hey, thanks and good morning, guys. Jim, I just want to pick up where you left off. So you mentioned the goal 60% from an OR perspective. And, obviously, there are some structural changes that you made during the quarter. Some of those might have been pulled forward from future plans because of the pandemic. But when you think about sort of the hump yard opportunities and some of the other structural network changes that you've made, how do you sort of see that potentially impacting that longer-term 60% goal? Is there an opportunity beyond 60%? Can you just put some numbers around it?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Good morning, Chris. Good question and really shines a light on what is our main focus right now, which is to continue driving productivity and efficiency gains in the current economic environment. And we took action in that regard in the second quarter through the conversion of one hump yard and the closure of another. We also took offline one of two major back shop locomotive maintenance facilities.

So we demonstrated our commitment to driving productivity in the midst of the volume challenges in the second quarter, and we will continue to push hard on that as we move through the rest of the year and beyond. Mike, let me turn it over to you for some additional comments.

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Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.
A

We're not letting off the gas. We've got several things we continue to look at that are in the hopper, and we'll roll out, as appropriate, based on the volumes in the business. But like I've said before, we are going to continue to push ourselves to find ways to reduce our structural costs out there and the terminals that we can do without, while still providing the service product that we've committed to. So we still have things we're working on and you'll see those roll out in the future.

Chris Wetherbee
Analyst, Citigroup Global Markets, Inc.
Q

Okay, that's helpful. I appreciate that. And then maybe, Alan, one for you on the Yield-Up strategy, obviously, you put up, I think, 10 consecutive quarters of yield growth, RPU growth, less fuel. When you think about the potential for an improving truckload cycle, so our rate environment getting better potentially next year, how quickly does that translate down into the business, say, into the merchandise or intermodal business? Can you capitalize on that in the back half of the year, or is it something we need to see potentially rolling out into 2021? Can you just give us some comments on that?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.
A

Chris, it depends upon how quickly it moves up and whether those spot rates that we're seeing right now translate into contract rates. But yes, we generally touch 50% – 55% of our revenue every year. And we've got a great service product, and we've got confidence in the quality of that product and we're pricing accordingly.

Chris Wetherbee
Analyst, Citigroup Global Markets, Inc.
Q

Okay, I appreciate the time. Thank you.

Operator: The next question is from the line of Tom Wadewitz with UBS.

Thomas Wadewitz
Analyst, UBS Securities LLC
Q

Yes, good morning. So maybe I can start off with one for you, Jim, just in terms of the Chief Operating Officer transition. So Mike, congratulations on the retirement...

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.
A

Thank you.

Thomas Wadewitz
Analyst, UBS Securities LLC
Q

...and all the progress on PSR and TOP21. Jim, how did you think about the search process and, given the success with TOP21, this decision to go external as opposed to going internal?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.
A

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Sure, Tom. Well, I too want to thank Mike again for his many contributions over the years and we deeply appreciate your service, Mike.

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.

A

Thank you.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Let me describe briefly the process that the Board of Directors went through in selecting Cindy as our next Chief Operating Officer. It was a comprehensive search process. It began by defining the experiences and qualities we were looking for as a Board of Directors in our next COO. And these were things like demonstrated experience with operations at a very high level, at a leadership level; a commitment to safety in operations as paramount; qualities like success in working with regulators and other stakeholders; a commitment to service – great service for our customers.

So we began with a large field of candidates. We steadily narrowed it down, and we ended up with Cindy. And she brings to us all of the qualities and experiences that I just outlined. And in addition, she brings experience with the PSR model specifically, having worked at both Union Pacific and CSX, which, like NS, are in the midst of implementing PSR. So we're delighted to welcome her to our team starting September 1.

Thomas Wadewitz
Analyst, UBS Securities LLC

Q

Okay. Great. And then for the follow-up question, just wanted to see if you could offer some broader thoughts on how we think about the move over the next year or, plus or minus, the move in the operating ratio. Is this primarily a volume-driven operating leverage type of framework? Is that the way we should look at it in terms of really focusing on volume? Or is there really a lot to go still on the kind of pure costs, productivity, TOP21 framework? I'm sure it's a mix of both but I'm just trying to get a sense of which would be more important looking forward or looking to 2021? Thank you.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Let me start by acknowledging that the operating ratio in the second quarter is not where we need it to be and not where the operating ratio will be going forward, we believe. It was a tough quarter, particularly the first part of it, with revenue down as much as it was, particularly in key areas. So we struggled in the first couple of months in the quarter.

Now things began to turn around in June and we saw the volume pick up. And naturally, we saw the operating leverage kick in, in the month of June. And that has continued, thus far, in July as well. Who knows what the rest of the year may hold. As you heard from Alan, it's a mixed outlook. We're feeling pretty bullish about the current volume levels relative to where they were in the second quarter, but we'll see.

