THE RAILROAD WEEK IN REVIEW
APRIL 24, 2009

"*Without stock buybacks, many companies [that bought back stock] would have little debt and would have greater flexibility during this period of increased credit constraints." Michael Milken on Capital Structure in the WSJ April 21, 2009*

Canadian National leveraged what CEO Hunter Harrison called "outstanding operating performance" into some powerful lessons on how to run a railroad at a lower cost by doing things smarter. Start with a 16% drop in revenue units, price those revenue units so that revenue only dips 4%, manage ops expense down two percent and – voila! – operating income drops eight percent. The reported operating ratio came in at 74.1, up 1.27 points over first quarter 2008, though take away the last-hour EJ&E acquisition costs and it's really 71.7, beating the 72.9 posted a year ago.

Below the line, reported net income was C$424 mm (helped in large measure by the $161 mm other income gain from the sale of some Toronto right-of-way to GO Transit), up 36%, while a three percent drop in share count took diluted earnings-per-share to C$0.90, up 41 percent. However, that number includes C$0.26 in one-time benefits, so the true measure is C$0.64 a share, up two cents from last year's C$0.62.

But the real story is in performance. In his opening remarks, Harrison talked about how difficult it is to find productivity gains when car-counts are down double-digits. And yet four of six operating metrics – cars/yard switching hour, terminal dwell in hours, car miles per day (hit 182 and HH thinks they can hit 200 in short order) and train velocity – improved by double-digit percentages. GTMs per train and mainline GTMs per available horsepower increased by three and one percent respectively. Yet train-starts (yard and road) were down 20%.

Revenue unit counts dropped by double-digits everywhere but coal, up 3% on steam coal brought by the J, offsetting the drop in met coal, the traditional CN move. Still, merch carload and auto RPUs were up healthy double-digits. During the call Chief Commercial Officer Jim Foote said the same-store price gains in the neighborhood of five percent offset dips elsewhere: petrol products did well while metals tanked, e.g. Looking ahead, US steam coal off the ex-IC in southern Illinois and the J will improve that mix while the outlook for grains and potash will likely push into the second half.

Elsewhere, CN announced Tuesday morning that CFO Claude Mongeau has been tapped to succeed Hunter Harrison as President and CEO effective Jan 1, 2010. Harrison has been running railroads since 1993 when he took the helm of the IC and joining CN as COO and EVP in 2003. Mongeau has been EVP and COO since 1994.

Together the two of them have turned CN into a financial company as much as a railroad company. JPM 's Tom Wadewitz gets it right: "Given his critical role on CNI's acquisitions and as long time CFO, Claude is a very strong choice for new CEO at CNI." Congratulations, Claude, and thanks, Harrison, for an intellectually invigorating ride (and I'm *still* dining out on your six turns a month for IC grain trains to the Gulf circa 1999).

Norfolk Southern did not have a good day Wednesday due in part to what CEO Wick Moorman called "uncertain business conditions." NS reported a 20% drop in revenue units that turned into a 22% drop in total revenues and took operating income down 34%, pushing the operating ratio back into the 80s for the first time since the first quarter of 2005. Revenue per unit dropped two percent with the biggest bit coming from intermodal, down eight percent thanks in part to volume drops of more than 30% in both international and domestic box-counts. Making matters worse, fuel-related revenue dropped $226 mm year-over-year and represented approximately 41% of the overall decrease in revenue. This decline was partially offset by a $10 million positive lag effect for fuel.

Drilling down to the individual carload commodities, ag products dropped 14% on weakness in fertilizer demand, lower volumes of export grain and corn to Midwest processors. On the upside, ethanol continued its growth trend as shipments increased by 14%. Paper, clay and forest products shipments were down 26% as U.S. paper production declined by 18%. Lumber and wood products declined by 33% in the face of the worst housing market since World War II. Offsetting some of these declines were new shipments of waste that began moving during the quarter from the Northeast to landfills in the Southeast.

Rounding out the group, chems vols dropped 21% with lower production of basic chemicals and plastics as a result of depressed housing and automotive demand. Metals and construction volume declined 35% in the first quarter as lower domestic steel production resulted in two permanent plant closures and 16 idled blast furnaces in our service territory. On a positive note, new scrubber stone shipments to coal fired power plants increased by 27% as four additional power plants completed scrubber installation over the past several months.

