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Kansas City Southern (KSU) CEO Pat Ottensmeyer on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-18-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $1.94 beats by $0.15 | Revenue of $747.7M (6.97% Y/Y) beats by $13.31M

Earning Call Audio

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Kansas City Southern (NYSE:KSU) Q3 2019 Earnings Conference Call October 18, 2019 8:45 AM ET

Company Participants

Pat Ottensmeyer - President & Chief Executive Officer

Jose Zozaya - President & Executive Representative, KCSM

Mike Naatz - Executive Vice President & Chief Marketing Officer

Mike Upchurch - Executive Vice President & Chief Financial Officer

Sameh Fahmy - Executive Vice President, Precision Scheduled Railroading

Jeff Songer - Executive Vice President & Chief Operating Officer

Brian Hancock - Executive Vice President & Chief Innovation Officer

Conference Call Participants

Chris Wetherbee - Citigroup

Justin Long - Stephens

Tom Wadewitz - UBS

Amit Mehrotra - Deutsche Bank

Allison Landry - Credit Suisse

Scott Group - Wolfe Research

Ravi Shanker - Morgan Stanley

Jason Seidl - Cowen

Brandon Oglenski - Barclays.

Ken Hoexter - Bank of America

Brian Ossenbeck - JPMorgan

Operator

Good morning, and welcome to the Kansas City Southern Third Quarter 2019 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

This presentation includes statements concerning potential future events involving the company, which could materially differ from events that actually occur. The differences could be caused by a number of factors, including those factors identified in the Risk Factors section of the Company's Form 10-K for the year ended December 31, 2018, filed with the SEC. The Company is not obligated to update any forward-looking statements in this presentation to reflect future events or developments. All reconciliations to GAAP can be found on the KCS website, www.kcsouthern.com.

It is now my pleasure to introduce your host, Pat Ottensmeyer, President and Chief Executive Officer for Kansas City Southern.

Pat Ottensmeyer

Okay. Thank you and good morning, everyone and welcome to our third quarter earnings call. I will start the presentation; obviously, everyone saw the press release that came out earlier.

Slide 4, we just list the folks who are on the call today. I'll mention -- hopefully this won't be all that noticeable, but I'm actually not with the rest of the team in Kansas City calling in remotely from New York, and I'm very proud to have been accepting an award last night for Kansas City Southern for -- from The Latino Corporate Directors Association for Exceptional Diversity, specifically the number of Latinos on our Board of Directors here in New York. So, hopefully get through any -- not have any technical issues here, but I will -- in the room with the rest of the team. Jose Zozaya is also on the phone from New York.

So, let's move on to Slide 5, the punch line slide for our third quarter earnings and I think we feel like we had a really good quarter. Revenue is up 7%, Mike Naatz will talk about the revenue side of the business and the outlook, which -- not to steal Mike's thunder, but we still feel that about 70% of our business units looked there to be positive for the remainder of the year, in spite of lots of [Technical Difficulty] about state of the economy in the U.S. and Mexico and around the world, we still feel that there's a reason to be hopeful and see signs of strength in a number of our business units.

[Technical Difficulty] not a real number when we exclude the impact of impairment charges that we took in the quarter that Mike Upchurch will get into in great detail in a few minutes, put us at 60.7%, 270 basis points from last year. And then when we back out and adjust for the impact of the -- the loss of the IEPS credit in Mexico, we could take that down by another 80 basis point. So, you can do the math in your head and what that results in as an operating ratio that put us in the low 60 for the third quarter.

Earnings per share of $1.81 adjusted again for the impact of impairment charges of $1.94, which is a 24% increase versus previous year. And that's feel really, really very good about the operating metrics [Technical Difficulty] into this in much greater detail. But – it's known and I’ll admit that year-over-year, quarter-over-quarter from the third quarter of last year the term easy comp would certainly apply to our performance a year ago. But we are just making exceptional progress in terms of service, suggestion, operating metrics and as I'll say in a couple of minutes, there is -- we feel equally confident that there is net income in the quarters ahead.

So moving on to slide 6. We're not changing any of our guidance at this point. So, we're sticking with same guidance that we had in the third quarter. We are in the process of updating. We're going through as you've heard -- some of you've heard us talked about previously this white-boarding exercise with respect to our transportation service plan. We're making great progress. Sameh will talk more about that in a few minutes and we certainly expect that when we finish that in the next few weeks or couple of months that we will get better visibility and clarity on what that is going to produce in terms of operational savings and perhaps further improvement in operating ratio.

Obviously, with the operating ratio that we just put up for the quarter, we know we're going to get a lot of questions about the guidance that we're giving here on this page. And yes, we do expect that to change and improve. But we're not prepared to give more specific or different guidance at this point until we get through that process. We complete our plan for 2020 and look beyond So, we will be updating that most likely on the fourth quarter call in January, possible that we will give some earlier indications at a couple of conferences that we're scheduled to speak at. But at this moment, we're not changing the guidance for any of these metrics that our shown on slide 6.

So with that, I will pass the presentation to Jeff Songer.

Jeff Songer

Okay. Thank you, Pat and good morning. Starting with a review of the key operating metrics for the quarter on slide 8, the gross velocity of 13.9 miles per hour improved 32% year-over-year and 11% sequentially. Dwell of 20.3 hours improved 23% year-over-year and 4% sequentially. We're continuing to see strong year-over-year improvements in our key metrics. Acknowledging the impact of 2018 congestions on year-over-year comps, we continue to execute sequential improvement, illustrating our PSR efforts on maturing, while KPIs are reaching historically high levels.

Resiliency has been another key outcome of our PSR efforts. September's record breaking floods in the South East Texas had relatively little impact on -- to our operations. Our ability to quickly adjust trained plans and provide adequate recourses, crews and equipments during these events, allowed us to remain more fluid versus other weather events and our recovery was timely.

Boarder initiatives continue to support oversized growth of 12% for the quarter in cross-border volumes. To-date, we have operated over 2,500 trains with international crews greatly improving transit times. As another benchmark of strong performance, we have grown our cross-border business, by 34% in the past two years, as compared to Q3, 2017.

Turning to slide nine, we continue to see positive trends in all key metrics. Year-to-date velocity has improved 17%. And we should achieve full year velocity close to 14 miles per hour. Further illustrating sequential improvement, October month-to-date velocity is over 15 miles per hour, as velocity remains a primary focus of our PSR transition.