Looking out, if the question is whether growth counts, whether growth matters for further operating ratio improvement, absolutely, it helps. And it would be a significant tailwind. If the question is whether our strategy for OR improvement is dependent on growth, the answer is no. We intend to drive the operating ratio lower and to get to our 60% goal under whatever conditions we experience. We believe we have a strategy that is adaptable

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enough and we have enough opportunities in other areas while pursuing strategies that we believe will grow the top line as well.

Thomas Wadewitz
Analyst, UBS Securities LLC

Q

Great. That's very helpful. Thank you.

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

Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.

Q

Thanks, operator. Hi, everybody. Just a quick question. Jim, do you think OR can be flat to down this year? I mean, it seems like the 71% OR this quarter is really a reflection of unprecedented volume decline. And to be fair, the cost performance was actually pretty good. But there's just a certain point where you can't react to a 30% decline in revenue from an OR perspective, which is an output.

But obviously, there's a lot of revenue – incremental revenue coming in, in the third and fourth quarter relative to the second quarter that could drive this step function improvement in OR, given the costs that you've done. So I'm just trying to understand, can you hold the line on OR on a year-over-year basis this year, even despite the volume challenges you had in the first half, given that it's getting a lot better in the second half so far?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

If the comparison is to the volume trough, what we hope will prove to be the trough, in April and May, then yes, we have seen a significant impact and is an uptick. And as I said, that has translated into operating leverage in the latter part of the second quarter and in the third quarter. And we would expect that to continue given current volume levels and the productivity measures we've undertaken. But there's so much uncertainty in the macro outlook. Not only for the remainder of this year, but going forward as well.

And let me turn it over to Alan. He made a few comments in prepared remarks on this. But Alan, why don't you talk a little bit about our macro outlook for the rest of this year and into next year.

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

As Jim noted, we're pretty optimistic about the third quarter. You saw a strong sequential improvement in June over our trough in April and May. Volumes are increasing again, sequentially, in July, which goes against normal seasonality, where you typically have a little bit of a downturn in July. And so we see retail activity was up 7.5% in June. We saw durable goods orders were up 7.3%. Housing starts were up 17.3%. Spot rates are up in the upper teens. And truck tonnage increased at the fastest pace in 8.5 years. The auto restart has certainly helped and that's reverberated through the supply chain.

So as we talk to our customers, there's a lot of near-term demand. The risks that we see going forward are increasing cases of COVID and the unsettled situation with fiscal policy and the stimulus, and the impact that that could potentially have on fourth quarter volume and revenue.

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Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.
Q

Right. So if I'm hearing you guys correctly, nobody knows the future but if the current trends hold, you think you can keep OR flat to even better on a year-over-year basis this year. Am I reading that correctly?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.
A

We're not willing to give guidance on OR, just given the overall uncertainty. We will continue to push hard on cost. And we have measures in the pipeline and we demonstrated our commitment to cost control in the second quarter as well. We'll keep doing that.

Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.
Q

Okay.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.
A

It's just that the macroeconomic – the macroeconomic outlook is so uncertain right now.

Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.
Q

Fair enough. And then, Mark, just a follow-up. The CapEx, year-to-date, is running lower than the 16% to 18% of sales, which is actually making free cash conversion look pretty good. I'm wondering if there's a potential to see CapEx come down relative to that guidance. You've kind of talked about it in the past, but I'm just wondering if there's any more update you can give there. Because the company's free cash conversion is lagging most of the peers, that's obviously going to weigh on the multiple of the company – the valuation of the company, I'm just wondering if there's any opportunity to bring down the CapEx to actually improve the free cash conversion.

Mark George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.
A

Thanks for the question, Amit. We didn't guide to really to 16% to 18% after the last call, we actually just gave a fixed guidance number on CapEx, where we brought it down to $1.5 billion. And really, the first half number, that is our run rate. So we are going to finish the year at or about $1.5 billion regardless of revenue. So I think hopefully, it means that as a percentage, it could actually be lower than the 16% to 18% range. So we started early in the year in February and said it's time to bring it down, and we took $0.5 billion out. We will have taken $0.5 billion out of our CapEx budget this year compared to last year.

And yes, definitely that is what's driving that good conversion you point out in the first half. So the CapEx in the back half is going to continue at that rate, so that should help. But also, Amit, as I mentioned in the prepared remarks, some of the conversion benefit that we did enjoy in the first half was a function of income tax payments that really, in large part, thanks to the CARES Act, were pushed into July. So some of that will be made up, unfortunately, in the second half, we won't have the same tax benefit.

And then we also had some working capital benefits in the first half. When volumes come down, you don't have as much AR building up. So that will probably unwind as volumes recover in the second half as well. But fully

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aware that from a cash conversion perspective, our goal is to try to raise that number from where it's been historically, and CapEx is one of the vehicles to get there.

Operator: Thank you. Our next question is from the line of Jordan Alliger with Goldman Sachs.

