The Railroad Week in Review, May 1, 2009

"I think every time you have to take [out] a lot of cost you learn a lot and you find ways to do things better when [the business] does come back." – Matt Rose, CEO, BNSF

BNSF checked in with total revenues of $3,520 mm, down 17 percent from last year's $4,261 mm. Of all the commodity groups only coal posted a revenue gain, up half a percent, even though revenue units dropped a point. Among commodity groups, double-digit revenue losses beginning with a two were the rule, save for domestic intermodal (down 19 percent) and auto (down 43 percent). Merchandise carload -- I put auto here to square with all the other roads; BNSF puts autos in "consumer" with intermodal -- revenue dropped 24 percent.

Car counts were the same story: double-digit percentage losses in the twos ex-coal, domestic intermodal (minus nine percent) and auto (off 46 percent). These sharp volume drops were not enough to create revenue-per-unit gains beyond industrial products (four percent), auto (seven percent) and coal (two percent). Happily for ISS-short lines, the merchandise-cum-auto sector gained a point in average revenue per carload. Mix changed as well, with coal up five points to 27 percent of the total from 22 percent; intermodal dropped to 28 percent from 30 percent and merchandise/auto dropped to 42 percent of the pie from 45 percent.

Now the expense story is a bit awkward. As noted above, total freight and ancillary revenues were $3,520 mm. However, there was a $96 mm charge to coal revenues as a result of the unfavorable short-haul coal ruling (2/20/2009) and BNSF has deducted that from the revenue line in the income statement. I opted not to lest it distort my view of how the railroad performed moving freight ex-the legal noise so I put the charge below the line. Thus my operating income and operating ratio will differ from what you might have read in the press release.

Operating expense dropped a total of $631 mm, 19 percent. Of this, fuel expense sank $431 mm, down 41 percent from what it was a year ago. Thus the fuel savings accounted for two thirds of the total expense savings. Still, cutting expenses 19 percent when revenue is down 17 percent drops the operating income delta to a minus 13 percent. During the call CFO Tom Hund said that, excluding depreciation and fuel, every expense category was down year-over-year with declines ranging from nine to 15 percent. Reported eps was 86 cents a share vs. a buck thirty in Q1 of 2008; add back the coal-case hit (19 cents) and the interest rate hedges (8 cents) and the pro forma comps become $1.13 vs. $1.30, down a "mere" 13 percent.

On the commercial side, Chief Marketing Officer John Lanigan said ag volumes were down on tough whole grain comps from 2008, exports were lower in the Gulf and PNW, fertilizer was down 30 percent and ethanol volumes were flat. Industrial products revenue was down 23 percent as all five segments of the industrial product commodity group experienced negative revenue growth. The biggest drops were in construction products (off 32 percent) and building products (off 28 percent). In closing, Lanigan said coal demand "is moderating" and the outlook for ag, auto, intermodal and industrial is about what it was in the first quarter.

Of course, with fewer revenue units cluttering up the railroad, one gets more room to move what's left, and that was the theme of what COO Carl Ice had to say: car miles per day up 11 percent to 224, system on-time performance up 11 points to 91.5 percent on the card and fuel consumption dropped

13 percent while GTMs/gallon remained unchanged. All of which leads me to ask, what happens when the railroad is running so well it doesn't need to add capacity and is happy at some number of revenue units a week? Given what we're hearing across the board about making fixed costs variable, the "right-sized railroad" does not seem out of the question.

Canadian Pacific Chief Executive Fred Green pretty well summed up the quarter's poor performance in his opening remarks on the conference call. "Volume decline and negative mix more than offset some very good cost control efforts. For clarity, our carloads were down about 19 percent, but in combination with some unprecedented decreases in long haul traffic, our revenue ton-miles were down a remarkable 22 percent on the quarter... [Moreover] until our long haul volumes return, you should expect the carload to RTM's negative differential of nearly 4 percent to continue."

Operating income (restated as if DM&E had been on the books for all of 2008) sank 35 percent (50 percent foreign-exchange adjusted) as revenues dropped 13 percent (24 percent FX-adjusted) and operating expenses came down only eight percent (18 percent FX-adjusted). Below the line operating income dove 54 percent and eps was off 55 percent to 34 cents Canadian from 75 cents Canadian in the first quarter of 2008.

There were some bright spots, however. Revenue per revenue-unit increased seven percent with double-digit gains across the board ex-coal (down 14 percent on mix and length of haul) and intermodal (up four percent). Not bad considering revenue units were off 19 percent from last year. Operating expense dropped C$96 mm just on "cost management," or costs CP can control unlike fuel prices, the weather and foreign exchange.

CFO Kathryn McQuade put it this way: "This is an excellent measure of how well we are adapting our operating plan to match volume declines. When compared to the volume impact on revenues of 224 million, we removed over $0.40 of expenses for every dollar we lost in revenues." SVP Operations Brock Winter was able to show marked improvement in five key operating metrics -- train speed, yard dwell, cars-on-line, numbers of train-starts and crew utilization. CP looks to save another $100 mm in the next year with more of the same: consolidating terminals and mechanical operations, closing satellite yards and reducing cycle times in key lanes.

