THE RAILROAD WEEK IN REVIEW
October 28, 2011

"We're flirting with a 70s operating ratio by the fourth quarter of 2012." -- RailAmerica president John Giles during the conference call Q&A, October 26, 2011

RailAmerica posted total third quarter sales of $140 million this week, up nine percent year-over-year. Freight sales came in at $105 million, up seven percent on 207,000 revenue units, down six percent from the year ago period. Operating income excluding 45G tax credits and other one-time items rose 11 percent to $30 million from $27 million a year ago. Net income was up 14 percent to $9 million helped somewhat by the five percent reduction in diluted shares thanks to the buy-back program.

The revenue-unit decrease is somewhat misleading. If you back out coal, itself down 12,000 units or 25 percent year-over-year, carloads were flat at 172,000 units, even after an 11 percent drop in ag units thanks in part to the Kansas-Oklahoma drought and a late corn harvest. The coal hit came as utilities took down time and did some source changing, but vols ought to start getting back to normal in Q4, said Chief Commercial Officer Charlie Patterson on the call. Same-store vols were off six percent, though I suspect coal and ag on just a few roads are the culprits.

System average RPU gained 14 percent, ten percent ex-coal. Among the merchandise carload commodity groups only ag and petroleum posted negative total-revenue numbers and petroleum alone saw a decrease in RPU. RailAmerica in its reports uses 12 commodity groups from ag products to coal to "other" and of these, only ag products and coal posted significant volume decreases. The good news here is that RA has a broad enough commodity franchise base so that a loss in coal or ag can be largely offset by gains elsewhere.

A year ago coal was 22 percent of carloads, most of it being in unit trains on two railroads. Now it's 17 percent of vols with the difference being partially made up with gains in metallic ores & minerals, non-metallic minerals and chemicals. Each of these groups sports an average revenue per carload (ARC) at least twice what coal brings in, which is partly why 3Q sales grew ten percent ex-coal. RA expects all-in vols to slip another two or so percent in Q4 and about that for the full year. Core prices, ex- fuel surcharge and foreign exchange, will remain in the plus four percent range. (Fuel surcharge collections alone in Q3 added four points to the ARC.)

The operating ratio excluding 45G credits and other items improved 30 basis points to 78.8; all-in the OR went from 77.8 a year ago to 77.5 in the present quarter. That may not seem like much, but put in context with where it was three years ago -- pushing 90 -- it speaks volumes about what the company has done to run a better railroad. Safety is a big part of it, and it shows up in the income statement under casualties and insurance. That expense line is down 16 percent year to date as FRA reportable accidents and the Personal Injury Ratio (now 1.5 reportables per 200,000 hours worked) have all improved significantly over three years.

One final thought. Year-to-date data always provides -- to me, at least -- a better picture of any company's health. Total revenue units YTD are off just three percent, half the Q3 rate. Coal is off 17 percent over the nine months, eight points better than the quarter just closed, and carloads ex-coal are actually up a point with ag off four percent vs the 11 percent drop just posted. And the all-in nine-month operating ratio is down 139 basis points to 79.1.

Norfolk Southern hit a home run Wed with total 3Q revenue up 18 percent to $2.9 billion on 1.8 million revenue units, up three percent, with intermodal (up nine percent) clearly in the driver's seat. Merchandise carloads (all except coal and intermodal) slipped two percent with negative deltas in three of the four merch commodity groups. The commodity revenue side of the equation did much better: double-digit gains in all commodity groups save paper/clay/forest and chemicals. ARC was up double digits everywhere but auto and increased 14 percent for the railroad as a whole and for the merch sector.

During the call, Chief Commercial Officer Don Seale drilled down into some commodity highlights. Metals/Construction gained 11,000 loads (seven percent) on coiled steel and frac sand and auto added eight percent (6,000 cars) chiefly on new vehicle shipments including the new VW plant in Chattanooga. Chems slipped 11 percent (12,000 cars) on mix, ag dropped 11,300 carloads (seven percent) on lower feed corn vols and paper/clay/forest was down five percent (4,000 units) on declines in pulp-board, kaolin and wood chips.