Jordan Alliger
Analyst, Goldman Sachs & Co. LLC

Q

Hi, a question on intermodal. You had noted the truckload market tightening. Of course, that's good for the longer-term intermodal. I'm just sort of curious. Are you actually seeing increased activity or dialogue with customers or perhaps even truck conversions now with regards to intermodal as the truckload market tightens? Thanks.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Alan?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

Jordan, absolutely, and you can see that reflected in our numbers. Intermodal is actually leading our growth right now, as is automotive. Basically, the consumer segments are doing really well. And we've got a powerful intermodal franchise. We've got a lot of channel partners and beneficial cargo owners out there who want to continue to align themselves with us.

And so we're delivering a wonderful service product and it gives us the strength and the confidence to initiate some of these new service products. We've got a couple new products that we're going to be launching in the third quarter between the Southwest and the Southeast, which are the two fastest-growing regions of the country, and also a product from the Southeast to the Northeast, which has already started. There is absolutely demand for intermodal in this market. And the truck market in certain regions of the country is extremely tight, and Norfolk Southern has got the solution for that.

Jordan Alliger
Analyst, Goldman Sachs & Co. LLC

Q

Great, and then just a follow-up. I know you mentioned – you guys mentioned on the call not bringing back crew starts one-for-one with volume, et cetera. Is there a way you could give some thoughts on head count as we move sequentially from here, based on where it ended in the second quarter? Is there a way to sort of think about the pace of that coming back?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Mike, why don't you comment on the trend in crew starts and then ripple through to T&E employment specifically. And then, Mark, maybe you can take the question on overall head count going forward.

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.

A

Yes. As you noticed in the slides, we continue to leverage crew starts versus volume. And the good news is that's continued in through July. Through July, our crew starts are down 20% while our volume is only down 10%. So we expect to see that leverage going forward. And we've got a great nimble group to be able to iterate the train

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plan as necessary and get the leverage on the volume. So really pleased about that, again, 20% down in crew starts July already while volume is only down 10%. So we continue to see that and will in the future. Mark?

Mark George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.
A

Yes. And just to remind, we've gone down 5,000 employees versus Q2 of last year, that's a 20% reduction. We're kind of lapping now the big step change from the TOP21 implementation, but obviously we're still chasing a Q2 volume decline that was pretty significant.

So we are focused on trying to rebuild that productivity curve. And as Mike said, hopefully, with any volume growth that comes here in the back half, we can absorb it with what we have, but also continue to look for more productivity opportunities. I'm not going to put a fine point or a number on guidance for head count, but for sure it's going to be an area that we're focused on leveraging while we enjoy the volume recovery.

Jordan Alliger
Analyst, Goldman Sachs & Co. LLC
Q

Thank you.

Operator: The next question's from the line of Scott Group with Wolfe Research.

Scott H. Group
Analyst, Wolfe Research LLC
Q

Hey, thanks. Good morning, guys. Mark, last quarter you gave us some good color on costs and said hey, don't expect them to be down more than 20%. Any initial thoughts on how to think about the OpEx in the third quarter? And I know there's been a bunch of OR questions and you guys aren't giving guidance, but I don't know if you're willing to share, but maybe it would be helpful if you have a sense on can you share what the June operating ratio was? Maybe that will give us a little bit of help.

Mark George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.
A

So pretty much, the volume variability that we had guided last quarter I think helped informed you on expectations on OpEx. And at the end of the day, we came in pretty much in line with what we guided. So it worked out well. I would hope now, Scott, that as we start to see volume growth, we actually do better than that curve, that we leverage it and get better incrementals. That's the goal and that's the objective that this leadership team is fully aligned on.

But really, the big variable is going to be does this momentum we saw with the June volume recovery and what we're enjoying here in July, does it continue on this trajectory or does it stabilize? And that is really – if it continues, and I'm fully expecting we're going to try to leverage – we'll leverage that and get more and greater incrementals than hopefully what I showed you.

And yeah, we had quite a curve – to your second part of your question – quite a curve within the second quarter. And I'm not going to give you the exact number, but I will tell you we weren't in the 70s in the month of June. So that was encouraging to see that we will – you know, hopefully now that's behind us. We had a real deep body blow we took in in April and May that's hard to recover from. But June, we started to be encouraged by the leverage that we started to see with a 12% sequential improvement in volumes. So with the costs that we took out, we had a decent quarter – sorry, a decent month in June with an OR that was back in the 60s.

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Scott H. Group
Analyst, Wolfe Research LLC

Q

Okay, thank you. And then, Alan, can you help us think about the coal RPU going forward? It was still positive in the second quarter, but is that possible in the third quarter, I don't know, year over year, sequentially, however you think is the best way to help us out here?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

Scott, as I noted, there were two factors that primarily drove coal RPU in the second quarter. One was volume shortfalls, the other was mix. And you can see that punctuated where utility was down 67%, whereas export was down 45%. So just there, you get some positive mix. So you peel back even more, Scott, there's mix within these markets as well. So our utility South franchise in the second quarter was about 54% of our volume. Last year at the time, it was 50%. So there's a positive mix there.

