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Norfolk Southern Corp. (NSC)

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Norfolk Southern Corporation Third Quarter 2020 Earnings Call. At this time, all participants are in 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 will 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 reconciliation of non-GAAP measures used today to the comparable GAAP measures. 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 and welcome to Norfolk Southern's Third Quarter 2020 Earnings Call. On the call with me today are Cindy Sanborn, Chief Operating Officer; Alan Shaw, Chief Marketing Officer; and Mark George, Chief Financial Officer.

Before diving into our third quarter results, I'll highlight a previously disclosed non-cash impairment charge of \$99 million related to an equity method investment. Slide 4 provides an adjusted view of our financials excluding this charge, which is the view I will speak to in my comments this morning. During the third quarter, our volumes decreased 7% year-over-year while adjusted operating expenses were down 15%, more than double the volume decline. On an adjusted basis, we reported our best operating ratio to-date, but this is just the beginning. As we continue rolling out PSR, our team sees additional opportunities for efficiency and growth that will close the OR gap with the rest of the industry, driving shareholder value creation.

As our third quarter results demonstrate, we are implementing sustainable cost structure improvements across our company. Employment levels are down 25% since the start of 2019 while active locomotives have decreased by 26%. We have advanced these resource improvements every quarter since launching TOP21 last year, including most recently by decreasing head count by 2% sequentially in the third quarter even as volumes surged 22%. We converted a fifth hump yard in the quarter, and you'll hear from Cindy regarding further network enhancements that are underway. In the coming quarters, we will identify and execute on additional productivity initiatives to yield further efficiency gains.

Turning to network performance. Even as we implemented deep and lasting cost structural moves in the third quarter, we ran a fast and fluid network with train speed, terminal dwell, train performance and shipment consistency all better than before TOP21. We've now pushed train size to record levels. Finally, we are excited to

have Cindy Sanborn join us as Chief Operating Officer. Cindy came to NS to drive operational change and improvement, bringing decades of experience and a deep commitment to Precision Scheduled Railroading. Cindy has made it clear she sees many opportunities to increase efficiency and bottom line results at NS, and I know she looks forward to sharing her thoughts. Cindy?

Cynthia M. Sanborn

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

Thank you, Jim. I am very excited to lead operations and look forward to participating in the analyst calls as Chief Operating Officer. For those of you I've not yet met, I've been railroading for 33 years and have experience working for several Class 1 railroads. My experiences included driving change and achieving what PSR is all about, being efficient, consistent and improving the operating ratio. What drew me to Norfolk Southern are the significant opportunities ahead. Each railroad is different in terms of markets and customer mix, but I believe we can and will operate at the very best levels of the industry. Across the organization, I am finding a team that is committed to driving efficiency while delivering the highest quality service to our customers. I know that we have great potential and are just getting started making this company more productive.

Moving to slide 6, we have a strong foundation in place, but we still have a lot more work to do and we need to move faster. Our top priority is building on the momentum underway by taking steps to further unlock our PSR capabilities. We are taking a bottoms-up approach to reviewing each part of the operation, and I am confident we will find opportunities to apply principles that have been successful during prior experiences. In my 58 days here, I've already found opportunities that will help us improve and achieve higher levels of productivity. We are transitioning to put additional focus on railcar velocity. This scrutiny at the most granular level represents a big opportunity to convert structural change into gains in fuel efficiency, train size, equipment utilization and service levels.

Turning to the quarter on slide 7, our mission was to absorb returning volumes with minimal additional costs. We successfully achieved this goal and, in so doing, made significant network changes that we expect to yield ongoing efficiencies. Here, we see continued year-over-year improvements in our service and productivity metrics. By leveraging the increased volumes versus the second quarter, we drove improved productivity while maintaining stable service metrics.

Returning volumes combined with disciplined execution and successful control of additional train starts enabled us to drive train weight and fuel efficiency to record levels. I've added train length to the metrics shown here because we actively manage train length, and this represents another opportunity for improvement. I've included a snapshot of our train length history in the appendix because it is important that we have a baseline for measurement. Across these efficiency indicators, we have significant opportunities for improvement.

The graph on the next slide is an updated illustration of our train productivity since the onset of the pandemic. As volume continued to ramp up throughout the quarter, we kept crew starts virtually flat in August and September. Instead of reverting to previous train plans, we blended traffic into our new train plan to leverage the existing available capacity. The more important takeaway is that most of our train plan still has capacity to absorb traffic and our initiatives in car velocity and train size are designed to produce even more productivity.

Moving to slide 9 to discuss where we are structurally with network configuration. As you already know, the beginning of the transformation included the idling of the hump at two yards last year. Then, in the second quarter of this year, two more were idled for a total of four. But as you've heard the team say many times, we are focused on creating additional opportunities for improvement. In September, we stopped using the hump at Enola,

Pennsylvania, the fifth hump to go down since last year. The change at Enola avoids an upcoming capital investment and will result in a more reliable and faster operation.

Next week, we are kicking off a much larger set of changes in the south when we stop hump operations at our yard in Macon, Georgia. Concurrently, we will also close several local yards in the Atlanta area. These changes enable us to rework many of our southeastern intermodal flows for improved service, lower cost and additional growth capacity. After the Macon conversion, we will have curtailed operations at six humps in just the past 18 months, leaving us with four high-volume hump yards.

Before I conclude, I want to emphasize the team is moving with a sense of urgency. The Macon change is just one example of how we have accelerated our plans to create efficiencies. That project, originally planned for early 2021, is being executed more quickly. I said it earlier, but let me reiterate; this is just the beginning. Our opportunities are significant, and I am excited about keeping you up to speed on the progress we're going to make.

