THE RAILROAD WEEK IN REVIEW

July 30, 2010

"We believe that revenue per unit is the best proxy for our overall pricing trends." Don Seale, Chief Commercial Officer, Norfolk Southern

Norfolk Southern's operating ratio dropped below 70 for the first time since before the Conrail merger. I'm reminded by Larry Kaufman that back in that day when we were both on consulting retainers to NS for that transaction, one of the NS staffers said we'd never see that number again. The argument was that the complexity of the Conrail network would never allow a sub-70 operating ratio. So here we are 13 years at a respectable 69.8 operating ratio. Why?

What it took was a revenue gain of 31 percent to $2.4 billion on 22 percent more revenue units -- a million-point-seven all told -- and holding ops cost increases to 22 percent to power a 57 percent jump in ops income to $733 million. Below the line there were no surprises so net income was $392 million, up 59 percent while earnings-per-share came in at $1.04, up 58 percent. Better yet, NS did it on only 10 percent more crew starts and eight percent more car hire.

Each of the three major NS commodity groups posted sharp revenue gains: merchandise (where most short lines live) loads were up 31 percent, hitting levels not seen since the 2008 third quarter, coal (where a lot of short lines handle either the origin or destination) jumped 36 percent and intermodal gained 23 percent.

Among the merchandise groups (including automotive), units increased 27 percent with metals and construction up 50 percent on domestic steel production, chemicals up 32 percent on increased production and ag products with 40 percent more loads thanks in part to ethanol, sweeteners and just plain corn.There was even some light at the end of the forest paper tunnel with paper-related loads including kaolin clay and pulpboard up 15 percent while lumber and panel products ticked up 12 percent.

The corridor program is paying off with 20 percent more intermodal movements, of which 64 percent were "domestic" (I'm lumping together Seale's Domestic, Triple Crown and Premium services here), up from 61 percent a year ago. The gains in domestic intermodal came chiefly from truckload diversions while the ten percent international box hike was "driven by improving global demand, said Seale.

Out on the railroad, COO Mark Manion said all furloughed T&E types have come off that status and NS has even started hiring in certain service areas. All but 8,000 of the 35,000 freight cars put in storage during the slump are back at work. Head-counts are about where they were a year ago while gross ton-miles increased 24 percent and ops expense ex-fuel held to a 16 percent gain. Fuel usage gained but 18 percent and GTMs per gallon increased five percent.

If I were to be allowed one quibble, it would be that NS ops expense ex-fuel per GTM is the highest in the industry: half again what UP spends and a third higher than the CSX number. But still, getting to the once-held unachievable goal of an OR beginning with a six *is* a big deal.

Kansas City Southern CEO Mike Haverty opened the call saying, "What a difference a year makes," The central theme for second quarter 2010 is how much incremental volume you can put across a well-tuned railroad at relatively low cost; KCS is a case in point. Top line revenue increased 35 percent to $462 million, up $120 million. Operating income increased an astounding 195 percent -- that's nearly a triple, sports fans -- to $127 million, up $84 million, taking the quarterly operating ratio down 15 points to a record 74.4. Better yet, the operating ratio on the incremental revenue was 30 for an incremental margin of 70 percent. Earnings per share ex-debt-retirement expense came in at $0.55 vs. $0.07 a year ago.

Merchandise carload business -- including auto, ex-coal -- represents 73 percent of KCS' book of business and posted a 37 percent revenue gain on 22 percent more revenue units. System revenue-per-unit was up ten percent while same-store (same car type, same OD pairs) RPU increased six percent. The total revenue-unit count increased 24 percent to 468,000 units; KCS thus becomes the first road reporting this season to regain mid-2008 volume levels.

The cross-border business with Mexico is exceeding all expectations. Sales are up 55 percent to $113 million or 25 percent of total KCS revenue. Said Haverty in his wrap, chemicals and the pulp/paper group are good indicators as to where the economy is headed. Car counts were up ten percent in the former and 17 percent in the latter. Operating expense ex-fuel increased a minuscule three percent, though GTMs per gallon dipped one percent. In sum, this is the way things are supposed to be with incremental margins off the charts and GTM volumes up 20 percent. Haverty turns over the CEO reins to Dave Staring directly, and I'm sure the latter will continue the momentum.

Canadian Pacific gave a good account of itself in its call Wednesday morning. Fred Green once again stressed CP's "long-train strategy" for increasing productivity. Year-over-year train weights were up four percent to 6,500 tons and train lengths also saw a four percent gain to 5,700 feet. CP moved 676,400 revenue units, up 20 percent, boosting GTMs by 22 percent and RTMs by 23 percent. Car miles-per-day improved 11 percent and yard dwell time came down three percent. However, network average train speed slipped slightly, down one mph to 25 from 26. And though Fred didn't drill down to this level, we know a slower railroad takes more locomotives and crew starts to handle the same tonnage; my sense is the slippage is temporary.

Revenues increased 20 percent to C$1.2 billion and operating income was up 48 percent as the ops expense delta was a plus 13 percent. Revenue units were up 20 percent, as were merchandise carloads including auto. Double-digit volume gains were the rule except for grains where units slipped three percent, revenues dipped 4 percent and RPU barely held its own. What Chief Commercial Officer Jane O'Hagan called "modest gains" in lumber and pulp contributed to a six percent revenue gain on 11 percent more volume.

