THE RAILROAD WEEK IN REVIEW

April 22, 2011

"Every $10 of fuel price movement will have a 0.5% impact on the operating ratio for CSX." -- Oscar Munoz, CFO

The railroads' first quarter 2011 earnings presentations began this week. We heard from -- in order -- CSX, UP, KCS and CP and they all showed positive performance gains and outlooks. Even CP, hard hit with an exceptionally bad winter weather experience in the Rockies and Plains, showed that the negative numbers were one-offs and they will be back stronger than ever in the coming months.

Taking the longer view, the quarter's performance, while encouraging, may indicate a bit of a slowing in the rate of volume recovery. I'm keeping a running six-quarter tally of volume changes against the 4Q2009 numbers as well as quarter-to-quarter sequentially. Each of the four rails reporting this week showed positive quarter-to-quarter volume changes every quarter since 4Q2009. Until now. The present quarter's volume numbers for each were down from 4Q2009. Given the lack of leadership in Washington, general global ill ease, and continued high US unemployment, a slowing in the rate of economic -- and railroad -- recovery is not surprising.

The merchandise carload sector still represents more than half the total revenue units on the Class Is, and I include everything that's not intermodal or coal in that number. It's also the dominant sector for the nation's 500+ short lines and, as every long-time WIR reader knows, it is is the shortline operator to whom WIR is addressed. Its purpose is to document what the Class Is are doing and why so that the owners and operators of the short lines that feed them can anticipate Class I actions and profit from them.

And so it is the following commentary is lifted largely from the conference call transcripts and supporting material. I mention net earnings and earnings per share almost in passing to put the operating numbers in perspective. The emphasis is first on what kind of merchandise commodities are moving and why; coal and intermodal get the occasional nod where patterns are clues to Class I commercial strategies. Read on and let me know what you think.

CSX first quarter revenues increased 13 percent to $2.8 billion on seven percent more revenue units, 1.6 million, of which merchandise including automotive was 41 percent, coal 24 percent and intermodal with 35 percent of the total revenue-unit count. CSX held the gain in operating expense to just under ten percent for an operating ratio of 72.5, a year-over-year improvement of two points, and leveraging a respectable 22 percent operating income increase to $773 million. Below the line, net earnings grew 30 percent to $395 million; earnings-per-share were up 36 percent helped in part by a six percent decrease in share-count.

The "incremental" operating ratio, the delta in expense as a percent of the delta in revenue, was 55.8 and operating expense increase ex-fuel was just four percent. Gross ton-miles also increased four percent but GTMs per gallon decreased two percent to 812 even as fuel burn increased six

percent. Still, with average price-per-gallon up 36 percent to $2.86, not too shabby. Revenue ton-miles also increased four percent.

The severe winter weather across the northern part of the system not only caused operating headaches where the snow was falling but also cascaded delays into the sunny south as crews and equipment were too often in the wrong place at the wrong time. That said, CSX got 96 percent of trains out of town on time, however, three of five trains arrived on time, down from three in ten a year ago. But Old Man Winter was not able to slow CSX's steady gains in safety stats: personal injuries dropped to 0.78 per 200,000 hours worked from 0.82 a year ago.

Automotive and "emerging markets" revenue units increased double digits on light vehicle sales, construction aggregates, and waste materials. The four top volume producers -- chemicals, ag products, forest products (both 24 and 26 STCCs) and metals -- also gained. The merch group posted a five-percent revenue-per-unit gain vs. plus 16 percent on coal and minus five percent on intermodal (some of the lingering after effects of the purchased transportation agreement terminated in 2010). Best of all, "same-store" pricing (same customer, same OD pair, same car type) was on target at plus seven percent.

The growth of export coal carloads is significant in terms of percentages, but in terms of tonnage, is still just a quarter of the total (I'm using total coal numbers, excluding the coke and ore CSX puts its coal commodity category). For the quarter, two out of every three tons moving on CSX was utility coal, down from 75 percent a year ago. As it happens, the 7.3 percentage point uptick in export coal exactly equals the 7.3 point slippage in domestic coal. The one factoid I'm missing is the private vs. railroad-owned equipment mix in utility and export coal. I suspect privates dominate in utility lanes and railroad-owned dominate in the export lanes.

Intermodal was a bit of a surprise. During the presentation Chief Commercial Officer Clarence Gooden noted domestic containers are now 51 percent of the total, with volumes "steady in a tightening truck market." Yet the year-over-year comps show international boxes up 24 percent vs. oh-point-four percent in domestic lanes. What's happened is the mix is going toward international (49 percent in 1Q2011 vs. 44 percent a year ago) and away from domestic (it was 56 percent a year ago). In his remarks, Clarence did say that the 11 percent expansion in intermodal volumes was from "increasing imports, truck conversions and expanded offerings."