Now I will turn it over to Alan who will cover the market outlook.

Alan H. Shaw

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

Thank you, Cindy, and good morning, everyone. In the third quarter, volume improved sequentially as business levels continued to recover from April and May lows. Consumer-driven markets are driving the gains, reflected in our intermodal and automotive franchises which delivered year-over-year volume growth in the third quarter. Norfolk Southern and our customers are responding to market needs amid an extremely tight truck market, playing to the strength of our service-focused product and our robust consumer-oriented franchise.

We continue to enhance our pipeline for growth with sustained investment by customers along our lines. We checked the pulse of economic trends and market shifts, innovating supply chain solutions for existing and potential customers. These solutions evolve as the environment changes, as exemplified by the COVID-induced supply chain shifts and the need for increased inventory levels and faster distribution. Our strong customer relationships and market knowledge have allowed us to respond to these market shifts and quickly secure new business.

Moving to slide 11, revenue for the quarter declined 12% year-over-year driven by a 39% decline in our energy-related markets, while our remaining markets declined 4%. Overall volume was down 7% as growth in intermodal and automotive partially offset energy declines. Price gains have now produced higher revenue per unit less fuel for 15 consecutive quarters in both our merchandise and intermodal business units. Overall RPU was impacted by the negative mix associated with increased intermodal volume and lower fuel surcharges.

The continued effects of the pandemic and lower energy prices led to a 10% decline in merchandise revenue for the quarter. Recovery in the automotive sector partially offset these declines with revenue 9% higher than prior year levels as manufacturers increased vehicle production to meet consumer demand. Merchandise RPU less fuel increased 3% year-over-year as we continued to deliver solid service. Our intermodal volume surpassed 2019 levels with growth in our domestic franchise. E-commerce activity and record tight truck capacity strengthened demand that was further enhanced by new intermodal services and our superior franchise.

International volume growth improved throughout the quarter with September daily volumes 13% above July. Intermodal revenue and RPU were impacted by lower fuel surcharge revenue with RPU less fuel up 3% due to positive price and mix. Coal revenue declined 38% year-over-year due to sustained low natural gas prices and

high inventories. Utility volumes fell 30% but improved on a sequential basis with warmer than normal weather. Year-over-year export continued to face demand challenges and low seaborne pricing.

Moving to our outlook on slide 12. We expect continued strength in our consumer-oriented markets. The energy market will remain a headwind, but its impact has decreased as coal revenue represented 10% of our top line in the third quarter. External economic forecasts remain optimistic and expect continued improvement as the economy adjusts. The impacts of lower interest rates and improved personal income will continue to drive spending in the consumer markets, with housing starts and durable goods spending experiencing V-shaped recoveries. Manufacturing has been slower to recover and has not kept pace with sales, evidenced by the decline in inventory sales ratio, a positive indicator for future transportation demand. Truck capacity is at the tightest level on record, also generating a greater need and opportunity for Norfolk Southern's product.

Within merchandise, the negative impacts of low energy prices will continue to be a drag on energy volume in the fourth quarter. Strength in the soybean export market will mitigate some of that headwind, while the automotive recovery will benefit adjacent markets like steel and plastics. Norfolk Southern's automotive volume is expected to decrease sequentially due to plant downtime associated with model changeovers, offsetting increased production from other plants. We are collaborating with our customers to deliver supply chain solutions and help them compete in an evolving market.

Intermodal's continued strength will be supported by economic factors including e-commerce, low inventories and a tight truck market as well as NS initiatives promoting new products and highway conversions. Deep supply chain disruptions from COVID have led many of our customers to re-evaluate how they move goods to reduce risk. We are working with our best-in-class channel partners on new opportunities, delivering a truck-like product and providing capacity to move their business safely and efficiently.

We continue to leverage our capacity dividend from efficiency improvements to expand our business, built upon the foundation of our robust and flexible intermodal franchise. Within coal, we expect the utility market to face pressure associated with high stockpiles and low natural gas prices. Export volumes are likely to improve sequentially, although seaborne prices will remain below prior year levels.

At Norfolk Southern, we remain poised to continue to seize immediate opportunities for growth at the same time that we strategize for the long game, focused on delivering profitable growth to our shareholders while serving our customers and growing our franchise. We are executing this strategy with investments already made in consumer-driven markets that provide access to over half of the US population, positioned to succeed in the fastest-growing segments of the US economy.

We will continue to realize the value of our service product, maintaining our focus on profitable growth through both revenue and volume. We built and maintain strong relationships with our strategic partners and provide them with an excellent service product, meeting their needs and allowing our customers and Norfolk Southern to grow profitably and sustainably, which I will discuss further on slide 13.

Through our powerful intermodal franchise and best-in-class network of industrial development sites, shortline partnerships and transload facilities which serve to expand the reach of our rail product, we are delivering more options than ever to a marketplace that is increasingly valuing low-carbon transportation solutions. Our unique pioneering role in sustainability is evidenced by our decade-long participation in forest carbon offset programs in South Carolina and along the Mississippi River as well as our wetland restoration projects.

In addition, we continue to reduce our impact by enhancing fuel efficiency, which you heard from Cindy, as we modernize our locomotive fleet and deploy energy management solutions. We have partnered with customers as part of a pledge called Operation Clean Sweep to prevent plastic pollution while it is in transit. These are just a few of the reasons Norfolk Southern was recently named one of the 100 Most Sustainably Managed Companies in The World by The Wall Street Journal. Rail is three to four times more fuel efficient than truck, and our leadership and sustainability resonates with our customers and the markets we serve and will be an important aspect of the continuing growth story across our truck-competitive segments as we leverage our commitment to sustainability.