Operating expenses increased 14 percent (eight percent ex-fuel); operating income jumped 26 percent to $938 million and the OR dropped to 67.5, a decrease of 2.1 points vs. a year ago. All the operating metrics showed sequential improvement: safety (0.67 injuries per 200,000 hours worked), composite service, train speed and terminal dwell. Total T&E employment continues to grow with the percentage of trainees in the workforce coming down.

Below the line, net income rose 25 percent to $554 million; diluted earnings per share jumped 33 percent to $1.59 partly on the share repurchase program that reduced the share count six percent year over year. It's also heartening to see the operating income delta carry through to the net income change, telling one there's not a lot of "noise" betwixt the two.

As noted above, rev units increased three percent and NS did it with crew starts up the same amount. Gross ton-miles and revenue ton-miles were both up four percent, indicating more tons per revenue unit. GTMs per gallon of diesel fuel came down two percent though GTMs per train hour increased two percent. In short, NS is running faster, heavier trains delivering more transportation bang per customer dollar. Short lines take note and propose new commodity O-D pairs accordingly.

Canadian Pacific's third quarter results were mixed. Total freight sales grew five percent year-over-year to C$1.3 billion with merch carload revs up seven percent, coal up 24 percent but -- surprise -- intermodal revs actually dropped six percent on winter service degradation and loss

of customer confidence. Non-freight revs dropped six percent; total revs were up four percent. Operating expenses increased seven percent to C$1 billion for operating income of C$325 million, down four percent, The operating ratio came in at 75.8, an increase of two points. Below the line, net income slid five percent to C$187 million; EPS dipped six percent to C$1.10.

On a currency-adjusted basis, revenues grew eight percent. Fuel surcharge revenues generated nearly five percent of that gain; the combination of price and mix was nearly six percent offest by vols down three percent. Improving Canadian grain vols partially offset fewer revenue units on CP's lines in the US on global demand for Canadian canola, high-quality wheat and durum. Chief Commercial Officer Jane O'Hagan says the combination of production, carryover stock and improved CP operations "should enable year-over-year growth" in Q4 and on into 2012.

Of particular interest to our Northern Plains readers, O'Hagan says

> Flooding and late-season weather have reduced the quantity and the quality of the U.S. Midwest harvest. Overall, crop production in the areas we serve is estimated to be down roughly one percent versus last year, with wheat production in North Dakota down substantially. With global supplies of feed grain competing with U.S. corn and soybean, the U.S. experienced a soft export market in the quarter, which resulted in an 11 percent reduction in the carloadings compared to Q3 2010. Looking forward, lower U.S. wheat production combined with volatile corn and bean export markets make forecasting through the first half of 2012 difficult.

Elsewhere, sulfur and fertilizer vols increased 16 percent as demand for potash and fertilizer is returning to historic levels thanks to increased global grain plantings and higher grain prices. Merchandise carloads increased four percent on Industrial Products (oil and gas E&P, ethanol), forest products (pulp and paperboard) and automotive. Specifically, the Bakken and Marcellus energy fields are helping the increases and O'Hagan says, "We continue to capitalize on the inbound materials growth in these areas. Our low-cost ethanol customer base is well-positioned to compete in markets across the United States."

Operating metrics such as train speed, car-miles per day, terminal dwell are trending in the right direction and the Long Train Strategy is working. CP is currently running four coal train-sets at 152 car lengths and potash trains of up to 170 cars -- they did 66 such trains in Q3 alone. Unfortunately, the personal injury rate increased to 2.15 injuries per 200,000 hours worked from 1.53 a year ago. Chief Operating Officer Mike Franczak says most of the increase was related to minor strain-type injuries, but they're still reportables and are preventable.

Very much on CP's mind is avoiding another winter like last year. The railroad is budgeting for some 500 additional qualified T&E employees on the property, 61 new AC locomotives, with another 30 coming on in Q1. Locos deemed surplus to the fleet go into "warm storage," the snowplow fleet is bigger, there is more snow fencing in the Dakotas and more remote-controlled

switch heaters. Franczak says, “There are many, many other changes we’ve made to protect our service and production plans, and I’m very confident that we’re ready.”

