THE RAILROAD WEEK IN REVIEW

January 28, 2011

"Clearly the [PTC mandate is] to some extent inhibiting us from making other investments that we would like to make." -- Michael Ward, CSX, fourth quarter 2010 earnings call[1]

All six of Class I railroads still holding quarterly conference calls reported their 2010 fourth quarter and full year results this week. (BNSF files a 10-Q but it's not out yet.) Revenues increased double-digits on volumes that are up in the nine-to-thirteen percent range. Revenue ton-miles were up by a wider percentage than revenue units everywhere but KCS with a minuscule (less than one percent) negative delta.

Merchandise carloads (total revenue units less intermodal and coal) likewise increased across the board, from a low of 11 percent at NS to a high of 19 percent at CSX. They're making more money doing it, too, with system average per-unit revenue increases in the range of two percent (CN) to eight percent (UP). Merchandise carloads remain the largest single commodity group across the board where KCS takes the brass ring with 72 percent. UP increased merchandise carloads the most (11 percent) and NS the least (three percent).

Operating expense percentage changes ranged from the high single-digits to low double digits. In four out of six instances the spread between ops expense delta and revenue delta was enough to power operating income jumps of 30 to 40 percent or more. CN and NS lagged. Operating ratios also came down handsomely. CN as usual won the low-point honors with a 63.4; KCS wins the award for the biggest year-over year improvement, 556 basis points to 71.8. At the other end of the scale, NS was least improved, 77 basis points, to 73.2 -- still not a bad number given where everybody was not that long ago.

One other metric that's making the Wall Street rounds is the "incremental margin" -- what each dollar of operating income costs. Since the railroad gross margin is the complement of the operating ratio, I prefer to think in terms of incremental operating ratios for an apples-to-apples comparison. Thus I look at the present quarter's operating expense less what it was a year ago all divided by the difference between the current quarter's revenue minus what it was last year. The numbers are most impressive, with four of six railroads reporting to date in the 40s, one (UP) breaking 50 and NS bringing up the markers at 67.5. Onward to the specifics.

Canadian National fourth quarter 2010 revenue came in at C$2.1 billion, up 13 percent on double-digit revenue gains across all commodity groups save forest products. Revenue-unit counts stayed in the nine percent range for coal and merchandise ex-grain and fertilizers; intermodal jumped 15 percent. Merchandise carloads stayed flat at 64 percent of CN's unit count against minor shifts between intermodal and coal. The system average RPU gained only two percent on 1.2 million revenue units crossing the railroad.

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[1] Quote from the transcript provided courtesy of www.seekingapha.com

Operating expense was up just nine percent, driving operating income up 19 percent to C$1.3 billion. Once again CN was the low-cost operator with its 63.4 operating ratio, down 186 basis points year-over-year. Net income, if you run the numbers according to GAAP, actually decreased 14 percent to C$503 million, though that's not a fair year-to-year comparison. One-time events not part of the usual operating scenario -- sale of three subdivisions, change in provincial tax rules, EJ&E acquisition costs, to name a few -- once taken out of the calculation, change the picture. Net income for the fourth quarter 2010 remains at C$503 million, but the adjusted comp makes it a gain of 19 percent.

Of particular interest to Canadian National's 30-plus short lines, Chief Marketing Officer Jean-Jacques Ruest cites continued strong fertilizer and potash demand, the Canadian Wheat Board's export program's upward revision of about two million metric tons, still more iron ore and metal products on the railroad, lumber to China -- some of it stuffed into containers from boxcars at the port -- and an upswing in petroleum products. Car supply fulfillment is running about 80 percent; it's north of 90 percent with proper customer car-order lead time.

Canadian Pacific's 2010 fourth quarter saw revenue rise 13 percent to C$1.3 billion, operating expenses held to an eight percent rise and operating income posted a respectable 34 percent increase to C$298 million. Revenue units were up nine percent to more than 673,000 with particular strength in sulfur and fertilizers, forest products (!!) and the industrial/consumer group. Every commodity group but grain posted double-digit revenue gains and the system average revenue per unit was up a modest four percent.