I will now turn it over to Mark who will cover our financial results.

Mark R. George

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

Thank you, Alan. Good morning, everyone. On slide 15, you see the key financial measures. I'll talk on this slide and in the remainder of the presentation to the adjusted numbers excluding the impact of the \$99 million impairment charge. Revenue was down 12% on volume that was down 7%. As Alan shared, RPU ex-fuel for our merchandise and intermodal segments was positive. But declining fuel surcharge revenue along with adverse business mix, including within coal, created revenue headwinds. We drove down operating expenses 15% in the quarter with comp and ben, purchased services, fuel and materials all declining by double-digit percentages, solidly in excess of the volume decline. This resulted in operating income being down 6% and an operating ratio of 62.5% that was 240 basis points better than Q3 of 2019. Despite the \$57 million decline in operating income, free cash flow of \$1.7 billion for the nine months was more durable, up by \$211 million or 14%, a record for NS.

On slide 16, you will see the walk of our adjusted earnings from Q3 2019 referenced at the bottom as a 240-basis point improvement in OR and a \$0.02 increase in EPS. You will recall that in Q3 2019, we had a receivable write-off that adversely impacted operating income, creating a unfavorability in the compares this quarter by 110 basis points in the OR and \$0.09 on EPS. That leaves core OR improvement in Q3 2020 as 130 basis points while EPS declined by \$0.07. The OR improvement was driven by strong operating expense reductions versus last year as you'll see on slide 17.

Operating expenses were down \$278 million or 15%. Comp and benefits are down 15%, led mainly by employment costs with the workforce down by 4,400 or 18%. Fuel was down \$100 million with lower pump prices contributing to \$61 million of that reduction; and consumption was down \$36 million, led by fewer GTMs as well as a strong 6% improvement in fuel efficiency in the quarter. Materials spend was down \$13 million due to lower spend associated with smaller and more efficient locomotive and railcar fleets. Purchased services was down \$35 million or 10% as we continue evaluating the structural and semi-structural costs within this category. I'll point out that the depreciation increase of \$7 million was due to a non-recurring leasehold improvement write-off due to a terminated lease.

Given the amount of structural change that we're driving into the business each and every month, I'd like to touch on how we have recovered from the volume trough in the second quarter on slide 18. As background, recall in Q2 we did a tremendous amount of work to manage the short-term by more than matching the volume decline with crew start leverage while also forging ahead with structural change by idling two hump operations and driving head count down 20%. As a result, we positioned ourselves very well for Q3 and beyond to leverage these sustainable cost structure improvements.

From Q2 levels, revenue increased 20% or \$421 million while we constrained costs to just 6% growth to deliver nearly 80% incremental margins. We drove head count down another 2% versus Q2. Materials, purchased

services and equipment rent combined were an increase of only 6% on the 20% sequential revenue gain. And fuel efficiency improved 3 points sequentially as increases to train weight and length continued to record levels as Cindy highlighted. We are confident that our advancing implementation of PSR is producing benefits and we have great momentum to build on our cost structure improvements moving forward.

On slide 19, we look at the full P&L with a Q3-to-Q3 look. And here, you'll see that other income net of \$39 million is \$17 million better than prior year. We had another strong quarter of gains on our company-owned life insurance investments. These COLI returns, including proceeds, are not subject to income tax as they contributed to our lower effective tax rate in the quarter of 22%, as did the tax benefits associated with stock-based compensation. This is why net income contraction was only 2% compared to the 6% contraction in operating income. Adjusted EPS, you'll note, was actually up 1%, supported by nearly \$300 million of share repurchase activity in the quarter.

Shifting to cash flow on slide 20. Through nine months ended September 2020, our free cash flow was a record at \$1.7 billion, aided in large part by fewer capital additions as well as timing of income tax payments. Spend on property additions was \$1.05 billion, nearly \$450 million below 2019 levels and on a run rate to be at our target of roughly \$1.5 billion for the year, which will be a 25% reduction from 2019 spend levels.

With our strong cash generation and liquidity profile, we were able to continue to distribute cash to shareholders through our dividend while ramping back up share repurchase activity. In the quarter, we repurchased 1.4 million shares for roughly \$300 million. As of now, we have approximately \$1.4 billion of cash on hand with less than \$100 million of debt maturities in the next year, providing us confidence that we have appropriate liquidity in this uncertain market.

With that, I'll hand back over to Jim.

James A. Squires

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

Thank you, Mark. Before we conclude, I want to recognize all of our employees for their dedication to operating this railroad as efficiently and safely as possible while continuing to deliver for our customers during these unprecedented times. As you've heard this morning, our leadership team is unified in a commitment to improving Norfolk Southern and will leave no stone unturned in the quest for shareholder value. We are confident our momentum will enable us to achieve our goal of a 60% operating ratio. And once we get there, we won't stop as we drive additional improvements across our network.

In closing, we have built an organization that is moving faster than ever to deliver returns for shareholders. Thank you for your attention, and we'll now open then line for Q&A. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now be conducting a question-and-answer session. [Operator Instructions] Thank you. And our first question comes from the line of Jon Chappell with Evercore ISI.

Jonathan Chappell

Analyst, Evercore Group LLC

Q

Thank you. Good morning, everybody. Alan, I wanted to start with you. You mentioned briefly that some of your auto customers are shutting down in the fourth quarter, so you expect a sequential decline. But if we look across auto and intermodal, incredibly strong third quarter; maybe the start to the fourth quarter a little bit less robust. Is there anything happening within the network, whether it's some of the initiatives that Cindy is putting into place, or is this really a focus on yield as you try to manage your capacity in a tight market?