As you can see, all of the metrics are tracking at or above goal for the year. And our improvement is accelerating into the fourth quarter. Of note, fuel efficiency has improved 3% year-to-date and 5% for the quarter, again illustrating continual improvement. As you will see in Mike's material, fuel is the largest category of PSR savings with $22 million projected annualized benefit.

Reduced train starts, technology, proper assignment of locomotives. And better enforcement of locomotive utilization, all contribute to the improvement. For the quarter, we've realized $3 million in labor efficiencies through a combination of TSP adjustments, train start reductions, improved crew cost and reduced over time.

Looking forward, we are actively working with our Mexican union to progress those work rules, not consistent with the other North American railroads. Access crew size and greater operational flexibility are the main areas that we intend to modernize.

I will now turn the presentation over to Sameh to provide detail on other PSR efforts.

Sameh Fahmy

Thank you, Jeff. As Jeff covered, the velocity and dwell improvements and they are significant. And they have been the result of the execution side of PSR, with a few waves of TSP changes, design changes to the train to schedule.

And when I talk about the execution, I mean, discipline, compliance, accountability, pealing the onion every morning, on low velocity trains and delays and failures. So these things have allowed us to move forward, with that velocity and dwell. And we still have room to go.

We get on some days now in the U.S. 18 miles per hour. In Mexico, we get 15 miles per hour. So a combination of the two is now beginning to get us into higher range of velocity and as well as dwell. These improvements allowed us to take assets out. So, you have a lot of numbers here on this slide. We took out 14% of our locomotives. So now we have an active fleet of 903, when we started the PSR exercise it was 1,046.

We also took out a lot of cars. When you look at the active car count, we now run at about 58,000 cars. We used to be at 64,000 cars online, this time last year. And clearly, the last cars we had in the network, the better up you are, because that's a sign of fluidity and less congestion.

The car mile, Jeff touched on it. We are getting -- actually in Mexico we got an improvement of about 41% in our car miles per day. But we still have a lot of room to go, like we went from 70 miles per day to 100 miles per day.

But if you look at the statistics, even on KCS and U.S., but also on other class ones, we know that we can get to 150 and even higher than that. So we still have room to go there. When you take out a lot of assets and typically we take out the worst least reliable assets, you improve reliability. So failures, mechanical failures have reduced by 31%. And also, when you have less cars online, especially foreign cars that costs us daily, car hire, you end up with significant improvement in significant savings in the equipment cost. So, our equipment cost have gone down by 24% in Q3.

At the same time, also, crew costs have come down and Jeff has touched on that. They have come down 9% in this quarter compared to the same quarter last year. And that's in spite, by the way, of a rate increase in Mexico of 5%. So essentially a flat 14%

improvement in productivity and things like that adding have come down by about 40%.

Fuel efficiency, Jeff touched on that, we have improved by 5%. When you have long trains and heavy trains, they are beautiful for fuel efficiency. And we are monitoring every morning, now the HPT, which is the horsepower per ton.

So, that you don't have too many locomotives for the tonnage. And we take every train that has a high HPT and challenge people and question, why do we have that many locomotives like five locomotives for 800 tons as an example, a few days ago, and same way as we check the velocity on every train. So that's a lot of what we have done so far.

Now looking forward, the biggest thing coming up is going to be the white-boarding exercise. Brian Hancock and his team, Olivia Daily and her team, they have done a superb job. I attended a full day meeting yesterday with a commercial team to make sure that the changes are going to be very well communicated to the customer, so that everything will be smooth when we implement this TSP change.

Now the genesis of our white-boarding is that, we went to San Luis Potosí on a field visit and it became clear to us that people were not compliant with the current TSP. And part of running a good railroad is that you comply with the plan. You don't ad-hoc. You don't run extra trains. You don't just do things by the seat of the pants, because you can end up improving what's happening in your yard, but you generate a lot of problems downstream.

Now what became clear to us is that the guys were doing that because of deficiencies in the current TSP. So we wanted to improve the TSP and no need for ad hocking, but put that in the plan itself. I'll give two examples of the new TSP that illustrated that what we are doing.

Right now, we have an area very important in Mexico, it's called the Saltillo. We have Encantada, Santa Maria, Rojas, Saltillo these are small yards that our always in 50 miles. And they service a lot of customers. So we have two intermodal trains that each one of them every day was set out three blocks to these areas.

And one manifest train that also drops three blocks. So you have a total of about nine blocks that come out of these trains every day. That switching, which is one of the things that are targeted by PSR, is you want to reduce touching cars and you need to reduce switch, and you want to reduce work events online.

Now these three trains are going to be replaced by one train that would combine the intermodal and manifest going to that area and will set out the blocks that will be combined, so if it's Santa Maria, intermodal and manifest, it will all go together. Rojas the same way.

So you drop three or four actually, because you have four locations, so four set out instead of today nine set outs of blocks. So, a significant improvement in reducing the work events, reducing train delays, improving velocity and reducing car dwell. That's an example.

Another small example is Escobedo, where we had another field visit in July and we are instead of building 16 blocks in that small yard, which is very tiny, we are going to build 10 blocks by moving some of the work to Mexico City where there is a very huge yard that is already building these blocks.

So these are two examples that show that we'll tax the car less, which is one principle of PSR and around fewer another trains, which is also an example of a target of PSR. We will also move gradually to big yards like Sanchez and Mexico City and try to do less work in these small yards where they have trouble handling big long trains on a lot of switching.

Two last points on my slide, we've put in place trip plan compliance measurements, so that we know a car from the time we get it until we deliver it, the exact time and seeing if that matches the expectations of the customers. So this is doing it through the eyes of the customer. So that our commercial people when they settle the customer, they are -- showing numbers that match what the customer wants to see.

And right now we have about 68% trip plan compliance. We have room to grow. We have room for improvement. We should be at 85% or 90%. And thankfully there is a survey that was done by the commercial team that shows that 77% of our customers are seeing a significant or moderate improvement in our transit time and our service.

Last point, we want to leverage capacity. We are freeing capacity without spending money, which is another principle of PSR. And we want to use that to grow our business. And the best example of that is grain, our cycles for grain. Our trips per months went from 1.20 to 1.42. That means instead of doing a trip, a round-trip, complete round-trip in 28 days, we do it in 21 days. Every day means $9 million increase annually in our revenue. And we have seen that in grain.