As for what's next, Clarence would only commit to "sustainable growth" in excess of GDP in an environment where core pricing could be "expected to exceed inflation." CFO Oscar Munoz sees export coal increasing to 40 million tons (implying full-year coal tonnage in the 160 million-ton range), an operating ratio in the "high 60s" for the year and a capital spend of $2 billion.

Union Pacific finished the quarter with a 13 percent revenue increase to $4.5 billon on 2.2 million revenue units, up five percent and taking system average revenue per unit up eight percent. Operating expense increased 13 percent, and ops income was up 15 percent to $1.1 billion. CEO Jim Young said in his opening remarks, "Intermodal, industrial products and chemical shipments drove about two-thirds of the volume growth. We achieved a record first quarter operating ratio of 74.7 in spite of 2.4 points of negative fuel price impact."

Operating expenses ex-fuel increased just six percent. Gross ton-miles were up five percent and fuel burn increased six percent causing a 40 basis-point decrease in GTMs per gallon. Chief Operating Officer Lance Fritz noted that some of the power brought out of storage and back to active duty is “older and generally less reliable” so keeping GTMs per gallon essentially unchanged indicates some pretty smart railroading.

Net income increased 24 percent to $639 million; earnings-per-share increased 28 percent to $1.29 thanks in part to a three percent decrease in shares. (Later in the call CFO Rob Knight said, “We’ve recently renewed our share repurchase authority for a new repurchase program of up to 40 million additional shares by March 31, 2014.”) Commenting on the fuel price impact Rob said, “If you look at our incremental margin for the first quarter, after adjusting for higher fuel prices and [other one-time] payments, revenues were up nearly 10 percent while costs grew only 7percent. That relationship equates to an incremental margin of about 45 percent.

UP is the only Class I that reports on customer satisfaction and I wish more would follow UP’s example. We all know that perceived quality in the eyes of the customer is the biggest driver of value and thus premium pricing, so UP’s record high Consumer Satisfaction score of 91 for the quarter speaks volumes, topping the previous quarterly best of 90. Says Chief Commercial Officer Jack Korleski, “We hit 92 in February, setting a new best-ever monthly mark. The strength of our value proposition, great service and continued slow improvement in the economy contributed to our first quarter volume increase with gains in all six of our businesses.”

In agricultural products, global demand for whole grains accounted for most of the volume growth, with a 69 percent increase in export wheat leading the way. The automotive sector posted a five percent gain in finished vehicles with the strongest increases coming from the Detroit Three while parts shipments increased four percent. The chemicals group was the top volume gainer, up ten percent. Petroleum products (crude oil, asphalt and refined petroleum products), fertilizers (export potash was up but represented less of the overall market than in previous quarters), and plastics (improved industrial production) all contributed.

Coal revenue units were up four percent. Southern Powder River Basin tonnage was up 5 percent, driven largely by the three new Wisconsin utilities and the carryover impact of the new San Antonio unit that also came online during the second quarter of last year. Colorado, Utah tonnage declined 5 percent as export demand was more than offset by weakened demand in the Eastern market.

Industrial commodities loads increased nine percent. Nonmetallic mineral shipments increased by a third as strong drilling activity continues to drive demand for frac sand, barite and bentonite. Production of pipe for drilling as well as steel coils and bars for the strengthening auto industry is reflected in the 15 percent increase in steel and scrap. Continuing a theme I’ve heard elsewhere, paperboard (think Amazon shipping boxes) volume was up 21 percent, with the growth coming from inventory replenishment and highway conversion.

Intermodal container counts increased by four percent as truck-competitive service continues to support highway conversions in domestic intermodal. UP is running about a 45-55 volume split between the international and domestic segments, with the former up six percent in the quarter

vs. one percent in domestic. (*My money's on domestic. At this week's NEARS conference, shipper and railroad speakers said they saw shifts to carload from truckload in lanes where rail has a price advantage and no more than one day door-to-door time penalty. -- rhb*)

Koraleski expects strong automotive growth in the second half as the industry recovery continues and sales ramp up. Industrial products markets tied to energy demand and the recovering auto industry should stay strong as the year progresses. Housing and construction continue to lag, but there's some expectation for the start of the recovery in housing and construction in the second half of the year. In chemicals, fertilizer shipments slow a bit, following kind of a more normal seasonal pattern. Whole grain exports, strong US wheat demand and feed grains will lead.