Alan H. Shaw

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

A

Yeah, Jon. We do have some specific plant outages and retooling in the fourth quarter within our automotive franchise that are going to create some pressure. I'll circle back to the results in the third quarter. Our revenue was up 9% year-over-year, and our auto team is working every day to make a better franchise for our customers. And so that's a – the phenomenon that you're seeing right now is a short-term phenomenon. We've got a lot of confidence in the strength in our automotive franchise moving forward. Same with the intermodal franchise. We're delivering record volumes within domestic and international volumes are starting to tick into the positive territory for us right now. So we're very confident in the strength of that franchise and basically all of our consumer-oriented markets moving forward. And I will tell you though, Cindy is focused on improving productivity. She's also focused on giving our customers a very good service product.

Jonathan Chappell

Analyst, Evercore Group LLC

Q

That's a good lead-in to my quick follow-up to Cindy. Just curious as you've been there now for two months. Is your kind of initiative to come in from the top-down with maybe a new team and invoke some pretty significant changes or are you just taking what NS has already been doing over the last year and a half and kind of tweaking here and there?

Cynthia M. Sanborn

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

A

Well, Jon, thanks for the question. I would say that there's a very strong foundation that's been built here and been operating here, very focused on the basics of running a good railroad. And I'm looking at it from the bottom-up and from the top-down and it's really more than tweaking, significantly more than tweaking. I've introduced some information around train length. We're going to be working on that. That helps us tremendously with our locomotive productivity as well as fuel.

And we will also be working very strongly on car velocity. A lot of these hump conversions that you've seen that were referenced in my early remarks, the team is engaged at a discrete level, actually improves car speed. And at a system level, what we want to do is avoid touches altogether, if at all possible. And if we can speed the cars up, that's good for us in terms of asset intensity and it's also good for our customers; it provides them a more timely

service product. So there's quite a bit of work going on and I'm really excited about the team here and excited about exactly what we're going to be working on. But thanks for the question.

Operator: The next question comes from the line of Justin Long with Stephens. Please proceed with your question.

Justin Long

Analyst, Stephens, Inc.

Q

Thanks and good morning, and congrats on the quarter. So maybe to start, I wanted to ask about head count. Is there any color you can provide on your expectations for head count sequentially going into the fourth quarter? And then maybe same question on the OR. Even if it's just directionally, would love to get your thoughts about 4Q and what we could see based on demand today. Thanks.

James A. Squires

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

A

Justin, good morning. Well, let me tackle the second question first and then I'll ask Mark to address the head count trend. We're not going to give quarterly guidance. You see the volume trend. We're working away on the expenses. I think it would be reasonable to expect an operating ratio in the fourth quarter below last year. But beyond that, we're not going to give guidance. Mark, the employment trend?

Mark R. George

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

A

Yeah. So as you saw, the employment trends are quite strong. We took out 4,400 or 18% since Q3 2019, actually 2,900 so far in the nine months of 2020. And sequentially, we did come down. I do believe that volume growth and attrition are both our friends from this point forward. Not going to give a specific target for Q4, but the hope is that we certainly won't add here in the fourth quarter. And hopefully with attrition being our friend, we might see a continued decline.

Justin Long

Analyst, Stephens, Inc.

Q

Okay. Great. That's helpful. And then Cindy, maybe one for you. When you look at that 500 to 600-basis point margin gap versus your eastern competitor today, I wanted to ask about how that gap looks in general merchandise versus intermodal. Is one of those segments or does one of those segments need to play more catch-up than the other from a margin perspective as you look to close that gap?

Cynthia M. Sanborn

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

A

Justin, I think about every railroad kind of has a difference in terms markets and customer mix. But our network is as good as any and I don't see any barriers to us continuing to reduce the gap between us and our competitor here in the east in both markets that you described, both merchandise and intermodal. We're going to drive very hard in that direction.

Operator: The next question comes from the line of Jason Seidl with Cowen. Please proceed with your question.

Jason Seidl

Analyst, Cowen & Co. LLC

Q

Thank you, operator, and good morning, everybody. I wanted to stay with Cindy there for a while. Cindy, you mentioned your great amount of railroad experience. You've been at two Class 1s that have implemented PSR. Can you talk a little bit about what you learned there with PSR and how you think you can apply that at Norfolk Southern? And also, what might be different?

Cynthia M. Sanborn

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

A

Well I would say, Jason, that PSR at its core is just very basic railroading and focusing on making every move count and accelerating asset intensity or improving asset intensity is the core of it. And no matter which railroad I've worked for, that has really been the effort as we implemented PSR. I don't see things different at Norfolk Southern. I see a workforce and a team that I've inherited that is very focused and very energized about what we're working on. They understand just how much work it's going to be, and I think we're going to be able to close the gap with any railroad in the country.

Jason Seidl

Analyst, Cowen & Co. LLC

Q

And Cindy, as a quick follow-up on as Norfolk starts gaining more and more ground with PSR, how should we think about maybe the gains on capital investments because it seems like closing some hump yards has already eliminated some capital investments? Are there more to come? Should we expect a smaller capital investment profile going forward as you guys make progress?

Cynthia M. Sanborn

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

A

Jason, I actually haven't gotten that far into the details on capital. I would say that you'll see us make some investments in locomotives that you might not see otherwise as we convert from a DC fleet to an AC fleet and so forth. But at this point, I really can't answer that question terribly fully. But Mark, I'm sure, has a view and I'll turn it to him.