The revenue in Q3 and Mike Naatz is going to talk about that went up by 15%. So this is a big demonstration of what PSR is all about we generate, we improve service, we grow the business, we improve the revenue and actually right now we have about 800 cars surplus grain harpers that we hopefully will get more business with or if -- partially we get more business than the rest I guess, we'll have to dispose off.

So on that, I will pass it to Mike Naatz.

Mike Naatz

Thank you very much, Sameh. Good morning, everyone. I'm going to begin my comments on page 13. You'll see our year-over-year third quarter revenue was up 7% on a slight increase in volumes. This established records for both revenue and volume.

Similar to our prior quarters, our cross-border business was a key contributor to our performance with revenue increasing 17% and volume increasing about 12% year-over-year. During the quarter, our revenue per unit grew 7%, which was led by our growth in our Chemical & Petroleum and Ag/Min business units. You may recall that these segments tend to have longer lengths of haul and higher revenue per unit. In addition, our fuel program also benefited our revenue per unit and our pricing renewals overall were consistent with our year-to-date performance.

As has been the case all year, the Chemical & Petroleum segment was our primary growth driver. Year-over-year third quarter revenue was up 21% on a 12% volume increase. The Mexico Energy Reform revenue grew 71% and a year-over-year volume increase of 59%. We did note, sequential decline in this traffic which was driven primarily by a reduction in LPG shipments, which tend to be influenced by the seasonal and commodity base pricing fluctuations.

Our Refined Products business was relatively flat sequentially, as we saw some delays and storage permitting in some overall demand softness. However, we remain very optimistic about the growth opportunity in the long-term and frankly our year-over-year refined product growth remained strong at 67%.

Driven largely by cross-border grain and food product business, our Ag/Min segment had a great quarter, seeing a 15% increase in revenue and a 10% increase in volume. During the quarter, we continue to see improved cycle time, as Sameh mentioned. Simply put, we handle more volume with less equipment, which helped us realize improvements in both revenue and costs. Again, a great case study for PSR.

On the energy side of things, volumes and revenues were down due to decreases in frac sand and Canadian crude, which was partially offset by year-over-year growth in utility coal volumes. Our industrial consumer business unit revenue was up slightly on flat volumes. In this segment, our metals business was up year-over-year due to sourcing shifts. But these gains were partially offset by declines in our paper business, which continue to see pressure from alternative packaging solutions and available truck capacity.

With respect to the Intermodal business, revenue was up slightly on a 3% decrease in volumes. Our cross-border franchise volumes grew at 8%, while revenues remain flat due to shorter length of haul.

Domestic Intermodal volumes decrease on the yields of weak demand and ample trucking availability in the U.S. and our Lazaro revenue was up 10% on lower volumes, primarily due to the impact of our fuel program. Revenues and volumes were down in our Automotive segment, primarily, due to an unplanned plant shutdown and year-over-year shift productions and I'll talk more about that in a moment.

I guess with that, I'll move onto slide 14, where you’ll see our revenue outlook for the fourth quarter 2019. As Pat mentioned, we are maintaining our revenue growth guidance of 5% to 7% and flat to slightly lower volumes. We do remain very positive on the Chemical and Petroleum business unit and the Mexico Energy Reform story.

Additionally, we expect to see favorable year-over-year growth in the Ag/Min, and Industrial and Consumer segment, and this is primarily due to the continuing service improvements we're experiencing. However, we are monitoring recent trends in the paper market which continues to be soft and we are monitoring available truck capacity.

We are adjusting our Automotive segment to neutral for the fourth quarter with the positive impact of a new plan opening being largely offset by lower production forecast and plant shut downs.

And very specifically, we're currently being impacted by the GM strike, which ideally be assembly and transmission plan since a -- and if you may remember it allow us one of three GM plants we served at Mexico. Suffice to say that we are pleased to see that UAW and GM have reached a tentative labor agreement. So, we'll see how that plays out at the end of the month here.

And finally our expectations for Energy and Intermodal segments remain below last year for reasons already mentioned. I guess in summary, we'll continue to monitor the overall economic environment, and I'm happy to reiterate Pat's comment earlier that, our outlook is favorable for 70% of our revenues.

And with that, thank you for your attention. I'll turn things over to our CFO, Mike Upchurch.

Mike Upchurch

Thanks Mike. I'm going to start my comments on slide 16. As Mike indicated, third quarter of 2019 revenues increased 7% over the prior year on a 7% increase in revenue per unit.

Fuel revenues increased $13 million or 19%, primarily due to a loss of the fuel excise tax credit that resulted in higher fuel prices in Mexico. The reported third quarter 2019 operating ratio was 62.3%, slightly worse than the 62% in the quarter a year ago.

However, operating ratio on an adjusted basis excluding the $12 million PSR restructuring charge was a record 60.7%, and 270 basis points improvement over the third quarter of 2018 adjusted operating ratio.

Included in the 60.7% operating ratio was a negative 80 basis point impact from the loss of the fuel excise tax credit. Adjusted expenses increased only 2%, evidence of strong cost control across all of our expense categories. Adjusted operating income increased 15% leading to strong incremental margins in the quarter of 78%.

KCS associates delivered a unique blend of topline growth, improving service, and strong cost control that led to outsized EPS growth in the quarter. And I'll speak more to expense details in the next two slides.

Third quarter of 2019 reported EPS of $1.81 was a 6% increase over the third quarter last year. However, on an adjusted basis, our EPS of $1.94, was a 24% increase over third quarter of 2018 with the majority of that increase coming from real operating income. A more detailed P&L and adjusted EPS details are contained in the Appendix on Slides 22 and 24.

And finally, our third quarter 2019 adjusted effective tax rate was 28.2%, and for the full year we expect our effective tax rate to be approximately 27% to 28%. You can find more details on our taxes in the Appendix on Slide 25.

So, turning to Slide 17, let me provide a little bit of detail on our PSR update relative to the expense savings. We now expect to generate $58 million of expense savings in 2019 that is up from the $40 million estimate we've provided in July on our second quarter earnings call. And on an annualized basis, we now expect $75 million of operating expense benefits from our implementation of PSR.

