THE RAILROAD WEEK IN REVIEW

July 29, 2011

"We're measuring every piece of the supply-chain on a daily basis and we are seeing significant improvements that are benefiting the customer in terms of dock-to-dock transit time." -- Claude Mongeau, President and CEO, Canadian National

Canadian National led off the lineup for Week Two of the second quarter earnings season. Total revenue increased 11% to C$2.3 billion on an FX-adjusted basis, improved from plus 9% in the first quarter; revenue units increased 4% from 3% in Q1. RTMs increased 5%: merchandise units (68% of total) 4%, coal (11% of total) 8%, intermodal (8% of total) 8%.

Operating expense increased 8% (an incredible 0.8% ex-fuel); ops income posted an 8% gain to C$874 mm. Car hire was down 10% on higher vols. GTMs/train-mile gained 3%, terminal dwell was an industry low of 16.2 hours. Net income grew 0.7% to C$538 mm; non-GAAP net income before a C$40mm tax adjustment was C$578 mm, up 8%. Reported EPS increased 4%, or 12% non-GAAP. The operating ratio was 61.3, unchanged year-over-year, though others would kill for an OR like this.

Merch carloads increased 5% with all commodities in mid-single-digits ex-coal (-14%) and intermodal (+10%). System RPU took a 5% increase and CN guides to that rate of change in the second half of 2011. All commodity RPUs were up mid-single-digits ex auto (-5%), coal (+22%).

"Supply chain collaboration" was the theme of the day. CN says strong customer focus is paying off in reduced car hire per customer and better train productivity. Short lines need to be an extension of this "precision railroading" model with seven-day operations and more car-miles per day. Expect to hear more on this theme between now and the CN shortline meeting in Montreal come November.

Let me add this tidbit from CN's Chief Commercial Officer, Jean-Jacques Ruest. He slipped in a comment about frack sand in Wisconsin during his formal remarks, but it wasn't till the Q&A that we got the full color. Question: Is the frack sand in Wisconsin for natural gas or liquid? Answer: "The frack sand is all going for shale gas. We're sitting very near the deposit of the right quality sand and we have more and more of the sand producers who are using CN to ship their sand, either directly on us or via transload."

The Norfolk Southern Q2 call sounded a very positive note with good direction on where NS wants the franchise to go. Total sales were $2.9 billion on 4% more revenue units than a year ago even though merchandise carloads dipped 2%; coal vols eked out a 2% gain while -- no surprises

here -- intermodal was up 9%. System RPU gained a respectable 14%. Ops expense was up 17%, pushing ops income up 19%.

The operating ratio came down 40 basis points to a respectable 69.5, though my sense is they can do even better with continued market-based pricing and hi-tech tools like LEADER and the Ops Plan Developer with their benefits in train-handling and fuel efficiency. Below the line, net income jumped 42%, helped by other income of $34 mm in coal royalties and other items. EPS increased 32% to $1.32 after backing out a favorable one-time $0.18 per share income tax adjustment.

All commodity groups save paper/clay/forest and chems saw double-digit revenue gains propelling the merchandise group up 12%; coal gained 28% and intermodal brought in 20% more revenue. Car-counts declined in all merch groups ex-auto with chems taking the biggest hit, down 10%. RPUs increased double-digits in every commodity group but automotive, down 2%.

During the call Chief Commercial Officer Don Seale said higher merch RPUs came in part from greater capacity and thus better service levels, to me implying they are shaking out low-rated moves cluttering up the railroad and slowing down higher-rated moves, making the latter move faster and thus more attractive to shippers. If my thesis is correct, it's very good news and excellent guidance for short lines as to what business is good business.

RTMs increased 6% with merch traffic 53% of total, coal 30% and IM 18%. Note the variance between deltas in vols and RTMs: units up 4%, RTMs up 6%, implying heavier cars moving farther, further strengthening the capacity/service thesis above. Intermodal remains the growth engine with domestic, Triple Crown and premium vols now 66% of total IM vols, up from 63% a year ago. Utility coal has declined to 67% of tonnage from 82% in 2009; export is now 11% of total coal tonnage, up from 6% in 2009. Longer hauls and generally higher rates for export drive the higher coal RPU increases.

NS postscript. At the Investors Day program at the Juniata shops last month, NS AVP-Mechanical Don Graab talked about the NS technology tradition and how they've designed and built their own replacement road locomotive, the SD60 E. There's precedent for this, and the story is beautifully told in a series of displays along the "Railwalk" adjacent to the NS main in Roanoke, Virginia.

While most of us were listening to presentations and in meetings at the NS Short Line Meeting at the Hotel Roanoke a few weeks ago, my wife Laura was clever enough to escape and go watch some trains. (View is from our room.)

In her perambulations, she documented the David R. and Susan S. Goode Railwalk and with it the details of the Class J 4-8-4 and Class Y6b 2-8-8-2 and why N&W rolled their own, even as

they've just created the SD60E to fill specific needs. Here's the link: http://bit.ly/NSrailwalk. And if you see a caption that needs an edit, do drop us a note.

The Canadian Pacific call was all about recovery from a truly dreadful season of heavy weather. At the time of the June, 2011 Analysts Day in NY, it seemed CP thought it was about over. Not so. In his opening remarks Wednesday, CEO Fred Green said the recovery gained by early June was totally gone by July 1 and went downhill from there. CFO Kathryn McQuade said some routes were out for 60 of the 90 days in the quarter.