Mark R. George

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

A

It's a very good question and observation. And actually, the Enola closure, the hump closure is an example where we will be avoiding some capital, so you do see some relief there. And the same thing; even the locomotive impairment that we took back in the first quarter where we idled 703 locomotives kind of reveals that we do feel with all this PSR momentum we have that we've got enough in the locomotive fleet and hopefully we won't be buying locomotives anytime soon. So I do think some of the transformations that we're making will relieve us of CapEx demands.

But that said, Cindy's coming in and really taking look at traffic patterns and looking at our train plan. And there may be areas where we need to do some siding extensions as an example to help accelerate the network. So overall, we are still working on that. Cindy and I have been spending a lot of time, along with Alan, trying to understand some of the ideas and observations that she's had coming in. And we'll know better I think as we enter the first quarter what the overall impact will be on capital certainly in the next year or two.

Operator: Thank you. The next question is coming from line of Allison Landry with Credit Suisse. Please proceed with your questions.

Allison M. Landry

Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks. Good morning. So given the step function improvements that you've made in train length and weight, I guess, first, how much further room do you have here? And then, are there any parts of the network that might need additional sidings to keep the train length moving higher? And then, if you could speak to how you're thinking about operating leverage and incremental margins in 2021 given these productivity improvements as well as the recent volume momentum.

James A. Squires

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

A

Allison, let me start out and then I'll turn it over to Cindy to fill in the details. But as you noted, we did achieve significant asset and other resource productivities in the third quarter. For example, we had record performance on fuel efficiency, train weight, train length, T&E productivity and locomotive productivity. So virtually across the board record levels of productivity, but that's just the beginning. As Cindy has just gone through, she sees and we see lots of additional opportunities for improvement. And those improvement opportunities will take the form of asset velocity, a focus on railcar velocity which is something she has brought to us, a signature initiative or focus within PSR. We'll continue to look at the network footprint. We'll continue to look at labor and all other aspects of our operation and, indeed, our company in search of productivities that will propel us toward the goal of the peer operating ratios. So Cindy?

Cynthia M. Sanborn

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

A

So yeah. To add to that, Allison, I think if we look at September, I was looking at some numbers here literally in the last couple of days. In our merchandise network, we operated with tonnage up to what our locomotives could pull, so maxing out that locomotive capability about 9% of the time. And we look at our intermodal opportunity in terms of length where we're going over 10,000 feet. We had about 10% of our trains over 10,000 feet for the entire district, so we have a lot of opportunity here. It may – as Mark alluded to, it's on the radar to think about where there might be barriers to that from a siding length perspective. Don't really have that completely fleshed out, but we do have significant opportunity to improve our train length.

James A. Squires

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

A

Allison, you mentioned incremental margin going forward. Mark, why don't you take a stab at that?

Mark R. George

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

A

Yeah. As you know, Allison, we had very strong sequential growth in the top line here from Q2 to Q3. That allowed us to really leverage it and deliver a 78% incremental margin. And frankly, that's the recipe we're hoping for going forward, that we can get good volume growth here, and our goal would be to leverage it and deliver very strong incremental margins. Now, I don't know that we can do 78% to 80% every single quarter. I think it will depend on how much volume we get and where that volume comes from. But certainly, I would expect that we would have accretive incremental margins in each quarter where we do have growth.

Cynthia M. Sanborn

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

A

And Allison, let me also add that these numbers that I provided, it's not something you're going to be able to do 100% of the time. There's going to be situations where you're not going to reach perfection, but that's what we have to work toward. And we're going to be – that's all part of closing the gap that we've got here on costs, and that's just some of the ingredients and the concepts and areas that we're looking at to find those opportunities.

Allison M. Landry

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. That was really helpful. So as my follow-up, is there a way to think about or quantify the cost savings or the OR benefit from the network changes that you made, hump closures, et cetera? And then more broadly, do you see opportunities for further rationalization, whether that's yards or facilities or other assets? Curious maybe what's left to do and if there's anything you're considering as far as changes to the coal network. Thank you.

Cynthia M. Sanborn

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

A

Let me add one component in terms of the terminal footprint. So we've – the team has redesigned traffic flows through the terminals and we're continuing to do that with the Macon change that we're talking about. But once we sort of go through it the first time, we don't stop looking. We go back to areas that we've looked, that we converted, and we continue to optimize the operation through those areas. So we, most recently, made some train consolidations that are a result of the changes we made at Bellevue that we just have put in place as we have seen traffic balance out. And traffic continues to change and allow us to continue to optimize, I guess is the best word, how we think about traffic flows through the areas that we've already been through. So a lot of – it's not like you go through this one time and it's done; it's continuous improvement and continuous focus and driving our cost gap reduction.

Operator: Our next question comes from the line of Chris Wetherbee with Citi. Please proceed with your question.

Chris Wetherbee

Analyst, Citigroup Global Markets, Inc.

Q

Hey. Thanks. Good morning. I wanted to touch on the 60% OR target. Kind of curious if you guys are comfortable reinstating or putting a time around that. Is it something that's achievable next year? And then maybe if you don't want to comment on the timing, could we talk a little bit sort of structurally, do you think you have the pieces in place? I'm thinking about the hump yard slide. Structurally, is the network kind of where it needs to be as volume comes back, if that's a clear line of sight to the 60% or is there more work to be done?

James A. Squires

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

A

Let me summarize, Chris. As we've noted several times already, our goal is to close the OR gap with our peers. And along the way, we will naturally get to a 60% operating ratio. We believe we have line of sight to a 60% during 2021 through a combination of cost reductions and revenue growth. But we're not going to stop there. I mean, we'll continue to drive hard and get that OR into the peer range and as low as we possibly can which ought to generate a great deal of shareholder value. The progress will come from a combination of productivity and efficiency initiatives as we've been discussing already this morning, and revenue growth in sight during 2021.

