THE RAILROAD WEEK IN REVIEW

June 17, 2011

"The greatest opportunities for added value at Canadian Pacific lie in our long-train strategy, improved asset velocity and sustained structural cost reductions." -- Fred Green, President, Canadian Pacific Railway

Canadian Pacific could not have picked a better spot for its 2011 Investor's Update. The venue was the second-floor conference center of the sleek, new Appela Event Center on Manhattan's East Side Drive at 29th Street, right at the bend in the East River, where the view was spectacular, especially given the low-temperature, low humidity, cloudless day. And, happily, the conference was as upbeat as the weather.

Our presenters were Fred Green himself, recently-tapped (April 2011) EVP Operations Mike Franczak; VP Canadian Operations Guido Deciccio; Scott MacDonald, VP Transportation; Gord Possobon, VP Engineering; Anthony Manconi, General Manager, Locomotive Reliability Centres; Phil Ireland, VP Service Design; Tracy Robinson, VP Marketing and Sales for Coal and Merchandise; and Kathryn McQuade, EVP and Chief Financial Officer. Janet Weiss, AVP for Investor Relations, kept things moving and on time.

CEO Green set the stage, saying, "We need greater performance consistency to earn back the market share we lost," and then laid out the recipe for doing so: volume growth (Tek coal, Bakken and oil sands, export potash and grain, intermodal), operating discipline, and tapping the diversity of the CP franchise. These elements together, he said, will lead to a two to three percent gain in revenue ton-miles at inflation-plus pricing and an operating ratio in the low 70s.

Or more. I've ridden trains across some of the core network and sense that the opportunity is there to grow RTMs at a faster rate. I can see where, using technologies such as mid-train distributed power to cut fuel expense and rail wear on curves, CP can generate double-digit gains in operating income. This will be good news for the Wall Street community as their analytical models can translate two points off the OR into so many cents in earnings-per-share which, when the current PE multiple is applied, can provide pretty good guidance as to share price.

Shippers and short lines will applaud these initiatives because they will cut transit times, lower supply-chain costs, and -- for private fleet operators -- decrease the size of the fleet needed to move a given annual tonnage of product. In this vein, it was encouraging to hear how CP is devoting time and energy to reducing the time interval between serving yard and customer dock.

Deciccio said they're going to a seven-day local operating plan and they've gotten customers to buy in to eliminate constructive placement and accelerate equipment turn times. The near-term goal is to cut that interval in half -- to 48 hours from the present 96 hours and to cut it in half again next year. Says he, "First mile, last mile efficiency is a key weapon in our war on car dwell." And getting customers to move cars rather than storing them in serving yards is critical.

Short lines, too, have a stake in this initiative. First of all, they begin behind the curve as they represent one train more between serving yard and customer, where the dwell at interchange detracts from achieving the target interval. Second, they are paid out of revenue, reducing CP's per-unit revenue for the move and degrading the key revenue-per-RTM measure. The short line thus represents a double hit: first to revenue per car or RTM and second in velocity, measured in car-miles per day origin to destination, including time on any short line in the route.

And, speaking of velocity, Franczak says they're targeting a three to five percent gain in car-miles per day. The first quarter 2011 average was 138 miles a day, meaning he's looking at something on the order of 144 miles a day, clearly closing in on CN's 188 car-miles a day racked up in this year's first quarter.

But then, I have to say the comps aren't exactly comparable as CP is running 34 percent bulk (coal, grains, fertilizer) to CN's 23 percent. CP's ag network serves 60 percent of Canada's high-throughput grain elevators so car-miles per day gains will come from a combination of shorter customer dwells and shorter transit times.

Enter route-structure improvements. CP has improved car order fulfillment and on-time spotting in part through specific day of the week service reliability and consistency, first in the critical Lethbridge grain hub in southern Alberta. As first-mile, last-mile gets faster, so must over-the-road transit times. Here CP has re-engineered MOW work territories and windows to cut work block assignments between Toronto to Vancouver to three blocks from six, sharing equipment consists between MOW crews and saving $1,700 (all dollar numbers from here on are in Canadian dollars) in maintenance expense per track mile.