Similarly within export, export met, which tends to also be longer-haul and higher RPU, was 74% of our volume in the second quarter comped to 56% in the second quarter of last year. So we had a lot of positive mix factors going for us in the quarter. I'd tell you seaborne coking coal prices continue to fall. In the first quarter, they averaged about $155 per metric ton and cascaded down throughout the second quarter. Right now, they stand at $110 to $115. And so that will put pressure on prices moving through the third quarter.

Operator: Thank you. Our next question comes from the line of Brandon Oglenski with Barclays.

Brandon R. Oglenski
Analyst, Barclays Capital, Inc.

Q

Hey, good morning, everyone, and thank you for taking my question. Alan or Jim, I guess can we just balance the comments you guys have made here because, Alan, I think in your prepared remarks, you said the recent pace of volume gains could moderate. But then I think as you've answered some questions here, you guys have sounded relatively bullish about volume outcomes. So what is it that you see in the market that gives you the bullishness now but just maybe making you moderate...

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Bullish for July, we've been bullish.

Brandon R. Oglenski
Analyst, Barclays Capital, Inc.

Q

It's just the idea that maybe we pull back here on recent COVID cases?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

Hey, Brandon, there are a couple of factors. Number one, we don't expect to continue a 12% sequential improvement in volume month-over-month as we saw – as we moved from May to June. As Jim noted, April and May were deep troughs for us. And we climbed out of that. We think that July's going to come in 4%, 5% probably above where we were in June. So you already see that pace starting to moderate.

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As we look forward, we see a lot of demand in our consumer-oriented markets, which includes merchandise and intermodal. The pressure continues within energy. And so that will have a governor on sequential improvement as we move through the year, and frankly, as I just noted with Scott Group.

Brandon R. Oglenski
Analyst, Barclays Capital, Inc.

Q

Okay. Appreciate that. And then Mike, congrats again on retirement. But I guess...

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.

A

Thank you.

Brandon R. Oglenski
Analyst, Barclays Capital, Inc.

Q

...I think you guys said that TOP21, you've gone through Phase 3 now. Can you just remind us what that phase was? I think it was integrating more line haul train operations, but can you dig deeper there and talk about what incremental changes you can make looking ahead too?

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.

A

Thank you. Yeah, sure. So the whole phases of TOP21 implementation has been about blending more and more traffic into the train network. And we first started out blending a lot of the merchandise into the automotive network. That was a big deal for last year's July 1 TOP21 implementation. A lot of that was done with the automotive multilevel into the merchandise, saw great results from that.

Phase 2 and 3 was more along the lines of integrating the intermodal into the operation and then continuing to look at what we could do with a reduced terminal footprint but still continue the integration of traffic into the train network. And then that's kind of where we're at now is we've got to the point where a train is a train and it gives us a lot of opportunities to add business back to the network, give it all sorts of opportunities for train rides and still meet the customer expectations. So we've got a lot of flexibility going forward now that we've blended all of that into the TOP21 network. So really pleased about that.

And again, a train is a train. And as volume comes back, it just gets added to the network in a really nice incremental way from a productivity metric. So really excited about that going forward. So we're ready to continue to iterate, as necessary, with to TOP21 as the business comes back. So pretty excited about it.

Operator: Thank you. Our next question is from the line of Ken Hoexter with Bank of America.

Ken Hoexter
Analyst, Bank of America Merrill Lynch

Q

Hey. Great. Mike, congrats and good luck. Jim, maybe I just want to step back on the clarifying your 60%. Is that now a long term, it's not – I just want to clarify, it's not a next year target. And then I guess I want to dig into this quarter, Mike, a little bit. If you took out 20% of employees but, as you noted, only 1,000 in the quarter with volumes down 26%. So most of the work was done before. Comp is now still 28% of costs, which is not different than it was back in 2017.

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So as you post an over 70% operating ratio, which is now 700 basis points worse than your peer and 1,300 basis points worse than the company that tried to acquire you. Just – I want to understand the confidence still in TOP21. What's missing? Even as companies were going through it, we saw others able to make improvements in that OR. What is the constraint here in getting the costs out, because in times like this, sometimes companies are able to pull out and be more aggressive in structurally taking out those costs? So Jim, as you step back, maybe give a view of what needs to be done here.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.
A

Sure, Ken. Well, as we said a few minutes ago, it was a challenging quarter, and we are not satisfied with the 70% operating ratio we posted in the second quarter. We fully expect operating ratios to trend down through a combination of the growth that we reasonably expect over time and that we will produce ourselves, and the productivity initiatives – the many productivity initiatives we have underway. Our strategy is adaptable, and we will lean one way or the other or into both, as necessary, given the environment we're in. And we are confident that we will make progress toward a 60% operating ratio. We'll get there as fast as we possibly can.

Ken Hoexter
Analyst, Bank of America Merrill Lynch
Q

But it is not – no longer is a 2021 target, right? It's now back to long term.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.
A

As I said, we'll get there as fast as we possibly can. And we have a lot of initiatives underway to do just that.