Canadian National President Caude Mongeau opened this week’s earnings call citing “record revenue performance, a good balance between volume increases, and good pricing. Overall, our revenues are up 12 percent [FX adjusted] over last quarter.” True enough. Using numbers straight from the financials and not adjusted for the vagaries of the exchange rate (as I will throughout this note), total sales increased nine percent to C$2.1 billon with revenue increases across all commodity groups and double-digit gains in metals/minerals and intermodal.

CN moved 1.3 million revenue units, up four percent; every commodity group but coal (down nine percent) posted gains. The merchandise commodity groups -- all but coal and intermodal -- increased eight percent year-over-year and average revenue per unit was up across the board to a respectable C$1,633, a five percent gain. Merch carloads averaged C$1,976, also up five percent, and make up 61 percent of total units, the highest merch volume percentage among all Class Is.

Operating expense increased a mere six percent with actual reductions in labor, car hire and casualty. Operating income grew 13 percent to C$938 million; the OR shed 136 basis points to 59.3, breaking 60 on the down side at last. Net income was up 19 percent to C$659 million and EPS gained 23 percent to C$1.46, helped by a four percent cut in the diluted-share count.

Chief Commercial Officer Jean-Jacques Ruest summarizes the commercial outlook thus:

> Intermodal will definitely remain CN’s growth engine for the fourth quarter and for 2012. Canadian grain will be the big driver in bulk (coal, ferts, grain). We were prepared for an early crop in Canada, and our western operation was ready for it by August. In the last five weeks we’ve experienced a record order book, which we have been blitzing with scheduled unit train service at record levels of train-starts. Our U.S. Grain business, however, is another story. We expect to be down as much as 13 percent, hurting Gulf Coast export numbers.
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> In other carload commodities, lumber volumes should uptick in the fourth quarter in spite of the lackluster US housing market. We have some sawmills that will restart, and we are expanding our lumber container export activity on the Canadian West Coast. Export pulp prices weakened last month because of the pull-back of a buyer in China, however, CN’s shipments should ramp up as two pulp mills come back from maintenance shut-downs.
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> Iron ore production is expected to run at capacity throughout year-end in advance of the vessel-season’s closing. The chemical commodities price outlook is only slightly down, and our customers are mindful of keeping inventory low. North American finished vehicle inventory bodes well at 49 days supply, a nine-day improvement from last year, which actually bodes well. Dealer inventories for Japanese marks remain very low at 37 days.

Chief Operating Office Keith Creel says all six key operating metrics showed improvement in the quarter: GTMs per train-mile, cars per yard switching hour, terminal dwell, trailing GTMs per total horsepower, car-miles per day, and system train speed. CN is adding "capacity enhancement investments" including some 10 siding extensions, a second or even third main track in certain lanes and a number of yard improvements. For example, the new EJ&E connection at Matteson, Ill., allows CN to make progressive moves in any direction. Before, it was a reverse move that required running around the train, at times a two-hour process; it's now a matter of minutes. In conclusion, says Creel,

> We're going into this winter with about 100 more DP locomotives than we had same time last year. We got the infrastructure upgrades I talked about. We've made huge strides in replacing jointed rail with CWR out on the main line. We've purchased and deployed more snow-fighting and road-repair equipment among a long laundry list of other items. Suffice to say, we fully expect CN to perform well this winter.

So do I.

The 18th Annual *Railway Age* "Passenger Trains on Freight Railroads" conference in Washington was a real winner. As usual, the room was filled with a distinguished list of speakers and panelists from Amtrak, the FRA, various government entities, suppliers and even a few short lines. As I scroll through my notes I remain convinced that (a) there is a real need for affordable, comfortable and reliable short haul transportation and (b) local governments will have to support and promote it.

Therein lies the conflict. The states are broke and the feds really don't have access to unleveraged money to fund passenger trains. Yet ridership is up and more municipalities are opting for light or even heavy rail passenger services. As a country, we're definitely behind the global curve when it comes to local passenger rail -- just pick up an issue of *Railway Age*'s sister pub, *International Railway Journal,* and see the strides from Dubai to Dublin.

Next week brings us RailTrends 2011, the eighth in a series, at the W Hotel at 50th and Lex in NYC. The theme is growing the business in uncertain times, zeroing in on the railway industry's best opportunities for the future. We'll be hearing from a number of true innovators who are on the leading edge of increasing rail volumes and share of market. Hope to see you there.

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