In the compensation and benefits area, we now expect about $8 million of savings in 2019 and $14 million on an annualized basis, due to a variety of actions, including a train consolidation resulting in crew start reductions, reductions in debt heads, mechanical labor savings from the reduction of locomotives and equipment, and some G&A savings from restructuring efforts.

In the depreciation expense line, we expect $5 million of savings in 2019 and $8 million on an annualized basis, the direct result of disposing idled and excess assets. In fuel expense, we now expect $19 million of fuel expense savings for 2019 and $22 million on an annualized basis.

Our year-to-date fuel efficiency has improved from 1.34 to 1.30 gallons per gross ton mile, thousand gross ton miles, but currently stands at 1.26. And we've seen improvements from various actions we have taken, including train consolidation and technology investments and the utilization of tools, such as Trip Optimizer and Smart HPT.

Equipment savings are expected to be $13 million in 2019 and $19 million on an annualized basis. Overall, we've seen a 15% year-to-date improvement in cycle times, meaning we're getting equipment off of our network much faster and paying less car hire. Overall, since the beginning of 2019, we have reduced cars online by 17% and more importantly, we have reduced the cars we pay car hire, on namely foreign and TTX cars, by 22% over the same period.

And finally, in purchase services and materials and other, expense savings are now expected to be $13 million in 2019, which includes a one-time $5 million contract settlement from a vendor. On an annualized basis, we expect an approximate $12 million in savings in these expenses, mainly from reduced repair incidence from disposing of equipment and contract restructuring.

Turning to slide 18. Adjusted operating expenses increased 2%; primary drivers of our expense increase were incentive compensation increase of $10 million and the $9 million third quarter year-over-year loss of the fuel excise tax credit. Fuel consumption was up $5 million, but efficiency gains offset the entire consumption increase.

I'll discuss comp and benefits and fuel expense more on the next slide, but let me comment on a few other expense items. First, we experienced higher year-over-year derailment in casualty expense of $4 million, largely due to one incident late in the quarter. Offsetting that derailment expense was a one-time credit from a vendor, resulting from poor performance.

Second, equipment expense declined 24%, and as I mentioned before, is the result of fewer cars online, particularly foreign and TTX card for which we pay car hire. In the third quarter, KCSM experienced a 25% improvement in cycle times.

Turning to slide 19. Comp and benefit expense increased largely due to higher incentive comp expense in the quarter. In 2018, we were recruited well below target in the third quarter, while in 2019, we are well above target. We recognized $6 million of incentive expense in the quarter to reflect the increased payout.

Wage inflation of $4 million was offset by a $3 million reduction in comp and benefits expense from lower headcount and fewer hours work. Headcount, excluding the in-sourcing of 91 FTE was down 1% and we continue to believe we will manage 2019 at reduced headcount levels from 2018.

And as a note, we're using average FTE for the quarter in the bar charts, but at September 30, 2019, we were down 2% year-over-year. Comp and benefit savings at this stage of our PSR implementation have resulted from train consolidation that has reduced crew starts, reduced hours worked, including overtime and mechanical reductions due to fewer locomotives and freight cars and finally in some G&A areas.

As Sameh talked about our white-boarding efforts and as we conclude those, we would expect to see some further reductions going forward. However, we will manage certain growth corridors, such as our cross-border network with more FTE.

And location such as Laredo, Texas and Sanchez, to support the strong double-digit volume and revenue growth, we have been experiencing for the past year. Simply put, we will continue to grow human resources in growth parts of our network, while rightsizing FTE, where traffic volumes do not support the level of human resources.

It's also important to remember that the formal process in Mexico is not as flexible as it is in the U.S. And unless we can agree to more flexible work rules with the union, we will continue to have a scenario where FTE reductions may not be as great.

However, our work hours will continue to decline, resulting in reduced compensation expense, as approximately 75% of pay is variable. And I might remind our analysts and investors that back in 2009, when we saw a 25% reduction in revenue and a 19% reduction in volume in Mexico, we've scaled comp and benefits expense extremely well showing a decline of 27%.

With respect to fuel expense, fuel expense declined 3%, as a result of efficiency improvements from our PSR implementation. We carried 6% more GTMs in the quarter, compared to a year ago, with essentially the same amount of fuel being burned. Lower prices in the U.S. also have help reduce fuel expense, but we did experience slightly higher fuel prices in Mexico.

And finally on slide 20, we have included our capital allocation priorities. We continue to believe investing in our network, particularly our cross-border network, to support the high-growth rates we are seeing, is the right priority. We expect capital expenditures of less than $600 million for the full year 2019. And on a longer-term basis, we would expect CapEx to revenue ratios at around 18%.

During the quarter, we have repurchased 816,000 shares of our stock, at an average price of $1.22. Year-to-date cash flow has increased 76%, for the nine months ending September 30, 2019. Despite paying cash for 50 new locomotives that we acquired in the first half of the year. Accordingly, we will continue to work in ways to return excess cash to investors through both dividends and stock buybacks.

And since we are on pace to complete the current $800 million stock buyback program by the end of this year, we are actively working with our board to develop a new capital allocation policy, that we intend to communicate to investors by the end of the year.

And now, I'll turn the call back to Pat.

Pat Ottensmeyer

Okay. Thank you, Mike. I just want to circle back on – quickly on a couple of things before we get into the Q&A. Again, we feel terrific about the performance of the quarter. Top line growth, significant progress and sustainable PSR-related cost savings. I think there is certainly more to come. We have a pretty positive outlook, certainly for the rest of the year. And please don't ask too many questions about 2020 guidance, we're going to be pretty stubborn in our position of not talking about 2020 on this call. There'll be more to come over the course of the next few months and certainly on the fourth quarter call about our outlook for the coming year -- or for next year and beyond. But very pleased with the progress we're making on improving our service most importantly.

As Sameh talked about the -- we are seeing this -- everyone is familiar with my favorite phrase, service begets growth, but we're seeing that playing out as we improve our service, as we are able to relieve congestion in our yards and on our network. We're putting assets; they're freed-up to use to handle more business. We're confident that some of these oversized growth opportunities that we've been talking about for the last several quarters are real. And if we can do our part to provide the service that is required to handle that business, it's actually materializing.

Go back to a comment that Mike talked about. Look at the improvement in operating income that we had versus last year, 15% record operating income and if you sort of take that down through the income statement, about 70% of our EPS gain year-over-year for the quarter was due to actual improvement in operating income. So, I think that's a significant fact to keep in mind, if you -- as you look at our performance.

