

# THE RAILROAD WEEK IN REVIEW

## JANUARY 29, 2010

*“Whenever the Fed attempts to stimulate the economy by facilitating low rates and rapid money growth, the economy responds. Reluctantly.” -- The Grantham Letter, January 2010*

**The common theme sounded** during earnings calls this week was one of using the present downturn in car-counts to position the railroad to handle more loads with little incremental cost as volumes come back. A sub-theme was a message to Congress that PTC and other regulatory changes will seriously compromise the rails’ ability to add capacity even as other Members are hollering for greener transportation modes. Onward.

**Canadian National led off** the week’s batting order with a 20 percent year-over-year decrease in quarterly operating income to C\$653 mm from C\$820 mm. Thank a 15 percent revenue drop combined with expenses that came down at half that rate. Commodity revenues continued their double-digit slide except for ag products and fertilizers at minus seven percent and coal down eight percent.

Total quarterly revenue units were unchanged year-over year (what a relief) with only forest products and auto down double-digits; coal actually rose 19 percent. The operating ratio lost a point to 65.3, a number any other railroad would kill for. Below the line reported eps was up a point to C\$1.23 though after one-time items it dropped 26 percent to C\$0.90.

During the call Chief Marketing Officer Jean-Jacques Ruest noted that the 2010 outlook is generally positive for the merchandise, bulk and intermodal groups. CEO Claude Mongeau added, “One of the headwinds CN will face in 2010 is the Canadian-U.S. dollar exchange rate, which averaged C\$0.88 in 2009 but is expected to be substantially higher in 2010.” Can’t fault him there - the USD\$ asking price for one Loonie is already 94 cents however as of Tuesday there were some players who felt this is about as high as it gets.

At the end of the day, CN delivered improved operating efficiency metrics in five of six categories with only yard dwell off a bit, but with train, car, loco and GTM numbers better, fewer train-starts are inferred and fewer train-starts means necessarily longer yard dwells. Fuel metrics reinforce this thesis: GTMs down four percent, gallons down 12 percent, RTMs per gallon down a point and GTMs per gallon up eight percent. The low operating ratio yet again reinforces the point that a faster smarter railroad costs less to operate.

Dahlman & Rose analyst Jason Seidl concludes, “The company reiterated its belief that a gradual economic recovery is likely to occur in 2010 and guided for double digit earnings growth and free cash flow of C\$700 million for the year... We note that the company is expected to face some headwinds in the first half of 2010 including an unfavorable currency impact, higher depreciation expense and increased casualty reserve. Additionally, the company announced a 7 percent increase in the its quarterly cash dividend effective 1Q10.”

**Norfolk Southern checked in** Wednesday afternoon with \$2.1 billion in total revenues, a 16 percent year-over-year drop, ops expenses down eight percent, and operating income slipping 32 percent to \$549 million. Revenue units slid nine percent and the operating ratio added more than six points. However, there’s more to it than that. During the Q&A an analyst noted the ops ratio delta and tried to make something out of it. Wrong. For apples-to-apples add back the \$245 mm drop in fuel surcharge collections and take an OR on *that*. Now the OR becomes 66.2, a point better than last

year, and the ops income delta becomes a meager 2.3 percent.

CEO Wick Moorman opened the call saying NS “gained momentum in the fourth quarter with the volume decline limited to a single-digit for the first time this year at 9 percent. On a sequential basis, volumes improved 3 percent from the third quarter to the fourth quarter and we saw a 52-week high in several commodities late in the quarter. Operationally, we continue to improve productivity against the nine percent year-over-year volume decline, crew starts were down ten percent and fuel consumption improved nine percent”

Large double-digit full year declines in all commodities shrank to single-digit losses in all but the metals-construction, paper-clay-forest and coal groups for the quarter. Chemicals and ag-consumer actually saw tiny gains. It was the same story in revenue-unit volume where ag-consumer, chemicals and auto posted gains. Coal loads declined nine percent for the quarter however record export coal tonnage was up 51 percent over 2007 levels. Chief Marketing Officer Don Seale cited double-digit declines in utility coal due to softer electricity demand and high stockpiles.

NS took operating expenses down eight percent with double-digit reductions in purchased services and rents, fuel, and materials. Comp and benefits was flat; absent a \$54 mm one-time hit for stock-based compensation that category would have been down nine percent. Right-sizing the railroad against the revenue-unit decrease, COO Mark Manion showed how they reduced crew starts by ten percent, increased GTMs per gallon and employee by four percent and GTMs per train hour by five percent. Car hire days per carload were unchanged, indicating an area where branch-line operations (short lines, too) could use a tweak.

As for 2010, Seale sees chemicals, agriculture, export coal and domestic intermodal as ripe for further recovery. He’s less encouraging about metals, steam and met coal, paper-forest products and auto and sees little improvement on the international intermodal scene. After a shot or two at the Washington situation Moorman closed the presentation portion of the call saying, “It is our intention to take the positive momentum that we generated in the past two quarters and continue to move ahead providing increasing value for our customers and our shareholders.” You can take that to the bank -- every new dollar in Retained Earnings for 2009 created \$3.66 in market cap for shareholders. I remain long NS.