SVP Sales and Marketing Marcella Szel drilled down through the revenue side noting that freight revenues were down by 24 percent before foreign exchange. "Among the largest declines were metallurgical coal with carloads off at 30 percent, automotive at 43 percent, and potash, especially export, down by 70 percent. To put this in perspective, in March we moved eleven export potash trains to Vancouver. In normal times we run the same volume over the course of three to four days. RTMs fell by 22 percent largely reflecting a decline in average length of haul. With respect to our pricing strategy, our strategy was to deliver four to five percent and this is what we achieved. Negative mix of three to four percent given the volume declines and uneven changes in segments somewhat offset price." Fuel surcharge revenues were down by six percent due to fuel price changes.

Genesee & Wyoming called in on Wednesday with what on the surface looked like some pretty good numbers. Total sales were off less than two percent against the rest of the railroad world off double-digits. Revenue units actually increased 13 percent against the Big Six units off double-digits again. Average revenue per carload (I'm using that term intentionally as intermodal is so small a part of the total that during Q&A after the call CEO Jack Hellman suggested it ought to be in "other") dropped 11 percent mainly due to the fixed contract Australian grain: vols up, RPU down; vols down, RPU up. Of course, this group has its own moving pieces as long-haul grain moving east is not part of the contract so high RPUs here can affect the farm & food line as well.

The revenue delta is a great example of how acquisitions can save a short line's bacon. Total sales were $138.5 mm, off $2.2 mm. Acquisitions brought in $21.2 mm, however declines in third party fuel sales, the depreciating Australian and Canadian dollars, and the nearly $10 mm drop in same-store sales conspired to take $23.4 mm out of total sales. (Note: for the first time GWR provided a slide deck to accompany the call; you can see this math on slide 4 if you wish to sing along.) Non-freight sales, aka Rail Link switching ops, dropped $3.7 mm year-over-year on much the same pattern: the $5.5 mm in sales from new operations was wiped out and then some by FX and fuel sales.

The commodity carload breakout has changes all over the map, from auto down 39 percent to farm & food up 47 percent to minerals & stone off one percent to other (which includes overhead coal haulage on the newly-acquired Ohio Central) up 283 percent (see presentation slide 6 for same-store carload deltas by commodity group and comments on each line). Partly as a result of these wide carload swings, "non-freight" switching revenue dropped two points to 36 percent of sales from 38 percent a year ago.

Operating income increased 23 percent as operating expense dropped three times as fast as revenue, off six percent; the OR dropped by 371 basis points to 81.1 thanks in part to drops in fuel consumption and price combined with acquisition revenues. There was little change below the line so net income from continuing operations increased 24 percent and earnings per share on net income increased 33 percent. The outlook for the second quarter is for revenues in the neighborhood of $140-145 mm with an operating ratio of 79-80.

Kansas City Southern wrapped up this rapid-fire earnings season with a 23 percent revenue drop to $346 mm as total units slid 15 percent. Double-digit decreases were the rule across units and revenues. The ag and mineral group, e.g., took a 24 percent dive in revenue, saw units slip 13 percent and RPU take a 12 percent hit. The main culprits were cross-border volumes, FX, a large Mexican harvest, and low vessel rates. The Industrial and Consumer Products group got tagged for 34 percent in revenues, 30 percent in volume, and a relatively light 5 percent in RPU as the weak US housing market continues to take its toll in lumber, steel and appliances. Chemicals and petroleum products got scalped to the tune of 18 percent in revenues, ten percent in units and eight percent in RPU. Blame cutbacks in auto, homebuilding and industrial uses.

It's an ill wind that blows no good and the good this ill wind is blowing comes in the form of better equipment and process management. As to the first, EVP Sales & Marketing Paul Ottensmeyer says they are moving to bigger boxcars, covered hoppers and other merch carload equipment to increase payload per car and lower the freight cost per ton for customers. Like the rest of the rails, KCS managed a 5 percent gain in core pricing but it was not enough.

On the other hand, the fuel story was most encouraging. Though KCS does not publish fuel use or price data, Ginger Adamiak, Director of Investor Relations, came through in response to an email. Here's the deal: Fuel expense was down 44 percent on a 25 percent drop in price per gallon and 16 percent fewer GTMs. However, there was a whopping 13 percent gain in GTMs per gallon as a third of the fleet (mostly older units) is in storage leaving the newer, bigger six axle power bought 2006-2008 to run much of the railroad. Price per gallon may seem on the low side at $1.72, though one must recall that diesel fuel is cheaper in Mexico and is paid for in pesos, thus the lower average price per gallon.

Operating income was $49 mm on 19 percent lower ops expense of which roughly half was fuel. COO Dave Starling said ops expense ex-depreciation was down 23 percent further strengthening the cash-conservation story. KCS set all-time records in performance metrics such as velocity, dwell and

GTMs per train while parking 30 percent of cars, 36 percent of locos and taking headcount down eight percent. Even with all that the operating ratio gained 450 basis points to 86, a number the likes of which we have not seen for lo these many a day on KCS.

