THE RAILROAD WEEK IN REVIEW
January 27, 2012

"The ISM Manufacturing Index had a six-month high of 53.9 in December, marking 29 consecutive months of expansion." Don Seale, Chief Commercial Officer, NS

Whew. Fourth Quarter 2012 Earnings Week truly was a week, at least for the Class Is. UP kicked things off Thursday Jan 19 and by the close yesterday we'd heard from 'em all. As is our custom, the focus is on the carload sector -- automotive gets a nod mainly for parts in boxcars on short lines and export coal is important to more short lines than steam coal for electric generating plants. My broad take is that across-the-board revenue was up in low double-digits and revenue units were up at half that rate -- not good news for short lines and switch carriers that live on fixed per-car allowances. The 2012 outlook is for more of the same.

Kansas City Southern led off with a Monday after-the-bell earnings release and call. Revenues increased 11 percent to $530 mm with strong double-digit gains in auto, coal and intermodal. Cross-border revenues for the quarter increased 19 percent year-over-year with the intermodal container count up 56 percent and revenue up 76 percent; the port at Lazaro Cardenas pushed out 32 percent more containers, generating 35 more revenue.

Carloads ex-coal and automotive drifted south by three percent in the quarter; the chemicals, ag/minerals and industrial/consumer products commodity groups all posted smallish declines. System RPU increased three percent, however, and same-store pricing was up six percent excluding fuel surcharge and exchange rates.

Operating expense likewise increased 11 percent, providing a muted ops income gain of 11 percent to $150 mm and an operating ratio of 71.6, a 13 basis point improvement. Net income jumped 85 percent to $96 million on a laundry list of below-the-line items; reported earnings per share came in at 87 cents, up 75 percent. For the year, total sales hit $2.1 million, up 16 percent, operating income was $612 million, up a respectable 26 percent, for a full-year operating ratio of 70.9, down 234 basis points from the 2010 number. Net income grew 94 percent to $329 million; eps grew 82 percent as the diluted share count increased by eight percent.

The 2012 commodity outlook is for continued so-so results in the first half, accelerating in Q2 and on through the year. Mexico's GDP is expected to increase at three or four percent and the momentum in cross-border intermodal conversion is not likely to abate. Auto and household durables will benefit from "near-sourcing" as manufacturing moves to Mexico from the Pacific Rim, and export coal through the Lazaro expansion is a real possibility.

CSX reported results Monday after the bell and held its conference call Tuesday bright and early. But the question on everybody's mind was what happened to Chief Officer Dave Brown? Recall it was Tony Ingram who brought Brown -- his Chief Transportation Officer while at NS --

to CSX. Speculation was rife and it wasn't till the Q&A that the question came up. Responding to Merrill's Ken Hoexter, CEO Michael Ward said,

> We have, I think, a really good disciplined operation in our culture now. What we really need to do is -- to go to our "grow to 65%" -- to continue to get our productivity of $130 million to $140 million a year; we need to continue to get above-rail inflation pricing, which I'm confident we will do; we also need to grow the business. [To do so] we can take that disciplined culture, put in more rigor, add better customer service, and achieve better margin expansion through those efficiencies to really take it to the next level. And in my view, Oscar is the guy. He's been a proven leader here at CSX, a key business partner, and is a nine-year veteran of the company. I think Oscar is the guy to take us to that next level. So that's primarily the reason for those changes...
>
> David has left the company, it's the company decided that he should leave. And we're just going to leave it at that, we're not going to comment further on that at this point. I do think that this is a very positive thing with Oscar and Fredrik moving into the new positions. I think will really propel us into the next level. [*Call transcript courtesy of seekingalpha.com*]

It wasn't that bad a quarter, in the grand scheme of things, even if they were comparing a 14-week quarter in 2011 to a normal 13-week quarter a year ago. (We'll ignore that below and go with GAAP numbers.) Yes, total revenue units drifted south four percent (take out the extra week and they were up a point) thanks mainly to coal and intermodal declines, and the merch carload business slipped a point. System RPU was up nine percent; same-store sales (75 percent of the CSX franchise) increased seven percent.