Chris Wetherbee

Analyst, Citigroup Global Markets, Inc.

Q

Okay. Okay. That's very helpful. I appreciate that. As a quick follow-up for Alan. Can we talk a little bit about the intermodal competitive environment and specifically the yield up strategy? I think it was another record intermodal yield ex-fuel this year. Can you talk a little bit about sort of the opportunity as you turn the page into 2021 in terms of taking share? You have the cycle kind of turning in your favor from a truckload perspective. You have a pretty decent competitor in the east who's also wanting to grow that business. Can you just put a little bit of context on how you think about how intermodal looks as we move forward over the next couple quarters?

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

A

Chris, through strategic foresight and market approach, we've got the most robust intermodal franchise in the east and we are aligned with the best channel partners in the business who are also committed to growth. I think we're in a very unique truck environment. What you've seen is that truck capacity is inelastic with demand, and so spot rates are at two, three-year highs; capacity is about as tight as it's been and we're in the midst of a prolonged inventory replenishment cycle. And as I noted, we're getting record volumes in domestic right now and our international business is ticking up into positive territory. So I'm very confident about where we're going the remainder of this year and next year, and it's just a continuation of what we've delivered. Remember, in 2017 our revenue was up 11%. We followed that with 18% improvement in 2018. It declined very slightly last year in the midst of a truck recession and right now it's back to growth.

Operator: Thank you. Our next question is coming from the line of Ari Rosa with Bank of America. Please proceed with your question.

Ari Rosa*Analyst, Bank of America Merrill Lynch*

Q

Hey. Good morning, guys. So first question. I wanted to touch on how you're thinking about available capacity because, obviously, you've done a great job here of cutting resources. But as we see volume growth into 2021, do you think you can achieve that without further adding to head count or taking on additional resources?

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

A

Yes, yes, plenty of capacity particularly in light of our goal and our intent to increase train length. That right there will absorb additional volume into the train plan. As far as infrastructure is concerned, with the possible exception of some places where we need to increase siding lengths, we have more than adequate infrastructure capacity right now.

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

A

Can I add that the way the markets are shaping up, the incremental volume will largely fold into the existing train network. We've redesigned our network so that we've got capacity. You saw that in the incremental margins in the third quarter. And these consumer-oriented markets, whether it's in the merchandise network or the intermodal, additional growth is going to be all about creating additional revenue density on our trains.

Cynthia M. Sanborn*Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.*

A

And as we increase our train length, that reduces the number of trains actually on the network which frees up capacity on the [indiscernible] (00:44:28). So there's a number of levers here from a capacity perspective that we have in our favor.

Ari Rosa

Analyst, Bank of America Merrill Lynch

Q

Understood. That's very helpful. And then just looking at the evolution of PSR across some other railroads in North America. Obviously, it's opened up a lot of real estate opportunities for them, and I know you guys have taken some actions in that regard. But maybe you could talk about where you think you are in terms of the real estate footprint, what we could see in terms of opportunities for either real estate sales or maybe leveraging some available real estate to grow incremental volumes which you're clearly doing at very high margins. And so maybe just a couple of thoughts on where you are with your real estate strategy.

Mark R. George

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

A

This is Mark. I'll let Alan talk a little bit more about the tactics there. But I would say that we typically right now liberate about \$30 million to \$40 million of land per year. We generate gains from that and that is – we've got plenty of properties out there that contribute to that. And I think, Alan, why don't you talk a little bit more about what the strategies are?

Alan H. Shaw

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

A

Yeah. Within real estate, we're focused on delivering cash flow via two means; one is through land sales, the other is through ongoing leases. And our real estate team is linked very closely with our best-in-class industrial development team to work to sight additional business on our lines. And you just saw one announced in a dog food product that was recently announced on our network. It's one of the reasons that we serve more North American vehicle production than any other railroad. And then in addition to that, our real estate strategy is also about sustainability. And we're using some wetland credits on our real estate to provide offsets for infrastructure improvements on our lines to increase our capacity and also to help with local economic development which will drive more business to Norfolk Southern. So it's a multi-faceted approach all designed to improve ongoing profits for Norfolk Southern and our shareholders.

Operator: Our next question comes from the line of Cherilyn Radbourne with TD Securities. Please proceed with your question.

Cherilyn Radbourne

Analyst, TD Securities, Inc.

Q

Thanks very much and good morning. That was my question on real estate, so maybe I'll ask one on technology and just ask whether you could give us a bit more color on the joint venture that you announced last week and speak a bit more broadly about technology and whether you're looking at some of the automated inspection technologies that your peers are adopting.

James A. Squires

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

A

Let me take the question about technology. It is a core part of our strategy. One of our strategy pillars is digital strategy and development of technology to promote both efficiency and growth in our operations. Particular areas

of focus in the digital realm in recent years have been customer engagement and making sure that we have best-in-class customer tools, tracking tools and shipment intelligence tools. We've devoted quite a bit of technology, time and effort in that area. We're also very focused on improving asset productivity through technology, and that does include automated inspections. Yes, we are focused on that and we see a significant opportunity there and in other areas as well, replenishment of legacy information systems and artificial intelligence initiatives, machine vision initiatives. There's a raft of initiatives coming at us and we're very excited about the prospects for promoting shareholder value through those investments.