So, -- and again, we feel like that there is runway ahead of us, both on the cost and service improvement side and certainly on the revenue opportunity. So, with that, I will conclude our comments and open the call for questions.

Question-and-Answer Session

Operator

We will now begin the question-and-answer session. [Operator Instructions] The first question comes from Chris Wetherbee of Citigroup.

Chris Wetherbee

Hey, thanks. Good morning, guys. Pat, I just wanted to kind of ask question on Slide 6 you had mentioned earlier in the call that the guidance will change and improve. And I guess, I just want to make sure, I understood what you are kind of commenting there, I'm guessing it sort of the OR, EPS, and CapEx targets that our beyond 2019? But, just any thoughts you can give on that will be helpful?

Pat Ottensmeyer

Yeah. I think, it'll be across the Board obviously as we finish our plan I think the key for us and why we're really going to we stubborn about talking about 2020 is this white-boarding exercise that Sameh and Jeff talked about; Brian, his team -- we're making great progress on that, but we aren't at point where we really feel like we know what that's going to result in terms of service improvements, cost profile, et cetera. So, -- but let us finish that.

So, certainly, the one number on Slide 6 that I'm sure everyone looks at with the quarter that we just produced and says that doesn't seem real is operating ratio. But we certainly expect to update that and I expect it to be certainly better than the guidance that we've given up to this point, but we'll certainly freshen the guidance on everything.

Chris Wetherbee

Okay. That's very helpful. I appreciate it. And then just a follow-up on the Mexican work rules and the progress there, can you give us a little bit of sense of what the timing might look like as you go through that process? And maybe what a potential outcome might look like as well?

Jeff Songer

This is Jeff. I'll take that one. So we continue to have discussions with the Mexican Union regarding just modernization rules more than anything. I've talked numerous times about crew size in Mexico, significant amount of three and four personal crews. We know where we're heading in the U.S. and then for the rest of the North American trade systems. So there's ample room for a crew size. But probably an equally and maybe even more important are just our flexibility. The way the union sections are structured, we have a lot of division within the network.

You have a lot of overlap and a lot of restrictions. For example, coming into one of our yards, you have three sections that integrate into that same yard and when the train pulls in, we have to arbitrarily stop a train, swap out a crew and maybe do that multiple times by the time that train could run through the terminal. So those types of work rule improvements as significant as maybe some of the headcount initiatives.

We're simply pulling off a fourth brakeman and third brakeman who literally don't have a lot to do if anything to do on these trains; it's something we're working on. I would underscore what Mike said about the cost -- relatively if these road crews aren't working there's relatively little cost associated with it. So that's why I wanted to highlight the cost benefit of the labor without necessarily seeing all the headcount reductions at this point.

Timing wise, I think it will be -- we're continuing to discuss. There was meeting in Mexico City last week. We’re continuing to facilitate this. I hope we have some breakthrough here before the end of the year. But it's something that we're still working very hard on.

Operator

The next question comes from Justin Long of Stephens. Please go ahead.

Justin Long

Thanks. Good morning and congrats on the quarter. So as we think about the new run rate for PSR savings, can you talk about how dependent these savings are -- on how the top-line trends? I think it's pretty clear, we've seen some weakness in the broader freight market in the economy. So do you think these savings or maybe something higher or -- are still achievable if the demand backdrop just stays around where it is today?

Mike Naatz

Yeah. This is Mike. I certainly think so Justin. And we were really challenging ourselves here with access equipment as Sameh said. Our goal here is if we can deploy that access idle equipment in the marketplace and sell more product like we did in the third quarter with grain. We absolutely want to keep that equipment because the margin that you generate on that is certainly a lot better, but if we see a macro downturn that's more significant than where we're at today. We may have to adjust if the demand for those assets isn't out in the marketplace.

Justin Long

Okay. And secondly, I wanted to ask about revenue per carload. It seems like you're continuing to benefit from positive mix with Chemical & Petroleum and the AG segment performing really well on the top line. Can you just talk about the sustainability of this positive mix going forward? And, should we also be thinking about the OR and incremental margin this quarter being impacted fairly significantly from that mix tailwind?

Mike Upchurch

Hi, good morning. This is Mike. I'll take a crack at that. So, yes we do anticipate that revenue per unit is going to continue to be healthy like you're seeing today. And that is because as you said the mix changes.

The Chemical & Petroleum units, definitely brings in more revenue per unit. And as long as that continues to grow disproportionately to some of the other business units like intermodal, that revenue per unit is going to continue to improve.

Operator

The next question comes from Tom Wadewitz of UBS. Please go ahead.

Tom Wadewitz

Yeah. Good morning and Jeff congratulations on the strong results. It seems like you've got a lot of momentum. Wonder if -- I know Pat, you said, you're going to be pretty careful about 2020 commentary. Perhaps if I pose it little bit more narrowly, how are you thinking about the white-boarding process, and I guess what the outcome might be? Are you looking at -- should we expect a pretty significant reduction in train starts from that? If so, is it 10% reduction in train starts? What's kind of -- I don't know if they're broader framework for our expectations on the white-boarding? And also if you are on track, on timing to implement it at the end of the fourth quarter?

Pat Ottensmeyer

Hey Tom, see, I think I used the word stubborn, not careful when I talked about 2020 guidance. I'd like to have Sameh and Brian, since a lot of the work in the white-boarding is taking place with his group.

But to talk about, maybe some of the things we're focusing on the activities and the expected outcomes in terms of activities. And not financial results of the white-boarding results.

Sameh Fahmy

Yeah. Like I said, this is Sameh. Like I said earlier, we are very focused on the two things that are the pillars of PSR. One is, reduce switching, which is -- lot of people call it how many times you touch a car.

And the second one is, reducing trains with train consolidation. And that's where you'll reduce crew starts. The example I gave was really very illustrative of that. I said that, instead of three trains, you essentially go down to two.

One is going to do all the work, in these places around all deals [ph], the other one will go through without stopping. So you reduce the switching, you reduce delays, by the way these trains when they do that work, setting out locks, they block the mainline.

So, when you go down from line of these operations every day to four, you reduce obviously delays significantly. And that will help with the velocity of the network. What we need to understand is that on the Mexico network, yards are where we spent a lot of time; yard is where the big potential and the big opportunity is.