Net to common shareholders posted a loss of $7.5 mm, eight cents a share, against a profit of 34 cents a year ago. Free cash flow after capex was a negative $36 mm as cash from operations dropped 46 percent. Capex was $100 mm, half of which went toward finishing up the Victoria-Rosenburg cut-off with completion now scheduled for July 2009.

As for the outlook and where the share price is going, UBS' Rick Paterson sums it up nicely: "On Thursday morning KCS reported a Q1 loss, missed consensus, and Street EPS cuts seemed sure to follow. Yet the stock rallied 3.4 percent and outperformed every other rail in a flat tape. If anyone is looking for evidence this is a story investors want to like – we say here it is. Some of the performance was no doubt short-covering as KCS failed to report the disaster some were expecting, and management comments were positive on the conference call: we'll get through swine flu, don't be concerned about the drug cartels, pricing is strong, productivity is strong and nothing except the economy has changed. Relax."

A summary of first quarter reports follows. Double-digit declines are the rule with ops ratio deltas split between horrible and so-so. However the common thread of making fixed costs variable runs throughout. The goal is to make much of the total ops expense volume-dependent; KSC stating ops expense sans depreciation is good because it's a more accurate picture of where the cash is flowing.

Short lines in particular must do the same thing. Look at any short line loco roster and see nine locos where four can do the work. Or there is a collection of tampers, spike pullers, tie-inserters, regulators and other yellow – um, stuff -- that spends more time gathering rust than fixing track. Better to sell it and out-source the work to the full-time track guys who can do the job twice as well in half the time.

Finally, there is a strong Class I theme that says an uncluttered railroad is a faster, cheaper more efficient railroad. This theme presents three challenges for short lines: what do you do if volume never changes much for the next three years and you're paid an FAK allowance; what do you do if your customer goes to bigger cars, limiting your car count while increasing tonnage (see KCS, above); what do you do if your class I says, "We're full" (see UNP re 200,000 cars a week, above).

Look for these themes to pop up now and again. Your thoughts are solicited.

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Class I Commodity Carload Comps
Quarter ending 3/31/09
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 3,520	$ 1,859	$ 1,071	$ 2,247	$ 346	$ 1,943	$ 3,415
YOY Pct. Change	**-17.4%**	**-3.5%**	**-12.6%**	**-17.2%**	**-23.2%**	**-22.3%**	**-20.0%**
Revenue Units (000)	2,128	954	576	1,419	384	1,456	1,847
YOY Pct. Change	**-14.4%**	**-15.7%**	***-18.6%***	**-17.4%**	**-15.1%**	**-20.4%**	**-20.9%**
RTMs	149,148	38,961	25,925	53,100		39,700	118,420
YOY Pct. Change	**-11.2%**	**-13.3%**	***-22.4%***	**-14.8%**		**-18.1%**	**-15.8%**
Carload revs (2)	$ 1,472	$ 1,274	$ 656	$ 1,170	$ 248	$ 975	$ 1,882
YOY Pct. Change	**-23.9%**	**-2.7%**	**-10.7%**	**-24.2%**	**-28.6%**	**-27.9%**	**-24.6%**
System RPU Pct Chg.	**-3.9%**	**14.3%**	**7.3%**	**0.2%**	**-10.7%**	**-2.4%**	**0.9%**
Pct carload	41.8%	68.5%	62.5%	52.1%	71.8%	50.2%	55.1%
Pct Intermodal	27.8%	17.2%	26.5%	12.0%	8.8%	18.8%	16.1%
Pct Coal	27.2%	5.1%	11.1%	33.1%	13.7%	31.0%	23.6%
Mdse Carloads (000)	726	572	262	548	194	468	711
YOY Pct. Change	**-24.8%**	**-20.3%**	**-22.1%**	**-26.5%**	**-23.9%**	**-29.2%**	**-25.7%**
Rev/CL x coal, IM	$ 2,696	$ 2,227	$ 2,509	$ 2,135	$ 1,278	$ 2,083	$ 2,647
YOY Pct. Change	1.2%	22.1%	14.6%	3.2%	-6.1%	1.8%	1.5%
Operating Expense	$ 2,755	$ 1,378	$ 931	$ 1,725	$ 298	$ 1,560	$ 2,743
YOY Pct. Change	**-18.6%**	**-1.9%**	**-7.7%**	**-17.3%**	**-19.0%**	**-18.8%**	**-21.2%**
RR Operating Income	$ 765	$ 481	$ 139	$ 522	$ 49	$ 383	$ 672
YOY Pct. Change	**-12.6%**	**-8.0%**	**-35.4%**	**-16.6%**	**-41.8%**	**-33.7%**	**-14.7%**
RR Operating Ratio	**78.3%**	**74.1%**	**87.0%**	**76.8%**	**86.0%**	**80.3%**	**80.3%**
YOY Point change	**(1.20)**	**1.27**	**4.60**	**(0.16)**	**4.49**	**3.41**	**(1.22)**

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal
Source: company financials
Week in Review for 5/1/2009