In his first earnings call appearance as Chief Operating Officer, Mark Manion gets good marks for a level of detail and insight as to what NS is doing to lower direct costs while maintaining a fluid, competitive railroad. Like his counterparts at CN and CSX, Manion stresses right-sizing the railroad to match business conditions while retaining the ability to respond with the appropriate asset deployment as volumes return.

Says he, “While you can take a certain number of trains out of the network, you have to keep running some number of trains if you are going to maintain a scheduled operation and the level of service our customers want. Clearly, the amount of variable cost you can reduce depends largely upon the type of business. Merchandise tends to be the most difficult so we are continuing to scrub our train and yard plans on a weekly basis as we see changing traffic patterns.” [And that includes blocking trains to eliminate intermediate yards; short lines can help by pre-blocking for the distant nodes before they put trains on the interchange.]

Below the line net income skidded 39% even as income taxes took 43% less. The diluted share count came down three percent but still eps was off 38%. Still, not a big spread between deltas in ops and net incomes. Which tells me if NS can hold ops expense art this level even as the vols come back they will be in excellent shape. That’s the common thread among the first three to report and I see no reason for that trend not to hold.

As to why NS seems to be taking a go-slow approach to reducing assets in the downturn, UBS’ Rick Paterson offers an eloquent – and I think right on the money -- explanation: “NS disappointed on cost takeouts in Q1; specifically labor. Average headcount was down only 2% vs. Q3/08 (CSX took out 7% over same period). We think NS has a different strategy here. At one extreme is ‘fire and hire’ through the recession, while the other is to smooth resources leading to excess costs at the recession trough but driving a better transition into recovery. We think NS has chosen the latter path. Why? More than any other US rail we think NS has a longer-term focus and cares less what Wall St. thinks, so is prepared to weather a few poor quarters.”

Union Pacific turned a 21% drop in revenue units and a 22% revenue decline into mere 15% drop in operating income by running a faster, smarter railroad that took more than a point out of the operating ratio, posting an all-time best of 80.1, thanks in part to cutting fuel burn faster than GTMs and a 5% gain in GTMs per gallon. Below the line UP earned 72 cents a share vs. a consensus of 66 cents; UP made 85 cents in 1Q08. In his opening remarks CEO Jim Young said UP "has never run better" and that customer satisfaction is at a new high.

Well said. As proof of that pudding, ARC was up a point even with fuel surcharge receipts $300 mm less than a year ago. Coal and ag were the best performers holding volume declines to 12% and 11% respectively, once again validating the WIR "heat and eat" thesis. There was some decline in ethanol loadings due to the Verasun closings, however DDGs are holding and the new California RailExpress for carload perishables to the east is up 50%. Add to that a new used car transport product (see www.shipcarsnow.com), increased Texas rock shipments for "stimulus" projects and a 113% gain in the intermodal "Streamline" product and the picture is not entirely bleak.

The proof of Young's claim that the railroad is running better than ever is in the performance measures showing consecutive year-to-year improvements in velocity, yard dwell, car cycle days and the service delivery index. As we've said repeatedly in these pages a faster railroad is a cheaper railroad, borne out again by UP's making better car connections, faster turns, lower car hire expense and getting happier customers in the bargain. As a result of these changes network capacity is now pushing 200,000 cars a week, meaning that at today's depressed 140,000 car levels any volume-driven revenue gains will go straight to the bottom line.

Key to decreasing dwell and increasing car-miles per day is taking out intermediate yard stops and UP is pushing switching ops into the most efficient yards. Moreover, lower absolute volumes and faster yards contribute to UP's doing more with less, allowing the company to reduce train-starts, TYE employee headcount, active road locos and freight cars, each by 20%or more. Naturally, as the asset base shrinks, more of the operating costs shift to the variable cost side from the fixed cost side. UP says it can get 55% of costs to be volume-dependent.

Clearly UP learned its lesson in the 2003-4 recession when it cut back on variable expenses and capex to meet then current volumes and missing the upturn because the capacity was not there. Even if we don't see a "V" recovery, UP says it is taking a more disciplined approach this time around. The mere fact that they're running 140,000 cars a week on a 200,000-car railroad says UP is ready.

I'm must ask for your indulgence for my putting off comments on BNSF and CP earnings until next week. A family gathering in North Carolina takes me outta here Friday through Sunday. We also have GWR and KCS calls next Wed and Thurs so it'll be a full week. Thanks.

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