# THE RAILROAD WEEK IN REVIEW
## APRIL 25, 2008

*"The capability of the supply chain is considerable if everybody does their part." – Fred Green, CP earnings call*

**Canadian National reported** first quarter ops income down 7% to C$523 as revenues were relatively stagnant at plus 1% to a C$1.9 bn and expenses were up 4% propelled largely by fuel (ex-fuel expenses actually dropped two points, see below). In his opening remarks on Monday's call CEO Hunter Harrison said, "CN experienced some of the worst winter weather in decades during the first quarter of this year. Extreme cold and snow affected us system-wide -- particularly in Western Canada -- delaying trains and putting crews, cars and locomotives out of cycle. In January, we took the unprecedented step of suspending most operations in the West for almost two days to ensure the safety of our employees. All these factors depressed traffic volumes and increased costs."

There wasn't much room to take revenue up -- coal saw the only double-digit RPU increase. Chief Commercial Officer Jim Foote said during the call that even in spite of the harsh operating environment same store prices were up 4%, though roughly half the gain was from fuel surcharges. Still, grains/ferts and IM were the best volume performers, up 7% each.

Below the line, eps gained just 2% to $C64 cents helped by 6% fewer shares out than a year ago; net income itself dropped 4%. Free cash flow, long a CN strong point, was a negative C$12 mm before dividends and share buybacks; after these items, it was (C$502 mm). Net debt to equity was the lowest we've seen this quarter, 59.6%, and operating income covered interest expense a healthy six times. This ops performance is not what one expects of CN and IMHO it is an aberration. HH concluded the call saying, "The worst winter weather is behind us, we're beginning to see some pricing momentum, and there are still places where we can improve productivity."

Here's one way. Foote said something particularly noteworthy about forest products and paper out of eastern Canada. He cited the different markets for lumber, panels and paper and how "solutions" might vary for each as CN seeks to "rationalize capacity" while the forest products shippers curtail capacity. Listening between the lines, it sure sounded to me like he's looking at substituting the custom process that is intermodal for the batch process that is boxcar. Then it came out during the Q&A that in Q1 CN filled between four and five hundred containers of "new" forest products business. Excellent notion.

**Canadian Pacific likewise** did not set the world afire with total reported revenues of C$1.1 bn, up 3%, with revenue units up 2% on RPU essentially unchanged yoy. Once again, CP's strong bulk business was the main driver as grain, sulfur/ferts and coal representing a third of total volume, up 3%, 4% and 11% yoy. FX adjusted revenue was up 14%, 14% and 9% for the three respectively. The RPU delta was less encouraging: less than 3% in grain ferts and sulfur and off 4% in coal. Forest products and auto continue to lag, both down yoy double-digits in volume.

Elsewhere in commodity-land the industrial products group pushed revs up 10% on 7% more volume and a 3% rate increase. Before the deleterious effects of foreign exchange, total Q1 revenue was up nearly 10% yoy. The 8.7% pure price and fuel gain, augmented by a 2.2% volume/mix delta, took a 1.3% hit in coal contract pricing. That gets you to 9.6%; take out FX' 6.5% and you're back to 3.1% revenue gain reported. CP expects the bulk franchise to gain yet more revenue momentum throughout 2008 with a slower return to life for the merch trade and a flat year for IM.

During the Q&A CEO Fred Green once again stressed the need for CP and customers to collaborate on supply chain management. The Elk River equipment utilization missteps seem to fester still. The mines can do 28-30 mm tons a year but we're not there yet as car cycle times have only recently begin to improve. Green said they can turn cars in 85 hours mine-port-mine depending on "customer behavior." To me, it is encouraging to hear this continuing mantra: turn the cars or we will price around you. We heard it first in Vancouver a few years ago and again in NY last Oct. To know it is still very much alive in Calgary speaks volumes about CP's approach to supply chain partnership.

Out on the railroad, ops exp jumped 7%, dragging operating income down 14% yoy to C$198 mm and adding back 327 BP to the OR, once again north of 80 to 82.7. Of course, fuel was the big hammer, up 35% yoy on 27% higher price per gallon and 6% higher consumption against 4% more GTMs and a 1% dip in GTMs/gallon. Ex-fuel, CP held ops expense unchanged yoy and the 4% GTM gain on 2% more revenue units tells us they're getting more GTMs per unit.

Below the line, net income was down 29% to C$91 mm thanks in part to a one-time accounting charge, higher interest and FX offset by C$11 mm equity income from the DM&E and a 75% drop in corporate income tax. EPS dropped 28% to C$0.59 as the share buy-back program reduced the diluted share count by 2% yoy. Free cash flow after capex was C$33 mm or 3% of revenues though the net margin at 7.9% is on the low side for the rails covered in this letter. Still, it was a good quarter because it shows clearly what CP is about and where they are taking the RR.