Ken Hoexter
Analyst, Bank of America Merrill Lynch
Q

Okay. And then, Alan, for a follow-up, your pricing up with the RPU program, which is yielding great results. Are you seeing any increased competitive moves, given your focus on pricing, or is the industry taking the opportunity to move on pricing as well? I want to understand like if others are viewing it as an opportunity to come in and take away business if you're focused more on pricing, and maybe that's why the extreme kind of volume swings.

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.
A

Ken, we have seen increased competitive pressures from truck, there's no doubt. And we went through a truck recession last year. But we remained focused during that time period on the long term and long-term value creation for our shareholders. And that's why we've got 10 consecutive quarters of RPU, ex-fuel, growth in all three of our business units. We're focused on revenue, revenue quality and margin improvement. We've got confidence in the strength of our franchise, in our markets, our customers and our service products, and the fact that we can provide a long-term platform for growth. And you see that reflected in our activity.

Operator: Our next question is from the line of Jon Chappell with Evercore.

Jonathan Chappell
Analyst, Evercore Group LLC
Q

Thank you and good morning, everyone. Alan, the auto snapback in the third quarter has been quite noteworthy, not just in your segments but even across the industry, double-digit jumps almost every single week since the

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third quarter started. How much of that, from your conversation with your customers, is a need to restock aggressively versus maybe how much of it is the network that you guys have to relatively outperform the rest of the industry?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

Hey, Jon, that's a very valid point. And that's kind of one of the issues that we've highlighted going forward. There are low inventory levels everywhere. We believe that auto finished vehicle inventories are close to a nine-year low at this point. And just look at retail sales, so the May inventory-to-sales ratio in retail was at the lowest point in eight years.

And so some of what we're seeing right now is an effort to rebuild inventories. And we saw our auto customers kind of adjust their normal July shutdown time period in an effort to rebuild inventories. Some of that will get pushed back until later in the year. So again, as we talked about, this pace of growth that we've seen over the last 10 weeks, we do not reasonably expect that to continue. But we are encouraged by the strength in the auto industry. And as a result, we're seeing our steel customers are out. They're raising their rates and they're adding capacity back as well.

Jonathan Chappell
Analyst, Evercore Group LLC

Q

Great, that's very helpful. And Alan, if I can keep you for the follow-up too. You mentioned the intermodal service offerings a couple times, the new ones in the growth part of the country. Just curious on the initial uptake response so far from the customers. On the one hand, you would think the cost proposition of rail is even more compelling, just given the pressure that most industries have right now. On the other hand, given the uncertainty in the market, maybe a little bit reluctant to transition more to the rails. How has the initial response been so far on some of those new offerings?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

It's been very strong. Customers are very interested in the product that Norfolk Southern delivers. And a lot of that has to do with the strength of our franchise. We've got the most robust intermodal franchise in the East. It is a powerful asset for Norfolk Southern, for our customers and our shareholders. We've made this investment and it's already in the ground, and it's created this network that's unrivaled in the East which is where a majority of the consumption and the manufacturing takes place.

And so we grew it, as you saw, by 11% in 2017. We grew it by 18% in 2018. It took a pause last year during the freight recession. We're very confident in the strength of our franchise, our market approach, the service product that we deliver, and the fact that it's going to be a unique platform for growth for us in the long term and near term.

Operator: Our next question is from the line of Allison Landry with Credit Suisse.

Allison M. Landry
Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks. Good morning. Jim, so you have Cindy starting in about a month or so. Could you talk a little bit about the initiatives that she'll tackle first in terms of the network? Any ideas that she may have already brought to the table from her time at UP or CSX, maybe, that are different or additive to what you're currently doing? And then where does Mike Farrell fit in? Will he report directly to Cindy and continue to roll out PSR?

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James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Cindy and I are very focused on maintaining the operational momentum that we have demonstrated in 2019 and 2020. So we, together, view this as an opportunity to continue to push hard on productivity. As we've said, that's a key part of our strategy. And the measures that we take will be similar to the measures we have taken, thus far, to work to enhance labor productivity, fuel productivity, asset productivity and on down the line. She and I are both also focused on maintaining a high level of service while we pursue these productivity initiatives. That's critical to our long-term success. That's the basis for our ability to grow the top line in the future.

And lastly, I would say that she and the rest of the Board are closely aligned on the central importance of safe operations. And we'll be looking for every possible way to continue to drive safety performance as well. So at a high level, that will be the agenda and the alignment that the two of us have.

Allison M. Landry
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. That's really helpful. And then just as my follow-up, is there a way to help us think through or quantify the cost savings or the OR benefit from the network changes that you made? And then more broadly, do you see opportunities for further rationalization, whether that's yards or other facilities or assets and possibly, are you considering any changes to the coal network? Thank you.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Mike?

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.

A

Yeah. Thank you, Allison. Like I noted, yeah, we are still going to continue to look at structural opportunities for cost reduction. We're going to find terminals that we can live without and still provide the service that we need. So we're going to push ourselves to do that.

I will note, we changed the operation at the two humps this quarter, and that's in addition to the two that we did last year. Jim noted the locomotive shop closure where we've just gone down to one heavy repair shop. We're reducing our production gangs here the rest of the year for capital reductions. So we're doing a lot of things to change the structural costs of the network. But that doesn't mean that we're going to stop.