Recall too that CP is a bulk railroad with 40 percent of its volume in grain, sulfur, fertilizers and coal. With the exception of grain (above), the rest did very well. Sulphur (to use the CP spelling) and K (potash to non-gardeners) volumes nearly doubled on strong exports and easy comps, though RPU slid 11 percent on mix. Coal gains (up 43 percent) were met coal shipments to Asia and steam coal stock pile replenishment at US utilities; RPU was unchanged. In fact, looking across the board at RPU deltas, it's not encouraging as the system average is essentially unchanged over a year ago. But then, CN's average revenue per unit came down nine percent. whereas the US roads were up seven percent or more. Clearly, something to keep an eye on.

The RailAmerica call was a real treat for its relaxed, conversational tone and lack of jargon. CEO John Giles set the pace, opening with accomplishments in organic growth (revenue, car counts, ops income), balance sheet strength (redeemed $74 million of senior notes) and external growth (acquiring Atlas Railroad Construction). To be sure, the numbers get noisy below the line (more on this below) though the presentation slides and the accompanying documentation made it all reasonably understandable. Onward.

Freight revenue increased 17 percent to $96.5 million on 11 percent more carloads (RA has no intermodal so a car's a car) while average revenue per car (ARC) was up six percent including fuel surcharge and foreign exchange (four percent without). Operating income is a little more involved as RA took in "45G" track maintenance tax credits of $4.1 million in the 2009 second quarter. Absent this credit, ops income was up 20 percent and the operating ratio shed a modest 40 basis points to a respectable 80.8. I was particularly pleased to hear Giles say the company has taken a "leadership position" in safety, with only 0.8 personal injuries per 200,000 hours worked Jan-June 2010. By way of comparison, GWR was 0.6 through March with FRA Groups 2 and 3 at 3.2 and 3.3 respectively.

Chief Commercial Officer Charlie Patterson's carload-commodity breakout not only showed carloads and percentage changes year-over-year but also showed what percentage each commodity represented in the RA book of business. The double-digit gainers were ag products (both 01 and 20 STCC), building products, chemicals, metals, waste and petroleum, comprising roughly two-thirds of total carloads. Coal was down less than two percent, not bad considering RA is in the steam coal business exclusively and given the way utility stockpiles have shrunken.

[And while we're on the subject of coal, read what RW Baird's Jon Langenfeld sent: " Rail industry commentary suggests improved outlook for coal. A strong summer coal burn and increasing industrial electrical demand suggests an improved 2H10 utility coal outlook, as utility coal stockpiles approach more normal levels. Utilities are running at high utilization rates to support above-normal summer energy consumption, a driver of the improved utility coal demand outlook."]

Below the line RA posted a GAAP loss of $4.2 million ($0.08 a diluted share) against an $18 million profit ($0.42 a diluted share) including a $12 million gain on discontinued operations a year ago. However -- and this is where the RA material really shone -- if you drill down to continuing operations and add back the one time charges for swap amortization, the foreign exchange impact on debt, and acquisition costs, earnings per share becomes $0.07 vs $0.13 a year ago, similarly adjusted. As I've said before, RA is a Work in Progress and the Giles team is making significant turnaround headway in creating one cohesive operating railroad company.

Rounding out the railroad earnings theme, I picked up the BNSF year-to-date revenue-unit count from the AAR figures provided in Jason Seidl's excellent "Track Work Weekly" note for Week 26. Hoping you'll forgive me the three-day spread between the end of the quarter and the July 3 end of Week 26, I compared the BNSF numbers with the first-half numbers for the rest of the Class I railroad group. What a disappointment.

Total first-half 2010 revenue units increased but five percent whereas the rest of the group came in with deltas three to five times that. Happily, the merchandise carload group including ag and autos was up 18 percent, about on a par with its peers and lagging UP by only 80 basis points. All groups but forest products were up double digits, so no surprises there. However, coal -- with a carload volume approaching that of the whole merch group, was off four percent and intermodal -- with a volume nearly twice coal's -- was up but three percent.

How this plays out will be instructive. Intermodal is largely consumer discretionary stuff, and the XLY -- the exchange-traded fund of consumer discretionary stocks from Amazon to Ford to Target -- is only now back to its Sep 2008 levels. Wednesday's WSJ says consumer saving levels are now four percent of disposable income, which bodes well for household net-debt levels but ill for consumers buying more discretionary stuff. I read Thursday, for example, that a recent consumer survey found the lowest level of intended car buying in 40 years.

I found the reason CN carloads increased at a faster rate than revenues. It's in the conference call transcript where CEO Claude Mongeau says, "It's mostly short-haul iron ore movements, so our revenues overall are up 18%, the volumes are up 27% on a carload basis and 15% on an RPM basis. That makes sense. It's also good business because cars are turning faster. In the RA call, for example, John Giles said demurrage revenue is down partly because steel customers are turning scrap cars faster. Faster turns and shorter hauls mean more revenue per asset.

GWR brings up the markers next week. Stay tuned.