Koraleski concludes, "Across all six groups, a strong value proposition remains the foundation of our business development efforts, positioning us to deliver both the economy plus volume gains and improved pricing that we discussed last November to drive overall revenue growth."

Canadian Pacific did not have the best of quarters. You saw some of the pix on the web and in WIR, where snowfall and avalanches literally buried whole trains in the Canadian Rockies. Total revenues were unchanged at C$1.1 billion. Grain and coal, representing 26 percent of total CP loads, were off double-digits and total revenue units dropped to 606,000, down three percent. Operating expense increased ten percent causing operating income to drop 47 percent to C$109 million and the operating ratio to worsen by 8.3 points to 90.6 as storm-related expenses pushed operating expense ex-fuel up by six percent.

Retiring Chief Operating Officer Ed Harris gave a graphic description of what was happening out there during the worst of it. "We had a once-in-30-year avalanche cycle in our Western Corridor. This caused us to be shut down about five times more often than in a normal winter. And it wasn't just us that was shut down but also the highway system, affecting our ability to shuttle crews to and from trains. We even had to rail in food and supplies to our bunkhouses.

"We had record snowfall in the Midwest U.S. As a result, we had to plow our St. Paul Yards, something we haven't needed to do in over 40 years. As you can imagine, when you need to plow a yard, it is a big deal. You have to pull all the cars from the tracks, plow it, dig out the switches and you certainly lose a lot of productivity and capacity while doing so. We also saw a lot of snow and blowing snow right across the entire network. There is nothing more frustrating than plowing at noon, having the snow blow back in by the end of the day and having to dig out those same switches all over again.

"And finally, we had instances of running long distances as single track because we couldn't keep the passing sidings clean, clear and open for our train meets. That really eats at your capacity and increases your fuel burn as you have a lot of trains waiting for track time. The sequential nature of the outages and capacity reductions took us out of our rhythm and extended the impacts. For instance, in the West corridor, we would be out for avalanches, get cleaned up and ready to go and then have four terminal outages at destination. This kind of chain reaction magnified and extended the impact of our original outage."

In a way, CP's commitment to and knowledge of distributed power helped sustain train productivity metrics: tons per train, flat; train length, flat; terminal dwell, down two percent. But then, some metrics did get bit: GTMs per available horsepower, down 14 percent; train speed, down 14 percent; GTMs per gallon of diesel fuel, down six percent; car-miles per day down seven percent. Happily, these metrics and others were showing signs of improvement late in the quarter and as the snows recede CP will hit its stride once again, I'm sure.

With the exception of the afore mentioned grain and coal, CP's carload business actually held its own through the worst of it. The sulfur and fertilizer, industrial and consumer, and auto commodity groups all registered nine percent year-over-year volume gains, though the finished auto traffic may take a hit later as the effects of the Japanese quake and tsunami cascade down. In her concluding remarks, Chief Commercial Officer Jane O'Hagen said, "We still have to work through the impacts of flooding, as all the snow from the winter melts, but we expect strong revenue growth over the remainder of the year. Above-inflation pricing continues to be our target, and my team continues to pursue growth opportunities across the network."

Kansas City Southern reported revenues of $489 million, up 12 percent year-over-year on seven percent increase in carloadings. Operating income was $128 million, up 18 percent, and that took the operating ratio down to 73.8, a 1.4 point improvement over first quarter 2010. Net income to holders of the common stock was $63 million, up a whopping 92 percent, yet earnings per share increased "just" 72 percent due to a 13 percent increase in shares outstanding.

Commodity revenue gains were led by automotive at 43 percent followed by intermodal at 27 percent. The industrial and consumer products group was up 19 percent; coal gained nine percent and the chemicals and petroleum group gained eight percent. Ag products was the only decliner, off one percent, thanks to a decline in cross-border traffic into Mexico as availability of crops from a strong Mexican harvest has been sufficient to meet the local demand.

Drilling down into industrial products, I have to note that KCS uses a novel commodity grouping with ores, minerals, stone-clay-glass, and "other" in with ag products. By rearranging commodities into what might be an IP group comparable with other Class Is, I find forest products is a third of the total with metals and scrap in second place at 30 percent. Ores and minerals plus aggregates added to the first-named are 80 percent of the lot and together with "other" posted a respectable 12 percent volume gain in the quarter.

KCS said at the end of the call that it expects to see increases across the whole commodity spectrum in the second quarter (cross-border grain is a soft spot). I'm particularly encouraged by the new business opportunities in Mexico -- cross border revenue was 22 percent of total revenue -- including what some call the "near-sourcing" phenomenon that helped propel intermodal cross-border volumes up 70 percent and sales up 81 percent.

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