Everybody's out there looking every day, turning over every rock to try and continue to find ways to do that. And yes, terminals will be a part of that, just like we've always talked about. We've got more in the hopper and we'll continue to look at that, but it will all be with an eye toward continuing to provide the service product that we've committed to, like we have. So more in the gas tank and more to come.

Mark George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

A

And Allison, this is Mark. I think we've mentioned before, you can probably pencil in $10 million to $15 million for the humps that we've close – for each of the two humps that we've closed. So to your specific question on quantifying them. That's the number.

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Operator: Our next question is from the line of Bascome Majors with Susquehanna.

Bascome Majors
Analyst, Susquehanna Financial Group LLLP

Q

Yeah. Alan, looking at your coal volumes, specifically in the domestic utility side, and 10 years ago, that was 30 million tons in the second quarter. This year, it's closer to 6 million tons, with quite a bit of that just coming out in the last year. Can you help us understand some of the differences between the structural pressure that you're feeling this year?

And what I mean by that is, have you seen any newer accelerated customary retirements on the domestic utility side of plants, where that's just gone and gone forever. In the cyclical, and you know what I mean by that, is just the pressure from natural gas and how power is being dispatched and just lower overall power consumption in the US? Thank you.

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

Hey, Bascome, we understand that coal's in a secular decline. We get that. And so what you've seen us do over time is adjust our coal network. We've idled Ashtabula. We've short lined some property in our coal fields. We have reorganized our operations in conjunction with our customers in the coal fields, into the southern utility market and actually improved service and improved efficiency.

So we understand the pressures that we're facing. Natural gas prices in June were at an inflation-adjusted low for the last 30 years. So that's created some headwinds, as we talked about. And I also had talked about before that we fully expected that the economic shutdown would negatively impact load in commercial and in industrial markets for our utility customers. So that's where it's headed.

Frankly, we've got a diverse merchandise franchise that set a record for revenue last year in a pretty weak freight environment, and we've got the most powerful intermodal franchise in the East. So we are well positioned for where markets are headed.

Bascome Majors
Analyst, Susquehanna Financial Group LLLP

Q

Okay. So looking into next year, clearly, these declines are pretty substantial in the coal franchise today. Do you expect that to moderate as at least the inventory withdrawal and the power consumption decline inevitably cyclically adjust, or should we just kind of model zero several years out in the domestic business to be safe? Thank you.

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

There's going to be 0.5 billion tons of coal produced in the United States this year. We're going to haul our share of it. There will be close to 0.5 billion tons of coal produced in the United States next year. We're going to continue to participate in that market where it drives shareholder value. And we're going to continue to look for opportunities within our strong merchandise and intermodal market to compete with truck.

Operator: Thank you. Our next question is coming from the line of David Vernon with Bernstein.

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David Vernon
Analyst, Sanford C. Bernstein & Co. LLC

Q

Hey, good morning, guys. Jim or Alan, just a question for you on the commercial side. If we kind of look past the monthly sequential gains from the COVID volatility and we think about where Norfolk is going to be a year or two from now, presumably you're still going to have a little bit of an OR disadvantage to your eastern peer. How is that going to affect your ability to get back to a market level of growth, or should we not be thinking that that cost position relative to CSX is going to impact the growth rates across the business?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

We're going to continue to focus on revenue and revenue quality, and we've performed pretty well there. You can see that in the numbers. We are fully intent on competing with truck. We're going to deliver and we are delivering a best-in-class service product. We're implementing customer-facing technology. We've got a consistent and reliable service product with schedules that our customers value.

We also have this no-surprises approach to PSR and which we're collaborating with our customers on changes that we're making to the network. And so they know – they're confident that we're going to partner with them and continue to provide them with a platform for growth. We serve a majority of consumption and manufacturing in the United States. We're aligned with over 250 short-line partners. We've got a best-in-class industrial development team that is developing a robust pipeline of new opportunities.

Near-shoring, reshoring, and onshoring is only going to assist freight demand in the United States. We serve more North American vehicle production than anybody else and more integrated steel mills than anybody else. We've got a powerful franchise. We're very confident in where we're headed with this thing. We've got it positioned well where the consumer and the transportation markets are headed, and that's in areas in which Norfolk Southern excels.

David Vernon
Analyst, Sanford C. Bernstein & Co. LLC

Q

So no sort of direct impact on the rail competitiveness then, it's more about what's happening in the truck market for growth?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

We are going to continue to focus on the truck market for growth. And you're going to see us continue to be aggressive and kinetic in offering new service products that our customers value. And we're aligned with the best channel partners in the intermodal industry. We're in good shape going forward. This is where the long-term markets are headed.

David Vernon
Analyst, Sanford C. Bernstein & Co. LLC

Q

Thank you.

Operator: Our next question is from the line of Justin Long from Stephens.

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Justin Long
Analyst, Stephens, Inc.