Quarterly sales increased five percent to $2,952 million and operating expenses increased by seven percent, taking operating income down less than a point and adding a point and a half to the operating ratio, 71.5. Net earnings increased six percent on below-the-line items while eps grew 14 percent on a six percent reduction in shares outstanding. (*As an aside, it is instructive to note that the rails typically spend twice as much on share buy-backs as they do on dividends, paying out on average some 25-30 percent of net income -- rhb*]

Merchandise carload sales increased four percent (again on a GAAP quarter basis). Strength in fertilizer offset grain losses, metals moves were up on auto and energy extraction, and aggregates were up thanks to better construction numbers and, of course, frac sand. The 2012 outlook is a little better, with commodity lanes accounting for more than 70 percent of CSX revenue unit volume looking up, and most of it good for short lines: phosphates and ferts, feed grain and ethanol, frac sand, metals for autos and frac pipe, and paper for packaging.

CSX saw some year-over-year deterioration in train velocity, terminal dwell and on-time departures and arrivals. However, drilling down to specific commodity O-D pairs, CSX showed how they used the drop in domestic steam coal loading to increase train size, increase train speeds, and realign assets to the export coal market, again a positive for short lines. The

merchandise carload network is also running better with significant traffic density in the NY-Chicago, Chicago-Waycross and Tampa, and Hamlet-Birmingham on the old SAL alignment.

I came away from the call sorry to learn my mountain-biking buddy Dave Brown has left but encouraged by what CSX is doing to make money in a crummy economy. And it's showing up in end-of-year shareholder metrics, too: operating cash flow seven times net income, net debt up only eight percent compared to double-digits for some others, dropping share count six percent and increasing the dividend payout to 26 percent from 24 percent of the net.

Next up was Canadian National. Sales for the quarter rose 12 percent to C$2.4 billion as revenue units rose four percent to 1.2 million carloads and containers. RPU increased by double-digits in all but forest products, auto and intermodal. Merch carloads including auto were up two percent, coal was down 11 percent and intermodal units increased a like amount.

Operating income rose eight percent as the operating expense increase of 15 percent outstripped the revenue gains (the ops expense ex-fuel was ten percent, hardly the spread from the revenue delta one expects from CN). Still, CN remains the only Class I with a sub-70 operating ratio: 64.7 for the quarter, up 126 BP over the prior year. Below the line, net income was up 18 percent to C$592 mm; eps gained 22 percent to C$1.32 on four percent fewer shares.

Fuel expense increased 31 percent as price per US gallon jumped 25 percent. But GTMs per train-mile, terminal dwell and car miles per day all showed improvements as total GTMs increased five percent against units up four percent and fuel burn increased only three percent. On the call COO Keith Creel said merchandise car order fulfillment improved four percent even as demand for cars increased three percent. Creel credits that success with car distributors beginning to think in customer supply chain terms, something we heard about at the November CN shortline meeting in Montreal.

Even though the merch carload increase of only two percent is hardly robust, there were pockets of particular strength. Said Chief Marketing Officer Jean-Jacques Ruest on the call, "Crude oil out of Manitoba and Saskatchewan more than doubled from the third quarter, revenue units in the metals and minerals group grew by 29 percent, frac sand from Wisconsin and Michigan was up 43 percent and carloads of pipe out of Ontario increased an impressive 29 percent."

For 2012, Ruest sees a better grain franchise (units were off seven percent in Q4) with particular strength in Canadian wheat and canola offset by weaker US grain exports as sellers wait for higher prices. Sand, pipe and crude oil carloads will continue their upward trend, metals carloadings will increase on steel for autos, drilling and heavy equipment. Even housing starts may begin to recover.

Norfolk Southern closed out a very busy earnings day Tuesday with quarterly results ranked first or second among all publicly-traded Class I railroads. As I look across my Q4 cheat sheet with all the Class I reports side-by-side, I can see NS revenues were up the most (17 percent) and

revenue units (up six percent) lagged only KCS and that by just a point. RTMs were up five percent (tie with UP), merch carload revenues were up 13 percent to UP's 15 percent and operating income growth was number one at 25 percent. The personal injury ratio was a remarkable 0.73, some 18 percent below NS' previous best.

Total revenue for the quarter came in at $2.8 billion as revenue units increased six percent to 1.8 million units (on only five percent more crew-starts), propelled by intermodal's 11 percent gain where domestic boxes (including Premium and TripleCrown) increased 11 percent to international's nine percent). All commodity groups save intermodal posted double-digit RPU gains as NS continues its focus on market-based pricing that meets or exceeds rail inflation. Operating expense was up 14 percent allowing a 25 percent operating income gain. Net income was up 19 percent on a seven percent reduction in diluted shares.