**Canadian Pacific gave a strong a presentation** as I’ve heard in a long time. The year 2009 was one of extraordinary volume volatility where some commodities varied as much as 25 percent month-to-month. Yet CP was able to match expenses to volume to the point that the 16 percent revenue drop and the seven percent revenue-unit drop pulled quarterly operating income down only 12 percent. Double-digit carload decreases remained with all the usual suspects – sulfur-fertilizers, forest products and industrial-consumer. Sequentially, revenues and revenue-units increased from third quarter 2009 by three and two percent respectively.

Total revenues were C\$1.1 billion vs. C\$1.3 billion a year ago; operating expense was C\$853 million vs. C\$1,030 million a year ago and the operating ratio came down 117 basis points to a respectable 76 even, the best year-over-year change of any of the Class Is. Every expense line was down double-digits with two exceptions: depreciation up three percent, equipment rents down four percent. And here’s where making fixed costs variable really pays off. CP saved C\$13 million matching crew-starts to volumes and took fuel expense down 26 percent by burning less of it. In fact, CP cut fuel burn by 12 percent on a six percent GTM drop.

Cash flow deserves a special note, too. Full-year cash from operations came in at C\$552 million. Add back the C\$500 million pension pre-payment and the C\$73 million payment to RA for the

Ottawa Valley lease termination for a “normalized cash flow from operations” of \$1,125 million. From this take capex, dividends and other for free cash flow of C\$240 million, six times what there was for the full year of 2008. But that’s not all on the financial side. Normalized cash flow was more than twice net income; only BNSF came even close at 1.9 and change. Long-term debt outstanding is down 13 percent and investors have been awarded with the best year-over-year Class I railroad stock appreciation at 61 percent.

Group VP Sales Ray Foot doesn’t see any particular commodity hot spots for 2010. With SVP Brock Winter adhering to his make-big-trains-bigger game plan there’s room to add cars to both unit trains and manifests, sometimes putting previous unit train customers on manifest trains and vice versa if it means better turn times and filling out individual trains. I expect this will pay off with the anticipated lackluster deltas in grain and merchandise loadings, difficult-to-forecast changes in coal and fertilizer, and a potential first-half intermodal up tick.

During the Q&A Green hit upon a couple of particularly useful tidbits. First, he cautions against what he termed “unsupported optimism with regard to expectations of the recovery – as U.S. unemployment hovers at around 10 percent and more housing foreclosures (potentially 4 to 5 million) are likely. As the US’ largest trading partner Canada is hardly immune to these tremors. Second, re PTC Green said through 2015 CP’s total exposure is in the C\$250 mm range. A mere drop in the bucket compared to what we’re hearing from the US guys. Better keep the D&H in top shape to handle the transcon moves that PTC and other unfunded mandates will keep off the rails in the lower 48.

**The feds announced some winners** in the High Speed Rail lottery this week. Regional rail beneficiaries in the Northeast include RailAmerica’s New England Central and Pan Am Railways. Indirectly RA’s Connecticut Southern benefits where it operates over Amtrak New Haven-Springfield. Vermont gets \$50 mm for upgrading the NECR mainline and Connecticut gets money to restore the former New Haven Railroad double track line between its namesake city and Springfield.

Massachusetts gets \$70 million for upgrading Pan Am Railways’ ex-B&M Connecticut River Line between Springfield and East Northfield as part of a plan to shorten the route of Amtrak’s Vermonter, avoiding the non-progressive reverse move at Palmer. Then there’s \$30 million for Maine to get Amtrak service Portland-Brunswick. Kudos to Pan Am Rail and RailAmerica for winning these well-deserved projects.

**KSC reported some decent results** Thursday morning with revenues off by only four percent and revenue units off a point-plus, better than anybody else; the OR improved a point-plus, better than anybody else save CP. However, as usual, KCS included neither fuel usage or GTM data in the material accompanying the presentations. Look for the full write-up next week.

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### Selected FY 2009 Economic Measures for the Big Six Class I Railroads

Volume chart	Revs	Chg yoy	Rev Units	Chg yoy
BNI	\$ 14,016	-22.2%	8,418	-15.8%
CNI	\$ 7,367	-13.1%	3,991	-13.5%
CP	\$ 4,303	-17.7%	2,363	-17.2%
CSX	\$ 9,041	-19.7%	5,793	-15.1%
NSC	\$ 7,969	-25.3%	5,957	-18.9%
UNP	\$ 14,143	-21.3%	7,786	-15.9%

Mix Chart	Pct CL	Pct IM	Pct Coal	OR
BNI	44.6%	28.3%	24.1%	75.7%
CNI	64.6%	18.1%	6.0%	65.3%
CP	62.9%	26.8%	10.3%	76.0%
CSX	55.5%	14.7%	27.6%	74.9%
NSC	53.1%	19.3%	27.5%	73.9%
UNP	55.7%	18.2%	20.4%	73.3%

Revs vs GTMs	MGTM	chg	RU	Chg
BNI	984,120	-12.1%	7,718	-3.0%
CNI	304,690	-10.3%	3,539	-3.8%
CP	209,745	-16.4%	2,363	-17.2%
CSX	381,000	-15.3%	5,355	-3.5%
NSC	299,900	-16.5%	5,723	-4.2%
UNP	846,473	-17.0%	7,289	-1.7%