New passing sidings and track upgrades ($250 million over three years) Winnipeg-Edmonton on the "North Line" have in effect created an alternate east-west main line, taking pressure off the Winnipeg-Calgary core. The former Soo Line routes between the Twin Cities and Winnipeg/ Moose Jaw ($90 million in three or four years) will reduce terminal congestion, provide better service reliability and shorten recovery time. Best of all, these upgrades will improve system velocity where a one mile-per-hour drop in average train speed effectively adds 20 units to the loco fleet and expands the available freight car fleet by 400 units.

With all this energy on the west end (40 percent of CP tonnage flows over the Golden-Kamloops core), the east end of the railroad -- D&H to New England, Marcellus Shale, etc. -- was missing from the formal remarks. But that's what coffee breaks and receptions are for. I caught up with VP for US Operations, Doug McFarlane (he spoke for CP at NEARS in April) and he told me they've spit US operations into East and West at roughly Chicago and that the east end is very much on their mind, giving me some behind-the-scenes guidance. Suffice to say, I'm encouraged by what I heard and will pass on what I can one-on-one if you'd care to drop me a note.

CFO Kathryn McQuade wrapped up the presentations with some key metrics and financial guidance. She said that for every penny the Canadian dollar appreciates against the US dollar, annual earnings-per-share will drop an equal amount or possibly more. A ten-dollar change in the price of WTI crude moves the operating ratio by 50 basis points or so. And because so much of CP's comp and benefits line is tied to share price, every dollar delta in CP share price drives a

comp and benefits delta of roughly $1.5 million. Shortline operators ought to find these first two nuggets particularly useful.

At the end of the day, said Kathryn, the three-to-five year revenue growth CAGR is based on revenue ton-miles increasing at a rate of two to three percent per year with pricing gains at a rate of inflation-plus. Using 2010 revenue, RTMs, three percent RTM gain and five percent price gains, I get 2011 revenues of $5.4 billion, up eight percent.

FY 2010 operating income increased 39 percent, even with a seven percent operating expense increase against 13 percent more revenue. Applying the same ratios to 2011, I get a 2011 operating income estimate of $1.3 billion, up 20 percent year-over-year with a 75.0 operating ratio, down 260 basis points year over year. I'd say CP is well on its way to Fred's "low 70s operating ratio." Thanks, all.

Norfolk Southern was an intriguing topic of conversation during the breaks in and around the CP Investor Update festivities. One consistent thread had to do with sequential quarter-to-quarter changes in revenue unit volumes. Readers may recall I've been tracking all the rails on a trailing six quarters basis, watching not only sequential deltas but also year-over-year all the way back to the 2009 fourth quarter. It's not been pretty.

All Class Is posted negative revenue unit volume deltas in the 2011 first quarter against the previous quarter. Moreover, all but CSX and KCS ran fewer units in the 2010 fourth quarter than they did the previous quarter. For NS, the slowdown began in the 2010 third quarter with a mere two percent gain over the previous quarter even though year-over-year unit counts were up 15 percent. The 2010 fourth quarter was off three percent in units from the third quarter and the 2011 first quarter was unchanged from the final quarter of 2010.

The analyst reports were fairly consistent in their assessments of NS revenue-unit past performance and outlook. For example, Jon Langenfeld at RW Baird writes, "Key take-aways [from the Altoona gathering] include stable near-term demand trends, and long-term opportunities with 2QTD overall volume growth (+3% yoy) decelerating from 1Q's +7% yoy."

My read is while the pipeline "opportunites" that Don Seale cited in his excellent slide set -- coal, steel, intermodal corridors, ethanol, etc. -- suggest solid RPU gains, some sense of the NS outlook for commodity volume deltas would have strengthened the RPU story by allowing one to follow the money.

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