And the less work you do in these yards and the faster you can get trains through that yard, the faster the fluidity of the whole network is going to be. So, as an example and Jeff touched on that, if you have a train that doesn't do any work in that yard, don't make it go through that yard and that's part of the new white-boarding exercise.

Jeff was talking about this in particular, the train goes through the yard because of -- some of these labor rules and we hope to get that around the yard and not having to do -- not having to slowdown everything and slowing -- getting the train itself to be slowed down by the switching happening in the yard.

One of the biggest delays we have in the network is train held out of terminals, because they cannot get in because there is no space to get in. So these things -- the team has been very, very focused on. Like I said, I spend a day with them yesterday and the commercial people. A few days ago, I've spent a lot of time with Olivia, who's leading this effort under Brian Hancock's leadership, who is sitting right next to me here. And they are really doing a fantastic job.

And at the end of the day, we are going to reduce the number of blocks that we create. We'll do them more outsourced. We'll do them in the big yards like Sanchez, where there is a lot of room and it will be more efficient.

One thing that is contradictory between train consolidation and switching. When you have long trains, at the end of the day they go in yards. The yards have short tracks that are not necessarily -- they were not built for that kind of train. So, that sequence of doing these things and doing them in a smart way is very important, and that's what the team is focused on.

The implementation will start November 5, which was part of your question. That's going to be Phase 1. That is going to be three phases. The third phase will start towards the end of this quarter in December. So, we will hopefully complete this exercise around -- I would say, January, February at the latest. I don't know, Brian, if you want to add.

Brian Hancock

The only thing Tom that I would throw in as well is, I think one of the differences in our work that we're doing and Olivia’s team is doing is, we're continuing to try to build the network that can hold more freight. So this white-boarding exercise is not only taking out these work events. This waste of time that Jeff talked about in the yard, but we’re trying to make sure that these trains have capacity to be able to fill them with this additional freight, whether it is manifest freight, Intermodal freight, but there -- we continue to believe we can grow the network.

And so, it's a little bit different white-boarding exercise because we really feel good about not only the cost side, but the revenue upside. So, I think Sameh and Jeff hit the points very well. But very proud of the work that the team is doing and looking forward to what we see here in the backside of the fourth quarter and in the first quarter.

Operator

The next question comes from Amit Mehrotra of Deutsche Bank. Please go ahead.

Amit Mehrotra

Thank you, operator. Hi, everyone. Congrats again. So just cost -- I guess costs related to purchase services and equipment have never been lower relative to the size of the enterprise or the revenue base. So it does seem to be some further opportunity I guess in materials and other expenses.

So just related to the white-boarding exercise, if you could just help us think about how those cost can evolve maybe the right way to think about it or if you can express it in absolute dollar basis, because those buckets together are higher than total compensation and benefits on the annual basis. So if you could just -- do you think you can hold those costs flat to down as revenues continue to grow over the next few quarters? I think that would just be helpful on an absolute dollar basis, that hopefully….

Mike Upchurch

Amit, this is Mike. Yeah, I think we can continue to see this go down over the medium-term. I think going into fourth quarter, it may look a bit more like flattish because we included in other as casualty expense, and we had not so great quarter in the third quarter on casualties. But generally, the longer-term trend would be down on that. Fourth quarter, roughly flat maybe from third quarter, which implies some declines in the casualty expense.

Amit Mehrotra

Okay. That's helpful. And then, just maybe pivoting a little bit to the capital deployment, I guess, disclosure in the slide in terms of the year-end, getting some more update on that. Well, certainly are we going to wait till year end, but I guess, Mike, if you could just help us think about the philosophy of that company with respect to balancing the risk as well as the return to shareholders on capital deployment.

Is it a debt-based metric? I know you talked about, kind of, leverage being a 2.2 times. Do you think -- if you could just talk about the philosophy? And then, do you think your leverage profile used to be any different than the larger class ones and just how you think about that on a relative basis?

Mike Upchurch

Yes. No. Good question. I mean, we're going to have some more concrete answers for you before the end of the year. As I mentioned, we're working with our board right now and ultimately that's a board decision. But, specific to your leverage question, we feel quite comfortable with where we're at with leverage.

And if we can continue to manage this at a low two range, which is our desire that would imply with earnings growth that there's some flexibility on the balance sheet that could be put to use. But we don't want to get too far ahead of ourselves with the specific actions we may or may not take. So that would be my sense.

Only other comment I would make is, our credit metrics look as good as anybody's in the industry. But unfortunately, the rating agencies seem to think that smaller is not as good as being larger, but I have those debates with them probably twice a year. And I think our numbers speaks for themselves.

Operator

The next question comes from Allison Landry of Credit Suisse. Please go ahead.

Allison Landry

Thanks. Good morning. I just wonder if you could comment on what you're seeing in the pricing environment, maybe first, just sort of broadly speaking. And then, whether you're starting to see incremental yield benefit resulting from the improved service levels and reliability?

Mike Upchurch

This is Mike. And in general, we feel good about our pricing environment, and going forward, we expect that we're going to perform at the levels that you've seen this year. And certainly, it makes it easier to do so when we're improving our service product. It gives us a little more confidence when we're going in there and we're having those discussions with our customer.

Allison Landry

Okay. And then, I also wanted to ask about the -- there was a recent change, I believe, at the border where the CBP from both the U.S. and Mexico are now sort of sitting in the same building and doing inspections with the common viewer.

Is this something, we should think about or view as meaningful? And how much of an impact perhaps longer-term do you think that this could have in terms of speeding up the time it takes for our trains to cross a bridge or just sort of overall bridge capacity in the future? Thank you.

Brian Hancock

Hi, Allison. This is Brian. I'll take that one. Actually, Jeff and I were at the bridge yesterday. We had an outstanding trip and we had not only the CBP from the U.S., but SAT from Mexico. We went through our entire strategy with them and they were in complete agreement.

And so, what I would say right now at the border, as you have four organizations ourselves in the UP, as well as our two border crossing regulatory bodies focused on really making that border seamless as we possibly can, making sure security is high.

But I would tell you, it's going to have an impact. We're trying to create -- like Sameh said before, we're trying to create capacity without needing to spend capital dollars. One way to do that is to take those pinch points like the bridge and make them more fluid, use technology to make that happen and absolutely, that's -- it's an enormous focus for us and we just spent two days down there making sure that everybody continues to be aligned. So, yes, you'll see more.

