THE RAILROAD WEEK IN REVIEW
January 13, 2012

"The Board came to the unanimous conclusion that replacing the company's Chief Executive Officer is not in the best interests of CP or its shareholders." CP Chairman John Cleghorn

Canadian Pacific Chairman John Cleghorn has turned up the heat a notch in the exchange of letters with Pershing Square Capital Management. On Monday he sent a letter to shareholders saying CP already has a plan to increase revenue-unit volumes and control costs, unlike Pershing which "has not presented any detailed, credible plan." Moreover, says Cleghorn, Pershing hasn't realized the "structural differences between CP and its peers" and is basing its projections "at a pace never before achieved by any railway management team." As for replacing Fred Green, Cleghorn writes

> The Board takes all suggestions from shareholders seriously and has carefully considered Pershing Square's demand that CP replace the company's Chief Executive Officer with Hunter Harrison , age 67, who retired from his position as President and Chief Executive Officer of Canadian National Railway on December 31, 2009. Having considered Pershing Square's demand, the Board came to the unanimous conclusion that replacing the company's Chief Executive Officer, and thereby jeopardizing the successful execution of the Multi-Year Plan, is not in the best interests of CP or its shareholders.

Personally, I'm glad it was said. We don't need to try to re-create CP in CN's image and I think Harris and Ingram oversight is going to give the CP operating department the leadership and focus it deserves and needs to recognize CP's full potential. Besides, given the tenor of the exchange it's likely that the back-and-forth will continue, creating additional share-price volatility. I got stopped out Monday and will likely stay out as the saga could well turn into a proxy fight that won't be resolved until the May shareholder meeting.

Fellow pundit Fred Frailey writes

> You've got to give Green credit for trying. Just two weeks ago he persuaded two retired railroad operating executives, each with golden reputations for turning around troubled companies, to join Canadian Pacific's board of director. Tony Ingram was a seasoned Norfolk Southern operations executive whom CSX Mike Ward recruited to bust up the Old Boy Network that inhabited Ward's operating department.
>
> This Ingram did with a certainty and determination that must have surprised many of the general managers and division superintendents he fired when they failed to take him seriously. CSX became the Class I success story of the past decade, and I give Ingram and his boss Ward credit. Tony is as sophisticated as a Tennessee moonshiner, but he is smart, tough, and savvy in equal measures.

The analyst community seems supportive of Green as well. The Zacks note says CP has already "realized significant synergies." Moreover,

> Given Canadian Pacific's current financial position, we believe that the company's objection to replacing Green holds good given the positive changes brought in under its present leadership. The souring relationship between Ackman and Canadian Pacific has not gone according to plan and created uncertainties over the company's future. If further dragged, the issue can only worsen the matter for Canadian Pacific, which is already surrounded by several impediments like rising fuel prices, lackluster earnings, competitive threats and regulatory pressures.

And from Toronto Cherilyn Radbourne at TD Newcrest cautions that if Hunter moves to CP he may recruit former CN team-mates to CP. " In our opinion, CN has sufficient bench strength to mitigate this risk, but we believe it is a risk that is worth mentioning." I concur.

The 52-week revenue unit counts are in and I've got to say 2011 wasn't exactly a banner year for the merchandise carload franchise. Total revenue units, including coal and intermodal, ranged from -2 percent (CP) to +9 percent (KCS). Intermodal was a big factor across the board as merch carloads ex-coal stayed in the -0.2 percent (NS) to +6.6 percent (UP) range. The AAR North American summary has grain down due to tougher competition from non-US producers and the US wheat drought. Coal is another concern as cheap, local and clean NG displaces distant dirty coal. It's a mixed bag by railroad: UP +5.3 percent, BNSF -4.5 percent, CSX -1.4 percent, NS +4.6, CN -5.8 percent, CN -9.1 percent.

The difference between Canada and the US is the former is largely met coal to the Pacific Rim whereas the latter is mainly steam coal staying home. Mix matters, too. CN's coal is less than 10 percent of total vols to 22 percent for NS, for example. So the shift to gas from coal for electrical power is going to hit NS harder than it will CN.

As for the future of steam coal, the AAR says, "We've pointed out that the coal share of U.S. electricity generation has been trending down in recent years and is now around 45 percent. There are several reasons for this, but perhaps the most important is the big decline in natural gas prices for electricity generators as improved drilling techniques have unlocked huge new natural gas supplies." Pennsylvania's Marcellus Shale is Exhibit A.

Short lines saw coal +2.1 percent and grain -3.7 percent for the full year per the Week 52 RailConnect Index from RMI. These two commodity groups represent 22.8 percent of all shortline vols, including intermodal. Back out intermodal and grain-coal represents 23.5 percent of the total. Happily, the stone, clay & aggregates group -- where frack sand resides -- was up 13.7 percent for the year.

Watching stock reports on major railroad customers is a jolly good way to get a handle on likely traffic trends. This week's crop kicks off with a Deutsche Bank note on Ford Motor saying they're bullish on Ford's North American market for two reasons, both positive for the railroads. First, there is a suggestion that growth in demand could outstrip supply. Second, Ford's 2012 product pipeline has strengthened thanks in part to positive reactions to the new Fusion and Escape models.

Macquarie charts increased car loadings of crushed stone and says the trend "indicates the US economy has moved up from long term cyclical lows." AAR fourth-quarter data supports the note with total non-met minerals up 12% comprised of stone/clay/glass up eight percent, non-met minerals up 17 percent and crushed stone, sand and gravel up 13 percent.

And a JPM note on agricultural machinery says global supplies of most crops are "adequate," so any changes in what's out there "are likely to be driven by weather events rather than material changes to demand." The report cites bad weather affecting wheat in the Ukraine as well as corn and beans in South America. The note concludes that "U.S. crop prices are likely past their seasonal trough, at least through the current planting season."

RBC Wealth Management says the charts for crude oil mirror those of the stock market and have done so over the past few years. "On a longer-term basis, crude is in a trading range of about 80-100 and is currently rallying up towards the top end of the range. While we expect oil to stall in the 105-110 area, a possible break through the 110 area would be a bullish indication and no doubt would have an effect on many other parts of the market as well. So while the trend of oil is short-term positive, the real test comes later on whether or not it can break out of the range of the past year."

From *Railway Age* Editor Bill Vantuono comes this sad note: "This May 16, NS will have the opportunity to go for No. 23, and its competitors for the industry's most prestigious safety award will have a yet another chance to take NS's crown. It will be their last chance. It will also be the final opportunity for Kansas City Southern to add to its own five consecutive Gold Harrimans in Category B. Why? After this year's presentations, there will be no Harriman Awards to win, because the Association of American Railroads has scrapped the program, which has been affected by controversy in recent years." Another worthy cause bites the dust, though the "Jake Award" for shortline safety lives on.