Alan H. Shaw

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

A

Cherilyn, specific to your question about the recently announced Rail Pulse, that's just another example of Norfolk Southern innovating within the supply ecosystem, providing a value-added truck-competitive product. That's our partnership with G&W and Watco and GATX and TrinityRail. Combined with us, that's about 20% of the North American railcar fleet. And what we're focused on doing is providing – focused on improving safety and transparency within the overall ecosystem so that we can provide a truck-competitive product.

Cherilyn Radbourne

Analyst, TD Securities, Inc.

Q

Thank you for the time.

Operator: The next question is coming from the line of David Ross with Stifel. Please proceed with your question.

David G. Ross

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yes. Good morning, everyone. I wanted to talk a little bit about intermodal again because it's been a very hot area, and maybe it's due to the yield up strategy. But volumes are only up about 2% or 3% on Norfolk Southern last week, so wanted to know I guess why you think you're not seeing the same volume growth. Is that purposeful because of the yield choice or is there something else going on on the network or the customers?

Alan H. Shaw

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

A

Yeah. We're starting to see improvements within our international business, and we're looking for some gains as the quarter progresses from the West Coast. And so we're very confident about where our intermodal franchise is.

David G. Ross

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Do you think it'll be high single-digit growth in the fourth quarter?

Alan H. Shaw

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

A

I'm not going to provide guidance on it, but intermodal was a growth driver for us in the third quarter along with automotive, and we expect it to be a growth driver for us in the fourth quarter as well. We've got an unrivaled intermodal franchise in the east and we're in a very tight truck market. We're providing a really good service product.

David G. Ross

Analyst, Stifel, Nicolaus & Co., Inc.

Q

And then just last question because we've got the election coming up next week, Jim. Is there anything one way or the other that has a bigger impact on the rails? Is there something that maybe you're most concerned about or most excited about if it goes one way or the other?

James A. Squires

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

A

Well, we'll work through the implications of the election outcome either way. And of course, we have close relationships on both sides of the aisle and we maintain constant communication with all those who support the rail industry and Norfolk Southern in particular. So I'm confident that we will navigate through whatever political changes may come. We've been at this for a long time and are active in the political realm, and so I have a lot of confidence that we can manage through whatever changes may be on the horizon.

David G. Ross

Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thank you.

Operator: The next question is from the line of Jordan Alliger with Goldman Sachs. Please proceed with your question.

Jordan Alliger

Analyst, Goldman Sachs & Co. LLC

Q

Yeah, good morning. Question. I understand on the mix side revenue per carload, the impact of intermodal on the total RPU of the business. I'm just sort of curious, like within a specific commodity, like chemicals were up 6%, agriculture is down 1%, there's a couple others that were negative year-over-year, is that mostly a function of the fuel surcharge? Is there length of haul issues? Again, I understand sort of the total. I'm just sort of wondering within a commodity category what's been the biggest driver of the RPU. And when do you think you could start to see some of that total RPU negative mix start to look a little more normalized? Thanks.

Alan H. Shaw

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

A

Yeah. Most of our RPU pressure right now is coming from fuel surcharge and from seaborne coke and coal pricing which we've provided some color on in the past. Unwind our RPU a little bit and you're going to see 15 consecutive quarters of RPU less fuel growth, both merchandise and in intermodal. And even within intermodal, we just posted a record for RPU less fuel. So we're fully committed to revenue growth and we understand that that's got two components; one of that's price, one of that's volume. And we're providing the most stable service product that we ever have over a long time period and we've got – we are positioned for where markets are headed. Strength in the consumer is where NS is positioned and where we excel.

Jordan Alliger

Analyst, Goldman Sachs & Co. LLC

Q

Okay. So, I mean, presumably then, as the fuel stuff starts to normalize the revenue per carload as we move, I'm assuming, into next year [Technical Difficulty] (00:53:30) or maybe more than gradual?

Alan H. Shaw

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

A

I think I identified the two headwinds. Look at our revenue per revenue ton mile. It's up 3% for the quarter.

Jordan Alliger

Analyst, Goldman Sachs & Co. LLC

Q

Okay. All right. Well, thanks very much.

Operator: Thank you. The next question is from the line of Scott Group with Wolfe Research. Please proceed with your questions.

Scott H. Group

Analyst, Wolfe Research LLC

Q

Hey. Thanks. Morning, guys. So wanted to just ask on some of the cost pieces. Mark, any way to think about comp per employee going forward? And then purchased services were down, I think down year-over-year for the first time. Is that a sustainable sort of inflection in purchased services? And then maybe if we just tie it all together. When you talk about line of sight to a 60% OR next year, what level of revenue growth, if any, do you think you need to get there?

Mark R. George

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

A

Yeah, Scott. Thanks. The comp per employee sequentially looking forward into Q4 I'd say is likely to be in the flattish range. This quarter, obviously we were up very, very modestly at 1.3%. I would expect us to be flat going into Q4. Sorry, the second question?

Scott H. Group

Analyst, Wolfe Research LLC

Q

Just purchased services and...

Mark R. George

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

A

Was on purchased services?

Scott H. Group

Analyst, Wolfe Research LLC

Q

Yeah.

Mark R. George

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

A

Yeah. So, look, purchased services, I thought we did a very good job. We've got some of the structural changes that we've been implementing kind of flowing through that line as well, so pretty good momentum going into the fourth quarter. I do think as volume steps up especially in intermodal, we'll start to see purchased services elevate a bit in conjunction with volume and that volume variability equation.

James A. Squires

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

A

And Scott, your question about line of sight to 60% during 2021. A combination of cost reductions and revenue growth would be our expectation, and we do expect to see a rebound in revenue next year and growth year-over-year during 2021. So it'll come from the two, but we have a lot of productivity initiatives in the hopper. And I think we've shown that during times of volume softness, this year, that we are fully committed to the PSR way and to driving cost structural improvements throughout the organization. So that will be something we continue to rely on as we push for that peer OR.