**Having the two Canadian roads report** on the heels of CSX was an education in contrasts. First, there was the weather. Whereas much of CSX operates in the Sunny South, the Canadians get to traverse the northern Rockies and deal with the plains of Alberta and Saskatchewan, a part of the world not known for its temperate climes. Then there's the matter of operating revenue management. CSX has always had an aggressive marketing and sales department, matched only by Big Conrail for thoroughness and consistency.

CN under HH has always been the leader in ops efficiency, something he brought from the way he ran the IC (and which we saw on the FEC under McPherson, a Harrison protégé). CP is a Work in Progress having been set free from the Mother Ship, CP Ltd., not that long ago. CEO Fred Green had a great teacher in Rob Ritchie and you can see Green bringing his staff along just as Ritchie brought Green along. I've known COO Kathryn McQuade for years having met her when she worked with NS' CFO Hank Wolf. And though I only met Marketing SVP Marcella Szel last Oct, I've always found her marketing and sales approach refreshing and energizing.

Here are some points of comparison between and among the three, starting with the top line and drilling down through eps and a few other metrics. CSX boosted revenues the most, 12%, but saw volume down 2% to CP's up 2% and CN essentially unchanged. CSX' carload revs were up 9% to CN down 2% and CP up 2%. The driver is clearly system RPU, up 15% at CSX while the others barely moved.

Operating expense including fuel increased 7% and 8% and CP and CSX respectively while CN was only up 4%, not surprising given Hunter's Five Guiding Principles approach. And though fuel is a necessary evil, knowing how a rail does in controlling expenses *ex-fuel* can be instructive. Here again, CP leads – down 3% while the others were up less than a point. CN remains the OR leader at 72.8, the first time it's broken above 70 in recent times. Yet CSX was most improved, down 305 BP while CP went up as many points to 82.7 as weather, FX and fuel conspired against Green and Harrison alike. However, what CSX and CP have in common is somebody with NS roots running railroad operations. Stay tuned.

**As for Norfolk Southern** itself, first quarter revs hit a record $2.5 bn (do we hear $10 bn for the year??), up 11% yoy, record revenues for ag, chems and coal, all up double-digits with RPU gains in the same range. RPUs were off 4% driven by the usual suspects (forest products and auto) and intermodal – this last taking a hit from a combination of changes in international trade flows, the domestic and truckload business and a slowing of demand for premium services; Triple Crown was actually the only bright spot, up 2%. The other bright spot was the *three sell lines* in Don Seale's very first slide – something NS hasn't done enough of in the past. I'm hoping this is a trend.

NS continues to be a pricing story on the merch side. They have certainly set the bar with the single car business with tools from the Thoroughbred Operating Plan to the Operating Plan Developer to the Local Operating Plan Adherence (LOPA) measure. Together these operating systems and measures make sure the railroad not only runs to plan but also eliminates wasted moves and the resultant degradation of asset utilization.

I mean, ag revs were up 24% on a 4% volume delta with RPU up a whopping 20% including FSC. Mets and construction revenue was up 11% on even carloads and RPU up 10% yoy. And chems, even taking a volume hit from the combination of plastics and feedstock volume deltas and housing-related factors, took revs up 11% on 15% higher RPUs. Finally, coal revenues increased 19% on 2% more revenue units thanks mainly to export coal being up 64% on strong global demand, reduced Chinese exports as they're keeping more of the stuff at home to fuel their own fires, and disruptions in Australian coal production.

NS held the ops expense gain to 12%, so ops income was $1.9 bn, up only 10% and the OR was actually down 38 BP to 76.9 yoy. Net income improved 2% to $291 mm, diluted shares shrank by 5% and eps posted a 7% gain. As one would expect, NS was hit with the same fuel increases as everybody else – up 63%. Usage was up 1% on unchanged GTMs and ops expense ex-fuel increased 3% or $47 mm, of which $13 mm or 2 cents a share was due to the Graniteville settlement and another $12 mm went for increased costs associated with loco and car repair. There's half the non-fuel delta.

Capex was $304 mm for the quarter, 12% of revenues; free cash flow (ops cash less capex) was $300 mm or 12% of revenues, best to date of the four Class Is reporting. This is worth noting because in this business, we're dealing with wasting assets – you produce value by wearing out the tools you use to deliver the service. As CEO Wick Moorman said in his opening remarks, "We believe that the factors that support long-term growth in rail freight demand remain in place" and that volumes will start to go up again. NS wants to be ready and "as the economy rebounds we will be poised to handle that growth." Three hundred $million a quarter in free cash flow will sure help.

**As noted last week,** the NEARS conference kept me from the UP and KCS calls. Look for detailed reports on these plus BNSF and GWR next week. I'll also provide some observations from what was the best NEARS conference in recent memory according to not a few of those present.