THE RAILROAD WEEK IN REVIEW

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"North America and the railroad industry face many of the same challenges: global competitiveness; growth and capacity, an aging infrastructure." Kathryn McQuade, COO, Canadian Pacific at the CP Short Line conference, May 15, 2008

Canadian Pacific short lines, as noted last week, handled 273,000 revenue units worth C$630 mm in sales. That's about 10% of all 2007 revenue units and 14% of 2007 freight sales (reported revenue less ancillary fees etc). CP showed the percentage of short line revenue units represented by each of its seven commodity croups with Industrial Products incl consumer carload, grain and forest products accounting for 88% of short line carloads. But we need to go a step further.

More to the point, short lines handled 23% of CP's total 2007 merchandise (ex coal and IM) carloads. Short lines handled 45% of CP total forest products loads, 31% of industrial products loads and 23% of all grain loads. At the other end of the carload food chain, short lines handled 5% of coal, 4% of automotive and 4% of ferts/sulfur loads. That tells us CP short line strengths lie in forest products, industrial products and grain – not a bad place to be, as you'll see below.

Short line 2007 loads at CP were off 4% from 2005 levels with forest products off 8,600 units or 14%. Coal was the other big loser, down 11,300 units or 43%, but with that group, accounting for just 5% of short line loads and 5% of CP coal loads its not as scary as it seems. The good news is that gains in ferts/sulfur, auto, grain and industrial/consumer more than offset the forest prods loss by 1,600 units.

Marcella Szel, SVP for marketing and sales, noted in her remarks that CP's diverse franchise provides a balanced mix with bulk and merchandise representing 81% of revenues. About 60% of total revenues come from global trade and 60% of total revenues are derived from commodity OD pairs that are independent of the North American GDP. This last is what Marcella calls a "natural hedge" that provides short lines some insulation from the vagaries of the Canadian and US markets.

CP builds on these strengths with "Strategic Accounts" that represent 58% of revenues and have a five-year CAGR of 11%. The common thread among these accounts is they are industry leaders, they have been around forever, and they are growth-oriented. Here again the CP focus on customer behavior is paying off. During the Q&A after her presentation, Marcella said short lines could be especially effective because they are close to their customers and can keep the assets turning. (Recall that during the 1Q08 earnings call CEO Fred Green made some pointed remarks on this topic. See WIR 4/25/2008.)

My sense is that the commercial relationships between CP and its short lines are pretty much under control as they are at most Class Is. However, there remain many opportunities to improve the operating interface. SVP Ops Brock Winters drilled down through the Integrated Operating Plan (IOP) elements -- balance, network and velocity -- and gave specific examples of things short lines can do to improve system fluidity and asset utilization.

Three short line tasks stand out: single-speed train design, local service operating plans (LSOPs) and workload smoothing. With respect to single-speed train design, short lines can time load/empty release so that the size and weight of loads left at interchange is constant -- CP can power the local once and leave it there. LSOPs are one way to do it --- alternate days of service by customer size, mixing large and small to achieve a consistent outbound mix. Thus, workload smoothing is automatically achieved, addressing Brock's third point.

CP's outlook for bulk (coal grain, ferts/sulfur) is neutral through 1H08 and improving to a positive view beyond. Merchandise is weak to start and gradually improving late in the year though not quite to a "positive" view. Lesson to short lines: Pick the commodity groups and customers that will assure adequate asset turns and decent revenues. Don't swing for the fences just yet --- a series of singles will pile up more scores than the odd homer. And look to fit the IOP of your local division. CP has provided a winning recipe; all short lines need do is follow it to be *really* cooking.

Chop Hardenbergh (the *Atlantic Northeast Rails and Ports* letter) sends this note: "I'd like to put a gloss on these sentences of yours (WIR 5/16/2008) – 'I'd also like to see short lines developing intermodal business where carload economics do not work. A handling fee for a container load of paper is worth more than a handling fee for a boxcar that won't move.'

"Container terminals cost a pretty penny, in part because of the lifters required. Transload terminals are much cheaper. Short lines, at least in New England, quickly seize transload opportunities. For example, Rian Nemeroff is doing some inbound pipe for the Algonquin Pipeline at HRRC's bulk transfer facility. Mike Rennicke of PVRR won an award at the ASLRRA meeting for a transload to get wax to Yankee Candle. Put another way, as long-haul truckers are priced out of the market, the nimble short line (assuming it has an equally nimble Class I), can quickly move the truck traffic onto the rail via transload. Setting up new lines of container traffic and container terminals will take much longer to set up."