Operator

The next question comes from Scott Group of Wolfe Research. Please go ahead.

Scott Group

Hey, thanks. Good morning, guys. So, Pat you talked about on the guidance slide that the OR guidance, sort of, stands out now. I'm wondering with the white-boarding going on, if you think the supplies take CapEx as well?

Pat Ottensmeyer

Yes. No doubt about that. I mean, we obviously took our guidance down on CapEx last quarter. Feel very confident that well come in well below -- below the $600 million that we talked about. We didn't take of our guidance down again. But I think we're very confident that we'll come in below that $600 million level.

And we're seeing areas, Sameh talked a little bit about some of the yard work that we're doing in Mexico, there maybe some CapEx required as we, sort of, rethink how we use the yards and how we use the network in Mexico, deemphasizing some of the smaller, more congested yards should require some capital in the larger kind of load centers that we're going to be focusing on. But we don't really have a real clear idea on what that might involve, probably not substantial enough to move the needle. So, yes, as we continue to operate more efficiently, do more for -- with less equipment, it's obviously going to have an impact on our CapEx going forward.

Scott Group

Okay, good to hear. And then just wanted to follow-up on the mix question again on Ag and Chems. So, I mean your Ag is growing -- I don't think anybody else's is. Do you think that piece on Ag is sustainable?

And then on the Chemical side, I know you don't want to get too much into 2020, but like -- are the pieces there to sustain double-digit volume growth in that business segment?

Mike Naatz

This is Mike. And yes, we do continue to see -- do expect to see continued strong growth on cross-border, whether that's coming from the Chemical & Petroleum business or the Ag/Min or frankly other segments. Year-over-year comps may make it a little more challenging, but we feel very good about the cross-border franchise.

Operator

The next question comes from Ravi Shanker of Morgan Stanley. Please go ahead.

Ravi Shanker

Thanks. Good morning, everyone. Pat or Mike, can you just give us an update on the intermodal competitive situation post the fuel excise credit, is that stabilizing? And to what extent are you able to recover some of that pricing through field clusters?

Mike Upchurch

Well, as you know the fuel excise tax credit was taken away from all railroads at the end of April and has not been reinstituted. We continue to have ongoing conversations with leadership -- government leadership in Mexico to try to get that reinstated because it is somewhat of a competitive disadvantage against the trucking that we compete with predominantly in the intermodal business.

I don't think we can handicap that. I'm probably not as optimistic that we're going to get that reinstated, but there is a possibility that generally happens towards the end of the year. But one other option the government has would be to level of playing field and no longer provide the credit to trucking industry. So that would be a favorable outcome as well and eliminate that disadvantage that we have.

With respect to putting those costs into our fuel program in Mexico, we started out in May and it's had the intended consequences that we wanted to offsetting the higher fuel prices that we were presented with at the end of April.

Ravi Shanker

Got it. And if I can follow-up to that, would you want the excise credit to come back? Does having a fuel surcharge mechanism actually benefit you in that? There are certain times when you can actually be on the right side of the equation and maybe even make some money in terms of the fuel pass through mechanism?

Mike Upchurch

We do not make money on the fuel program. Trust me, we would prefer to have that credit back because we have a structural difference here with higher fuel costs in Mexico and when you gross that up in the fuel program, that's a 100% OR business. And as I indicated earlier, it had an 80 basis point negative impact to our operating ratio in the third quarter. So getting that credit back would certainly help us from that standpoint.

Operator

The next question comes from Jason Seidl of Cowen. Please go ahead.

Jason Seidl

Thank you, operator. Hey, everyone. Appreciate the time. Just looking at some of the trade issues that's ongoing, both with China and USMCA. With China, I think you mentioned before that you guys might benefit with some trade moving towards Mexico. One, have you seen that? And two, do you think that's permanent? And on the USMCA, do you think once it is signed, you could see a boost in your business? And then I'll have a follow-up on your cross-border business.

Sameh Fahmy

Jason I think, we -- I can't give you a list of examples of companies who have made decisions and actually made investments moving business operations to Mexico as a result of the fallout with China. I was at a conference a couple of weeks ago in Mexico City that Graciela Márquez, who is the Finance Minister in Mexico, was speaking. And she mentioned that they are seeing more activity of companies, who are interested in relocating operations from Asia. So, we’re trying to engage with the Mexican government to help because logistic is consideration and how those companies can act to the rest of North America is certainly consideration for those decisions.

So, we believe that that is likely to happen. But I can't give you a list of specific companies that we're actually seeing do that. And I think largely because there are still a cloud of uncertainty about USMCA.

On the USMCA side, everything we hear in discussions, private, public, media, put it all together, everything that we hear is that speaker Pelosi is ready to bring it to the floor and believes that this is a good thing for America. So she is -- if you look at some of the comments that she has made publicly, she is kind of denying the fact that Democrats in Congress are trying to deny a victory for President Trump that this is a victory for the American people and it should be approved. It hasn't actually made it into the floor of the house yet. But everything we hear is that, it should be -- move forward. And we’re certainly hopeful and doing everything we can to nudge it in that positive direction to try to get it done by the end of the year. Brian mentioned event that they were at the border yesterday and earlier this week, that was actually a group that was hosted by us and the Commerce Department, focused on trade facilitation, border crossing issues.

And so I think we have the full support and cooperation of everyone in Washington, in the White House, the West Wing, the Commerce Department seem to be pushing forward with approval in fairly -- quick approval on USMCA.

Jason Seidl

Now, that’s some great color. And let's hope Washington gets up its buck still with some rail work. In terms of cross-border, obviously, I saw some nice growth in the quarter. There's a lot of opportunity at least I believe going forward to gain market share. What's the key going forward to have market share rate? Is it more your improved service reliability? Is it that along with increased visibility for the shippers? And where are you guys with sort of increases ability from origin to destination?

Mike Naatz

This is Mike. And I'll take that one. I think you hit the nail on the head. Key to our competitiveness on the cross-border side being able to move market share from other modes of transportation is going to be service related.

As we get in a more competitive product, as we have a more consistent reliable product, we believe we're much more efficient way, much more secure way to move freight across the border and that will help us.