During the call Chief Commercial Officer Jane O'Hagan cited six consecutive quarters of sequential revenue ton-mile gains -- not surprising given CP's drive to increase length of haul and revenue car-miles per day. It's particularly telling that the quarter's revenue unit count (up nine percent per above) generated 14 percent more revenue ton-miles, with that delta beating all comers but CSX for this quarter.

Still, the operating ratio at CP remains stubbornly high relative to its peers at 77, down three points from 80 a year ago. The incremental operating ratio was a respectable 50, and we know the great strides they're making in safety, train lengths and weights, gross ton-miles per active horse power, terminal dwell, car-miles per day, terminal dwell and so on.

Peter Nesvold at Jeffries & Co. posits, "CP actually has a higher percentage of bulk business, which suggests more unit trains and less single-car business. (Unit trains are typically more profitable than single-car business, although CN would disagree.) And while CP's revenue base is 60 percent of CN's, intuitively CP has more than sufficient scale to drive material operational and financial improvement intermediate term." He concludes a 72 operating ratio could be worth another dollar in annual earnings per share on top of the 2010's nearly C$4.00.

CSX rang up a number of firsts this quarter. They were in first place in year-over-year percentage change in total railroad revenues (up 21 percent), first place in revenue-unit gains (up 13 percent), first in revenue ton-miles (up 16 percent), first in merchandise carload revenue gains (up 19 percent), and pushed system average revenue per unit up seven percent. And in the bargain they took the quarter's operating ratio down 509 basis points to a record 70.0 low.

Total revenue was $2.8 billion on 1.7 million revenue units, up 13 percent over the 2009 fourth quarter. Every commodity group but emerging markets and intermodal posted double-digit revenue gains; revenue units also increased by double digits in all but emerging markets and phosphates/fertilizers, where length of haul and mix popped revenue per carload 32 percent. Operating income rose 46 percent to $846 million and the incremental operating margin clocked a second place 46 percent. Net income increased 42 percent to $430 million.

I think it boils down to CSX walking the talk -- the "talk" in this context is the CSX "Core Values," of which the lead item is, "It begins with the customer" (do a google-search on "csx core values" and it'll go right to the page). The first of four bullets under the heading is "Reliable service is our key to growth." It was this theme that played throughout the call and -- I think -- it played a leading part in reported revenue and volume increases.

Chief Marketing Office Clarence Gooden was the first of his peers to talk about same-store pricing on the calls and it's an excellent measure of how well one hangs on to existing customers. Yes, system average revenue per unit was up seven percent, but the same-store measure was up a respectable 6.2 percent. You don't get that kind of response from customers who've been told their business is too small or clogs up the network, a not-uncommon complaint in some quarters of late. Like the man says, it starts with the customer.

Norfolk Southern did not have a good day. Total fourth quarter 2010 revenue rose 14 percent to $2.4 billion, the lowest delta among the four US Class Is by three full points. Revenue units gained nine percent to 1.7 million; merchandise carload revenues -- key to shortline survival -- gained less than 11 percent. System average revenue per unit grew but four percent, while operating income was up just 17 percent, much less than what we have come to expect of NS.

Coal, intermodal, and metals/construction were the only double-digit volume gainers and the entire merchandise carload sector was up a paltry three percent. The double-digit revenue gainers were intermodal, coal, metals/construction and chemicals -- these last two drove the merchandise carload sector to an 11 percent revenue gain. Once again, domestic intermodal played a leading role at 66 percent of intermodal units (I'm including Triple Crown and Premium as domestic lanes), up from 63 percent a year ago. Coal continues to go the other way, with total tonnage still down 12 percent from 2008.

To see CSX come in three hundred basis points ahead of NS in operating ratio was a shocker. My good friend Jon Langengeld at RW Baird suggests that even though "NS has historically produced the best returns on capital and free cash flow among the US rails," NS has of late fallen behind its peers in its spreads between revenue and expense. "We attribute part of this underperformance to Norfolk's more conservative long-term orientation, as evidenced by its accelerated hiring and significant 2011 47 percent capex increase."

