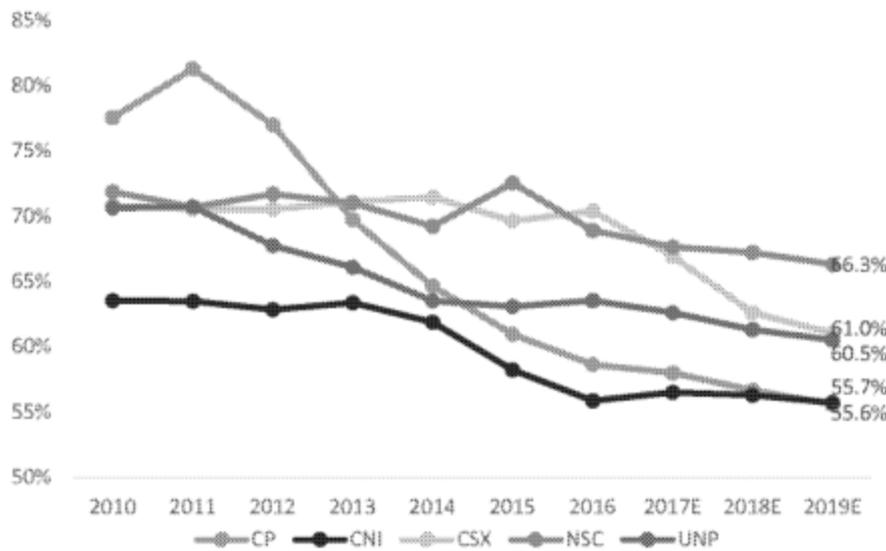




Profit and pricing discussion

All Class I railroads are solidly profitable in North America, with the companies under our coverage universe (CP, CNI, CSX, NSC, UNP) reporting an average ebit margin of 36.5% in 2016. This makes sense to use given the consolidated nature of the Class I industry, price discipline, and capital intensity needed to maintain an efficient railroad. There is some variability in the performance, however, with the Canadian rails achieving superior profitability relative to the U.S. rails.

Figure 24: Class I rail operating ratios (opex as a % of revenue) 2010-2019E



Source: Deutsche Bank, Company reports

*Hunter Harrison's Precision Railroading model has helped CP and CNI achieve best-in-class operating ratios.*

One driver of profit variation is yield differentials (i.e. revenue per unit or carload). For example, if we look at CNI, which has the lowest operating ratio (OR), 34% of its total traffic in 2016 came from its highest yielding end markets, compared to just 30% for CSX, which had the highest operating ratio of the Class I's in 2016. As you can see below, the companies with a larger percentage of revenue coming from higher yielding carloads typically see a lower operating ratio. While this does not entirely account for margin differentials (carloads are not created equal from an incremental margin standpoint and average length of haul needs and # of touch points need to be considered, which we discuss later), higher yields do translate to higher fixed cost leverage.