The traffic count and income statement tell the tale. Revenues were up 5% to C$1.3 billion FX-adjusted while units slid 4%. Most FX-adjusted year-over-year commodity revenue gains were in mid-single digits, though sulfur/ferts was +34%. Same-store pricing slid 2-3%. Ops expense was up10% FX-adjusted; ops income dropped 14% to C$213, also FX-adjusted. The operating ratio was 81.8, four points worse than 2Q2010. Net income declined 23% to C$128mm; EPS was off 28% to C$0.75.

Merch carloads were up 2% on minuscule year-over-year deltas in all merch groups ex-ferts, +25%, on the second-best ever second quarter for potash. Merchandise commodity highlights include pulp to China for printing paper, frack sand and east-coast ethanol. Coal carloads were up 14% though RTMs gained only 6% on longer-hauls and less short-haul US thermal coal. As in the US, domestic intermodal units were up and international units came down; CP is modeling "GDP-like" growth for the rest of 2011 as market share is starting to recover.

The operating metrics are recovering with July 2011 car-miles per-day almost back to July 2010 levels from the 2Q2011 lows. Terminal dwell, fuel burn per GTM and train speeds were all down a point or two over last year. Cutting cost per car handled 15% in major yards is a big plus.

My take: CP has used the unfortunate weather experience to sharpen its ops and commercial models and is better positioned now than it was a year ago to capitalize on opportunities to snag new revenue streams. One such is with its US short lines, particularly in the east. I will be keeping close track here because so much of the opportunity for improved results is right in my own Pennsylvania back yard and not that far away in New England.

I'm not the only one seeing a turnaround here. Peter Nesvold at Jefferies writes, "While near-term visibility remains the lowest in the group, we see a mid-decade opportunity to benefit from potentially improving network performance and overall profitability driven by the company's goal of a low 70s operating ratio. In the near term, we expect several more choppy quarters as management addresses multiple infrastructure issues."

And Cherilyn Radbourne at TD Newcrest in Toronto writes, "We felt that the conference call was modestly encouraging with respect to three important issues: 1) restoration of network fluidity; 2) recovery of lost market share in grain and intermodal; and 3) pricing. We are maintaining a Buy recommendation as we recognize that the shares are unlikely to outperform pending more convincing evidence of an operational recovery at CP; however, we believe investors have become too pessimistic with respect to the company's earnings power." I agree.

RailAmerica's second quarter freight sales were up 7% to $106 mm and non-freight revenues (the new Atlas Division, car storage, AAR repairs, etc.) jumped 59% to $34 mm, of which $8mm came from the July 2010 Atlas acquisition and the three roads bought from the Gulf & Ohio group in May, 2011. Ex-coal revs were up 11% with double-digit gains in 8 of 12 commodity groups, with particular strength in ag and met ores/mins.

Revenue units dipped 3% year-over-year on a 22% drop in coal due in part to flooding in Missouri and in part to an Illinois customer's change of steam coal supplier. Non-coal carloads increased 2% on double-digit carload gains in ag products, met ores & mins, with lesser positive deltas in STCC 26 and aggregates. STCC 24, chems, waste/scrap, STCC 20 food, petrol, auto and "other" all headed south by varying degrees.

Ag products and met ores/mins both increased their share of total tonnage to 16% and 9% respectively. Coal shed four points to 16% of total vols from 20%. During Charlie Patterson's presentation I got the feel that the downdrafts are fixable with a significant pipeline of new business already in place, in line to be on line soon or in development for the longer haul. Moreover, system RPU increased 11% and, as I see it, as mix changes (revenues increasing faster than vols) the yield will improve.

Reported operating expense increased 15% and operating income gained 24% to $29 mm for an OR of 79.4, 130 basis points better than 2Q2010. However, there were some moving parts -- 45G benefit, asset impairment charge, asset sales -- which, when backed out, yield an OR of 80.8, even with 2Q2010. Below the line, net income was $8.7 mm vs ($4.2) mm a year ago. Reported EPS came in at $0.17; after the puts and takes above and a change in tax liability it's 21 cents vs. ($0.08) a year ago.

Conclusion: RA has turned the corner in profitability by zeroing in on the commodity O-D pairs that best pay the rent, has the breadth of franchise to offset a major downturn in coal with gains in ag and met ores/mins, and -- thanks in part to its Horizon initiative -- has a better handle on cost-control than ever. And because RA is really 43 different properties spread all over the map with few common points, it's fairly representative of of the US short line community and the Q2 results show what smaller, non-affiliated short lines can do if they put their minds to it.

(As an aside, Jason Seidl at Dahlman & Rose thinks another acquisition is nigh "as the company has chosen thus far not to retire high-interest-rate notes that it has been able to call since late June, despite having a solid balance sheet with $116.5 MM in cash and a 37% net-debt-to-total-capitalization ratio. Indeed, management noted that the short-line rail acquisition market has improved." Personally, I've not heard of any short lines for sale worth buying. Let's see what if anything they've uncovered.)

End Notes. Last week I cited CSX's Clarence Gooden on "rail inflation" and asked if there were any reader comment on exactly what this is. As it happened, the question came up on the CN call Q&A. Here's how CN's CFO, Luc Jobin, responded: I'd probably put it close to 3.5%. It will run between 3% and 4% depending on what types of commodities we're securing and where the commodity prices are running. And we know that labor on average is going to be around 2.5% to 3%. And so it's a bit of a moving target, but between 3% and 4% is probably not a bad place."

As for labor, the recent UTU announcement about the 17% wage increase over five years works out to about 3.4% a year, the high end of what CN sees.

Genesee & Wyoming wraps up the railroad earnings season Tuesday. I'll be on the call.

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