Anecdotal evidence from shortline channel checks indicates local area performance is not up to scratch; Langenfeld senses it too -- "We attribute part of this underperformance to the company's less aggressive stance addressing its previous best-in-class cost structure." My sense is the systems and leadership skills are in place at NS and will (Langenfeld again) "result in earnings upside over the longer term, but the strategy represents a continued near-term overhang for the stock. As such, we maintain our Neutral rating."

Kansas City Southern brought up the markers for the week. Talk about finishing with a flourish: revenues up 18 percent to $479 million on a 12 percent volume jump to 489,000 revenue units. Operating expense added just nine percent, taking the operating ratio down 556 basis points to 71.8, a record low. Helping matters along on the capex and materials side, the Gateway and Tex-Mex portions of the network still qualify as short lines for the 45G tax credit worth maybe three cents a diluted share in earnings -- about $3 million cash, by my reckoning.

I'm really getting the feeling of One Railroad from Kansas City to Mexico City and beyond. It's well past KCS-US plus KCS-Mexico, and that's good. During the Q&A it was pointed out that KCS is buying its own containers to add capacity in the Houston-Mexico lanes, is adding to its leased-property footprint at the Lazaro Cardenas port, and sees an uptick in TOFC loadings due to over-the-road "cost dynamics" in Mexico. Moreover, Marketing EVP Pat Ottensmeyer says about two millions trucks a year use the Laredo border crossing on trips between points that are local to KCS; at the moment, the railroad has about one percent of that.

Toward the end of the prepared remarks, Railroad President Dave Starling said 2011 will be another strong year of operating leverage, adding another eight to ten percent capacity in Mexico with no headcount increases while adding about three percent net of attrition to current US T&E staffing levels. About 12 percent of the locomotive fleet and five percent of the freight car fleet remain stored-serviceable. They're adding capacity first on the main lines with the heaviest traffic density, letting the railroad do some 200,000 units a month before "hitting the velocity wall." Clearly, KCS is living up to the motto on the presentation slides: Business without Borders.

The year-over-year volume deltas give the impression of an industry returning to health after getting really hammered in mid 2009. However, if you go back six quarters and start with the third quarter of 2009, the recovery -- at least, as measured by changes between successive quarters -- does not seem to be all that robust. Even though the most recent quarter's revenue-unit count is up double digits over the 2009 third quarter, the rate of change between successive quarters peaked in the second quarter of 2010 and has slowed since.

I've written before in this space about the "ninety-percent economy," where today's household expenditures since the 2006-7 peak are off by the unemployment rate. That is to say, with ten percent more people working four years ago there was ten percent more money floating around in the economy. As is, less money is being spent on "stuff", and so less "stuff" is moving around in the economy.

All this week's presenters are pretty sure we will not see a double-dip recession. But we are seeing a slowdown in spending by both businesses and individual thanks to the continued uncertainty of the direction of the economy and Washington's reaction to it. Railroad capex for capacity expansion is constrained by both the unfunded PTC mandate and the uncertainty from Congress and the regulators. The fact remains, however, that the railroads alone among transportation providers have the wherewithal to add capacity and meet the need to move more "stuff" as the economy recovers and the roads become more certain that Washington will let us keep more of what we earn and let us mind our own business.

As for the Week that Was, perhaps UBS' Rick Paterson sums it up most eloquently: "The rails faced a high bar this earnings season as rising sentiment and associated valuations left little margin for error. While there was technically only one earnings miss, most of the hits and beats were achieved through an inelegant smorgasbord of casualty reserve adjustments and funky tax rates. Only KCS's beat would we characterize as high quality, and only CSX conveyed any conviction on 2011 with aggressive guidance to back it up (high-60s OR). Both were predictably rewarded.

"The Street also satiated its bizarre obsession with export coal with a total of 14 questions on the CSX and NS calls [*I'll say, especially with coal accounting for about 30 percent of revenues at each. Yet there were no questions of note on the merchandise sector accounting for well over half of total revenue at each. -- rhb*] NS results were a shocker and shifted investor sentiment on the stock from 'comfortable' to 'concerned.' Another quarter like that and it will downshift again to 'capitulating.' We're increasingly selective within the group as super-incremental margins begin to sunset at some rails sooner than others, and currently have Buys on just CSX and the Canadians."