Scott H. Group

Analyst, Wolfe Research LLC

Q

But just directionally, if you have thoughts, I mean, do you think you need – can you get there next year with mid-single-digit kind of revenue growth? Do you need closer to high single with easy comps to get there? Just any directional thoughts as you...

James A. Squires

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

A

Give us time to firm up our revenue outlook. And we'll talk a little bit more about what we expect for the year come January. We're still working on our forecasts. Right now, things appear to be headed in the right direction and we would expect growth year-over-year. But we'll get back to you with a little more detailed outlook in January.

Operator: Thank you. Our next question is from line of Brian Ossenbeck with JPMorgan. Please proceed with your questions.

Brian P. Ossenbeck

Analyst, JPMorgan Securities LLC

Q

Hey. Good morning. Thanks for taking the question. Maybe one for Alan. We've seen a few coal plant retirements announced in the last month or so. Looks like it's more of a western rail issue. But how do you see that risk for Norfolk based on the plants and mines that you serve? And given where natural gas is, above \$3, and export prices may be stabilizing a little bit, do you think you're past the peak of the headwinds when it comes to coal from an RPU perspective?

Alan H. Shaw

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

A

Brian, I think there was – plant closures are a result of the economic factors that are driving it. Power prices in the PJM right now are below \$20 a megawatt hour. Coal is going to have a really hard dispatching into that environment. And while natural gas has rebounded nicely to \$3, the spot market is still below \$2; it's closer to about \$1.70 which is kind of where – what coal uses to dispatch is that spot market. So that's going to create continued pressure for us in the fourth quarter in addition to the fact that stockpiles are about 45% higher than they were this time last year. We are seeing improvements in export demand as I noted. Although with the Chinese-Australian trade tensions, the premium low vol price out on the seaborne market actually declined. Then ag climbed up to about \$128 a metric ton; now it's closer to about \$115. So we'll see some more export volume in met and in thermal as China and India have opened up, but there's still going to be pressure on pricing there.

Brian P. Ossenbeck

Analyst, JPMorgan Securities LLC

Q

Okay. Got it. And just one follow-up on the comp per employee comment. Maybe, Mark, if you can give us a sense of how you think of overtime as potentially a productivity lever? You probably have to incur maybe a little bit more as you manage head count with the volume environment still a little bit uncertain. But as things sort of normalize and you start to draw that line of sight to the 60% OR, do you think this is an area of significant opportunity or are there maybe factors that would prevent you from being able to take some significant savings on the OT line item?

Mark R. George

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

A

Yes. Good question, Brian. And we've done a pretty good job already bringing overtime down quite a bit, and it is another area that we are looking at going into the future. There's a lot of things obviously that impact the comp per employee. Just increasing volumes has an impact on the T&E activity levels and their pay rates as well. So it's not just overtime but it's also the activity levels in general. But I'd say we're looking at all the levers. The reworks is another area where we've done a good job tackling, trying to keep a lid on it. And I think if you look at our overall comp and ben trends over time, you've seen we've done a pretty good job keeping a lid on things. But we do see more opportunity going forward, and those are exactly some the areas that Cindy and her team are talking about since she's come onboard.

Operator: Thank you. We're nearing the end of our allotted time for the question-and-answer session today. We have time for one additional question. That question is coming from the line of Tom Wadewitz with UBS. Please proceed with your question.

Michael Triano

Analyst, UBS Securities LLC

Q

Hey. This is Mike Triano on for Tom. So I just wanted to ask about industrial-related volumes. The energy complex is obviously weak, but are you optimistic that we see continued improvement in some of the other segments like metals or housing or do you see any headwinds as we enter into 2021?

Alan H. Shaw

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

A

Yeah. We do see – we have a lot of confidence in our consumer-oriented product, whether that's in industrial products or within intermodal. And I think we're going to see some improvements in ag, we're going to see improvements in metals, and intermodal is going to be a growth for us as well. And not only are we focused on growth, we're focused on productivity. Cindy talked a lot about some of the initiatives that she's implementing. And then within our intermodal network, we're applying technology and process improvement to improve the efficiency of the terminals and increase revenue density of the trains as well. So the consumer market is where NS is positioned. It's a position of strength for us and that's where we excel.

Michael Triano

Analyst, UBS Securities LLC

Q

Okay. How much exposure or leverage to housing do you have in the overall book? And do you think that can be a meaningful driver especially on the carloading side as we go forward here?

Alan H. Shaw

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

A

Exposure...?

Mark R. George

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

A

Housing?

Alan H. Shaw

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

A

...to housing?

Mark R. George

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

A

Is that what you asked?

Michael Triano

Analyst, UBS Securities LLC

Q

To housing, yes.

Mark R. George

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

A

Lumber maybe?

Alan H. Shaw

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

A

Yeah. It certainly helps with housing and housing products. As Mark noted, lumber, some steel, then you've got the stuff that goes in it. And then it also really helps drive the intermodal product as well as people furnish their houses or some of our larger BCOs are involved in the housing market, so there's opportunities there. And as I noted, we're seeing a V-shaped recovery in both durable goods and in the housing market. So we've got a lot of confidence in these consumer-oriented markets as we head into 2021.

Operator: Thank you. At this time, I will turn the floor back over to Mr. Jim Squires for his closing comments.

James A. Squires

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

Thanks, everyone, for your questions this morning and special thanks to all the Norfolk Southern employees who helped us deliver a solid result in the third quarter. Thank you.

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

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