Q

Thanks and good morning. Maybe circling back to the operating leverage question and asking it a little bit differently, as you look into the back half, third and fourth quarter, do you think that operating expenses can decline at a rate that's faster than revenue? And then also, Mark, if there's anything unusual in the second half in terms of gains on sale you're expecting or anything else from an operating expense perspective.

Mark George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

A

Thank you, Justin. So I'll answer the second one first. We don't anticipate any unusual activity in the second half, significant gains or significant write-offs at this point in time. Otherwise, we would have probably taken them, so nothing at this point. Of course, I do believe in the third quarter of last year, you'll recall there was some account receivable provision that was taken that will impact the compares in the third quarter, but I'm sure you all have that in your models.

And the first – truly the trajectory of OpEx will be influenced in part by volume. If volume steps back down, we will be attacking OpEx even more. If volumes do continue on an upward trajectory, then we're still going to put pressure on certain lines of OpEx to reduce them with structural things, and we're going to try to limit the volume variable type of increases that would typically come. And as we say, we're going to try to leverage the P&L with any growth that might come.

That said, there is – fuel cost is creeping back up. I think our average price at the pump in the second quarter was under $1 per gallon, so that will go up in the back half of the year. I think right now it's already trending in the $1.20-something range. So that will be something that we are fighting against. And since I bring that up, we will have some fuel surcharge probably headwinds in the third quarter because that's on a lag. And that $0.98 range in the second quarter will hit our fuel surcharge in the third quarter because it's a lag item.

Operator: Our next question is from the line of Brian Ossenbeck with JPMorgan.

Brian P. Ossenbeck
Analyst, JPMorgan Securities LLC

Q

Hey, thanks. Good morning. Coming back to intermodal, where you clearly are focusing a lot of time and effort there and see growth down the road, can you remind us how the clean sheeting program is going on within those intermodal terminals? Is that still pretty well developed, or is that something that you've yet to see much benefit from, especially if you're expecting for this to be one of the primary levers to drive growth across the network as you look out over the next couple of years?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

Brian, we continue our progress in making our intermodal network, both within the terminals and in our train performance, more efficient. And as Mike has talked about, we continue to look for opportunities to fix intermodal trains. And we know that as intermodal and merchandise revenues come back, it's going to fold into existing trains. And in the third quarter, we're going to be rolling out a terminal optimization system across our intermodal network, which is going to offer even further improvements in the service that we provide within our terminals to our customers as well as the efficiency of our terminals.

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But I also want to make sure that it's really clear, we are focused on growing merchandise just as much. And we're putting out new products in merchandise based on this strong and reliable and consistent service product that we've got that's going to allow us to take share from truck as well.

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.

A

And the capacity dividend that we have out there on the merchandise side as well.

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

A

That's exactly right. Mike referenced the capacity dividend, Brian. And so that's where we're going to fold new business into existing operations which is going to give us great operating leverage going forward as we continue to grow.

Brian P. Ossenbeck
Analyst, JPMorgan Securities LLC

Q

Okay, a quick follow-up for Mike then. Congrats, again, on the retirement and the recent success with TOP21 and Phase 3. What do you think would be – as you look forward, what are the biggest challenges you see structurally on the operating side as you look over the next couple years, and how do you think you would be addressing those? And I guess I'll take away the answer of volume as a big challenge. So maybe volume-agnostic, what are some of the bigger challenges? And also if you see any further opportunities as well in terms of what's left for the network the next couple of years and in the long term?

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.

A

Thank you. And the opportunity is the fact that our operation leadership team is completely bought into and aligned with the PSR principles. So they understand them. They know them. And they're implementing them. So they're using that every day to find ways to be more productive but still provide the good service product. So I think that's the great opportunity is we've got a great team out there, that every day is looking to turn over the rocks and find what they can do.

And then the network planning and optimization group that we've put together that's really helped drive the TOP21 iteration, take the structural costs out, they're in place, continuing to look at long-term structural cost changes. And these are the terminals that we're talking about.

And then the last thing is we continue to have technology implementation across the operating division, whether it's in engineering to look at where we need to replace ties and rail and making sure we're doing it the most efficient way and the safest way, how we do train handling.

So we have just got so many opportunities out there on the railroad to continue to provide the service product that allows marketing to grow the business, but also folks know how to take out tactical and structural costs, and then utilizing technology that we've put out there across the railroad.

And the technology really has driven our fuel efficiency that you've seen over the last couple quarters. And that will continue to be another opportunity for cost going out the door, because that's nothing but dollar savings right to the bottom line. And it fits in with the ESG, making us a really good partner there.

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Brian P. Ossenbeck
Analyst, JPMorgan Securities LLC

Thank you.

Operator: Our next question is from the line of Walter Spracklin with RBC Capital Markets.