Agreed. Actually, I was thinking of short lines getting a commission for selling container loads for direct dray to the closest Class I intermodal terminal. CN is doing this for its own account in Quebec and has gained in two ways. First, boxcars that would sit for days waiting to weigh out are now placed where they can load in hours, not days, thus increasing available turns per year per box. Second, CN picked up several hundred new container loads that might otherwise be on the roads.

The carload marketing and sales people won't like this but if it's more money in the company till at the end of the day then so be it. As Kathryn McQuade said to the short line crowd in Minneapolis last week, "Technology may be a better, lower-cost, alternative to hard assets." The technology to place containers and boxcars in lanes that produce the best yields – and car cost is part of the yield equation – lets one generate more sales revenue per asset. Ergo technology trumps assets.

My proprietary analysis of the four car builders' 1Q08 results ought to wave a lot of red flags for value investors and does not show a lot financial strength in the sector. Free cash flow before dividends yoy was a negative number everyplace but RAIL (Freight Car America) where FCF was a positive number. Across the board positive yoy changes in market cap met negative yoy changes in retained earnings propelled by the soft market for their shares. Only TRN increased yoy net -- 11% -- whereas its peers all saw net income drop by double digits or more.

There's no doubt there will be some consolidation among car suppliers. Tony Hatch picked up the short line convention buzz about two leasing companies exiting the market. The rumored ARII/GBX combo is still out there, though in a recent note Bear Stearn's Peter Nesvold says that combo looks less likely following the ARII earnings call. Moreover, the incessant carrier focus on asset utilization and doing more with less means more revenue-ton miles without a proportional increase in freight cars. Blanchard remains on the car-builder sidelines for the nonce.

From the TRAINS Newswire: The Indiana Rail Road will lease six SD9043MAC locomotives and 157 coal-service railcars from CIT Group Inc., the railroad has announced. Spokesman Chris Rund said the locomotives will go to VMV Paducahbuilt in Paducah, Ky., for service and paint; the coal cars are already on the property. Four of the six locomotives will work in pairs, with a pair each dedicated to coal trains bound for Indianapolis Power & Light and Hoosier Generating at Merom, Ind. The new aluminum cars, capable of both pneumatic bottom discharge and rotary dump, will replace a fleet of aging steel cars in service to IP&L.

From the Railway Age Newswire: Four Class I railroads posted double-digit returns on investment in the 12 months ended March 31. The seven Class I railroads as a group had an ROI of 9.76% in the latest 12-month period, based on total operating revenue of $56.5 bn and net railway operating income of $7.05 bn. For the 12 months ended March 31, 2006, the Class Is earned 10.15%, with revenues of $50.3 bn and operating income of $7.45 bn.

CP/Soo Line led the latest list with a return of 15.28%. Norfolk Southern earned 13.16%; BNSF, 10.07%; CN/Grand Trunk, 10.04%; Union Pacific, 8.83%; Kansas City Southern, 7.81%; and CSX Transportation, 7.61%. Rate of return is important to railroads as not only an indicator of earning power but also as a measure of revenue adequacy, which is based on the prevailing cost of capital. The Surface Transportation Board considers revenue adequacy in the handling of such issues as rate challenges by shippers and line abandonment requests.

Elsewhere, Railway Age notes that "In a response letter to Barrington, Ill., Village President Karen Darch, U.S. Senator and Democratic presidential candidate Barack Obama wrote he is "opposed to the merger as currently proposed" by Canadian National of the Elgin, Joliet and Eastern Railway. and "will work with affected communities to make certain their views are considered as part of the Surface Transportation Board process." Why am I not surprised?

Larry Kaufman got it right in *Argus Rail Business* (5/19) when he wrote, "The interminable presidential campaign has devolved into the pandering season. It isn't just presidential wannabes who pander to voters. Pandering members of Congress are right up there with the best of panderers…. It's good that there is no law against displaying ignorance in public. If there were, neither house of Congress would have a quorum and could not transact the people's business. That might not be all bad."

Tidbits: Short-line Tax Credit Bill passes House Ways & Means Committee. The bill provides a one-year extension for the 50% short-line rail tax credits… Class I road cuts local service, annoying loyal customers, putting serving local short line in a bind, and hammering asset utilization rates… Canary in the coal mine: Amtrak reporting Class I performance by route and delay cause by host railroad. Results confirm STB performance measures… Ed Wolfe: Smart shippers are no longer looking for TL rate cuts, but rather they are looking to lock up long-term truck capacity… Nesvold: Signs suggest railcar builds may be trending better than what was expected in Jan.

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