To the extent that we can provide greater supply chain visibility for our shipments that is something that Brian and the IT team are working on. We're currently embarking on a rewrite of the Mi, KCS system, which should improve many capabilities for our customers, including visibility.

Pat Ottensmeyer

I think one thing I would add to this is if you go back to our script and think about our comments from a year ago, certainly third and fourth quarter of last year, we said things like we weren't happy with our own performance. We weren't satisfying our customer expectation. We believed that there was more business that we could handle than we were able to handle because of service issues.

Look at our service metrics. I mean, they have improved substantially from this time last year and they're sustainable. We've always felt very confident that if we did our part in terms of consistency, reliability of service and resiliency of our network that these oversized growth opportunities were real and that they were materialized.

So kind of the -- go back to my favorite quote, service begets growth, we're seeing it happen and if we sustain and improve and continue to improve the consistency and reliability, we feel very confident that these growth opportunities are real and we'll see it in volume and revenue growth going forward.

Operator

The next question comes from Brandon Oglenski of Barclays. Please go ahead.

Brandon Oglenski

Hey, good morning, everyone. And thanks for taking my question here. I guess Mike, can you talk about, actually the balance sheet here, because you guys have at least given us outlook on capital to be about 18% of revenue looking forward. So at this margin levels, you guys are actually generating pretty decent cash flow. What's the priorities here below low CapEx, I guess?

Mike Upchurch

Return to shareholders and as I indicated earlier, we'll provide that guidance before the end of the year as we're currently working with our Board on a new capital allocation policy.

Brandon Oglenski

Okay. But I think it looks like, you did say your target leverage ratio is about 2.2, is that the right way to think about it? Or with better conversion lower tax rate should we think that could be higher in the future?

Mike Upchurch

Yeah, I think, we're still low twos, but it could go up a little bit from where we're at.

Operator

The next question comes from Ken Hoexter of Bank of America. Please go ahead.

Ken Hoexter

Hey. Great update on PSR and the cost gains for the quarter. So thanks for that. Jeff, just a quick one, you noted quickly – you quickly adjusted to the weather. Is that because of new plan or were you saying the weather was not new to your network? And then I guess and the same thing with the Mexican Energy Reform deceleration is that because of the lag to tank to truck permission or is it seasonal? Or are you saying it's now becoming more cyclical?

Jeff Songer

I'll take the first part of that. So the weather now this – there is actually more rain in certain parts than we saw in Harvey impacting basically Houston and trackage, right? So there were multiple days of outages on our – on trackage right segments through Houston, but again as I said, so it certainly was not near as impact was something like Harvey, but there was outage time that because of how we've kind of regenerated the service plan down there.

Mike indicated earlier, we've actually added some resources in some quarters to be able to shelf-through these things a little better now than we probably have in the past. So I think it's a combination of TSP design, resource allocation and just execution.

Mike Upchurch

I'll take the portion of your question regarding the movements of refined products or Energy Reform. Again, our growth has been very strong there on a year-over-year basis. While we did see a little bit of sequential weakness LPGs was really the driver of that, as I mentioned in my comments that tend to be influenced by seasonal and pricing fluctuations.

The refined products demand softness is probably driving a little bit of what's going on in Mexico coupled with the storage permitting and retail permitting delays. As those delays – and we expect that we'll be moving more product into Mexico, particularly as it relates to towing up all the storage tanks that are going to be built over the next couple of years, and including our TCM facility, which we have approval to move products now in and out of those tanks, which is a plus.

Operator

The next question comes from Brian Ossenbeck of JPMorgan. Please go ahead.

Brian Ossenbeck

Hi. Thanks for taking my question. Appreciate it. Mike, maybe if you can size the opportunity for when those permits come down the pipe in terms of additional payrolls, I think that was in your slide deck maybe last year. So, maybe if you can give us an update on some of those specific facilities as they stand out there's anything changed other than just waiting for the permitting?

Mike Upchurch

I'm flipping through my information here. I believe that, there is eight facilities that are opening up next year that will include storage. I don't have the barrel information in front of me. But we believe there's opening's in the second quarter, third quarter and fourth quarter of those eight facilities. We have direct access to five of those facilities and then we have secondary access into the remaining three.

So, again we're very, very optimistic about Mexico Energy Reform and our ability to drive revenue in that category.

Brian Ossenbeck

All right. Thanks Mike. Pat, may be one for you as we talked about crew size, I missed call for Mexico, but obviously, the crew size in the U.S. is going to be topic for discussion in the next couple of years.

Can you just give us some thoughts on how you see that rolling out? And to the extent that a positive change control have to play a big impact, a big factor in that rather, how is that working on -- excuse me, on your system, especially from an interoperability standpoint given the high-low of interchange you have at the other class 1s? So, appreciate some thoughts on crew size and impact of PTC.

Pat Ottensmeyer

Just basic comment on crew size, we're in the process, the collective bargaining process with the rest of the railroads. You probably saw an announcement a couple of weeks ago that involve the railroads actually filing a suit. That's really just part of the normal choreography to get the process started, so it was nothing unusual. It was really just sort of step that was required to kind of engage in the process for new collective bargaining agreement -- industry-wide agreement hopefully in the next few months.

As far as your other part of the question, I'll defer that one to Jeff.

Jeff Songer

So, I guess as far as PTC implementation, interoperability is moving along to schedule. I don't think we look at ourselves any different from the other railroads on any less or greater impact will PTC interoperability, something Brian and the team are working very hard against.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Pat Ottensmeyer for any closing remarks.

Pat Ottensmeyer

Okay. Thank you all very much for your time and attention. I know there are a lot of KCS associates and colleagues on the call here and I just want to make a comment that we’re very pleased and very proud with the performance that we've posted here in the quarter and the outlook and appreciate everyone's -- many members of the PSR, very cross functional deep into the organization effort here and appreciate all of your hard work and performance here.

So, for the analysts and investors on the call, I know you have found my suggestions about headlines very helpful in the past. A few phrases come to mind when we look at the quarter. We think this is really a quality quarter, a quality beat if you want to put it in those terms, with our performance driven by topline growth and sustainable PSR-related performance improvements and cost savings.

And perhaps most importantly, we believe that there is more to come. We're not done yet certainly with our transformation and we'll have more to say about that over the coming months and certainly on the fourth quarter call in January.

So, with that, I will conclude the call. Thank you very much for your attention.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.