Walter Spracklin
Analyst, RBC Capital Markets LLC

Yeah. Thanks very much. Good afternoon, everyone. I want to go back, Jim, to one of the questions on operating ratio. I understand that looking out to next year in the back half, I should say, is a little difficult given the macro uncertainty. So I wanted to kind of take out that uncertainty and give you a scenario where volume is down – or the volume rebound continues and year-over-year down just modestly. In that scenario, not guidance, but in that scenario where we have volume down modestly, could you do better in terms of operating ratio than you did last year?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

Walter, I think in the current environment of uncertainty, it's very difficult for us to sign up for any scenario, even a hypothetical one. But I would say this, we are committed to driving toward a 60% operating ratio, irrespective of the macro environment in which we find ourselves.

And that means that if we are unable to grow volume and revenue at the pace we would like, we will attempt to make it up through productivity improvements. And I think we demonstrated that. Yes, the operating ratio in the second quarter was not what we wanted it to be and not what it needs to be. But in the midst of that, we recommitted to productivity improvements and we demonstrated that commitment through the actions we took.

Walter Spracklin
Analyst, RBC Capital Markets LLC

Okay. As a follow-up, on yields, just regardless of base price, I don't know if you can give me an indication, ex-coal, what the mix effect is expected to be in the back half, just kind of – should it be additive or negative? I would assume with automotive and some of the other products that are higher yield coming back, that should be positive, but I just want to make sure.

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.

Walter, good morning, it will be negative as intermodal is a growth driver for us. So that's negative with respect to yield, certainly, positive with respect to revenue growth.

Operator: Our next question is from the line of David Ross with Stifel.

David G. Ross
Analyst, Stifel, Nicolaus & Co., Inc.

Yes. Good morning, gentlemen. I just want to circle back on intermodal, obviously, much better third quarter to date. In the second quarter, international was a lot weaker than the domestic. How would you characterize July so far in the international versus domestic?

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Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.
A

They both have improved quite a bit. What you're seeing is there's not a lot of exports right now. There's heavy demand for imports in the international space. Since inventories are so low, you're seeing a lot of stuff that's hitting the West Coast as opposed to coming all the way around to the East Coast. And so that's creating some transloads into 53-foot containers out on the West Coast, which has opened the domestic demand. But I should say that we do have several ports that we serve where import demand right now is very high as well.

David G. Ross
Analyst, Stifel, Nicolaus & Co., Inc.
Q

And when you talked about the new service offerings, is that fair to say that those are new intermodal lanes or new intermodal corridors? And then the question is, are they, I guess, new to intermodal as if a shipper did not have that intermodal choice versus truck in those lanes before, or are they just new to Norfolk Southern?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.
A

They are certainly new – they are a new level of product that is not out there in the marketplace right now – or had not been. And we're confident that it's going to help us grow moving forward. And as I noted, we are going to be very aggressive in launching new products based on the capacity dividend and the service product that Mike and his team are delivering.

Michael Joseph Wheeler
Chief Operating Officer & Executive Vice President, Norfolk Southern Corp.
A

And the good news, most of that folds into the current intermodal network that we have now.

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.
A

And we've got our investments in place in our intermodal network.

Operator: Thank you. Our next question is from the line of Jason Seidl with Cowen and Company.

Jason Seidl
Analyst, Cowen Inc.
Q

Thank you, operator. Jim and team, good morning. Mike, congratulations on the retirement and Cindy, if you're listening, welcome. Wanted to talk a little bit about your end markets and if you can sort of give us an idea what percentage of your end markets started to come back in 2Q, and what percent are out still here as we look in – as we operate in 3Q?

Alan H. Shaw
Executive Vice President & Chief Marketing Officer, Norfolk Southern Corp.
A

Jason, as we've talked about, about 70% of our business is tied to the consumer economy and that certainly has improved sharply in June and July, and that we maintain our optimism for that through the third quarter. We also saw some improvement as well, though, in the energy market, but you're still talking about pretty difficult year-over-year comparisons there. So we're seeing lift in all of our markets -sharper lift within the consumer-oriented products that we serve.

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Jason Seidl
Analyst, Cowen Inc.

That's good color. And the other one – and, Jim, this might be one for you. But you've got a joint venture with Pan Am up in New England. That railroad has been put up for sale. Just wondering, is this something that Norfolk would look at, and sort of how would it work if another Class 1 took over that railroad?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

Pan Am Southern is an important part of our network. It is our presence in New England and we're committed to maintaining a presence in New England as part of our overall network footprint. And let me leave it at that.

Operator: Thank you. At this time, this concludes our question-and-answer session. And I will now hand the call back to Mr. Jim Squires for closing comments.

James A. Squires

Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

Thank you for your questions this morning. Before we close, I want to take a moment to affirm for everyone on the call, whether you're an investor, customer or employee or other stakeholder of our company, Norfolk Southern's commitment to diversity, equity and inclusion.

At a time when our society is experiencing dramatic upheaval, it's important to state in this forum that such a commitment is essential to delivering shareholder value. By pursuing measures that ensure inclusion and equal opportunity inside our company and in our interactions with others, we will serve our bottom line and our shareholders well. Thank you and be safe.

Operator: Ladies and gentlemen, thank you for your participation. This does conclude today's teleconference. You may disconnect your lines and have a wonderful day.

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