Coal vols were up only three percent, but export coal is the story here: 16 percent of total coal tonnage, up from 11 percent in 2009, and tonnage up 59 percent in the same period. Domestic met coal tonnage is now 11 percent of total, up from seven percent in 2009 and with tonnage up 66 percent in the same period. Domestic utility coal, by way of contrast, is now 69 percent of total tonnage, down from 76 percent two years ago with tonnage up a mere one percent. Good for NS for finding new markets for the coal that's lain in the ground untouched by a miner's pick since the days of N&W Class Ys. Thanks in part to the coal story, NS revenues from "heat and eat" (coal and ag products) represent another first place at 43 percent.

The metals/construction and automotive commodity groups posted double-digit volume gains, with frac sand and pipe carrying the day in the former and a 13 percent gain in light vehicle production in the latter. Three of NS' merch commodity groups took hits: ag was down seven percent on corn and fertilizer pattern changes, chemicals came down ten percent on the now-ended TVA fly ash comps, and the forest products group slid six percent mainly on kaolin and wood pulp to the paper mills.

But, as every marketeer knows, business goes away and you have to replace it. During the call NS said customers have added plant capacity and jobs to the tune of $9 billion and 6,800 new employees. That said, merchandise carloads are expected to see significant improvements in drilling related activities (sand, pipe in; crude oil out), ethanol, auto and steel.

I came away pleased with the results (disclosure: NS is a core holding of mine) and evidently not the only one. UBS analyst Rick Paterson concludes, "We remain abundantly pleased with our recent upgrade given a now right-sized cost structure, good momentum on EPS and ROIC, today's 9% dividend hike, and a discounted valuation versus its comps and own history. Some patience here will be rewarded, in our view."

The theme of the Canadian Pacific call was to show how running a faster railroad can lower customer supply chain costs while reducing CP direct operating expense. For example, fourth quarter terminal dwell was down 20 percent, pushing up car-miles per day by 20 percent,

allowing a 14 percent cut in the size of the active car fleet and generating 5 percent more GTMs system-wide in the bargain.

Fourth quarter sales increased 9 percent to C$1.4 billion with particular strength in the coal, industrial products and auto commodity groups and a 9 percent average RPU gain across the board. Total revenue units were up a mere three-tenths of one percent, though revenue ton-miles grew four percent. Unfortunately, fuel expense was up 32 percent and that pushed ops expense up 11 percent for an OR of 78.5 -- up 151 basis points. (Ops expense ex-fuel was up just six percent.)

Operating income was up less than two percent to C$303 mm; the net was C$221 mm, up 19 percent, or C$1.30 a diluted share, thanks to a C$37mm income tax benefit. Absent that credit net income and eps were essentially unchanged year-over-year. For the year, revenue increased four percent to C$5.2 billion, operating expenses were up nine percent and operating income dipped 13 percent to c$967 mm. Net income shed 12% to C$570 mm and eps slid 13 percent to C$3.34; the full-year operating ratio came in at 81.3, a 373 basis point degradation year-over-year. Free cash flow was a negative C$592 mm.

The 2012 revenue outlook is best described as "uncertain." During the call Chief Marketing Officer Jane O'Hagan predicted "volatile" US grain markets at least through June, yet more volatility in export coal near-term, and -- in spite of the new 10-year agreement with Canpotex -- first-half uncertainty for the sulphur and fertilizers group. Domestic intermodal and the merchandise sector seem robust, with the latter looking for overall 2012 growth in the range of two to three times GDP. Auto and energy -- think frac sand, pipe and "crude by rail." Operating efficiencies starting with asset productivity will surely create a silk purse in shareholder value out of this sow's ear of an economy.

[*Note: CP was the last Class I to report and, PowerPoints aside, it was one of the weakest full-year showings: the only decrease in total revenue units, the highest operating ratio, the highest price-earnings ratio, the only negative free cash flow and the only current ratio less than one. As for year-over-year sales, well, see above. Yet CP share prices have increased 20 percent since October, besting all others. One must conclude the reason is what one analyst calls "the non-fundamental noise"over the Pershing Square action. And on today's call, Green specifically forbade any questions on it before they opened up the phones for questions.*]

A note from John Betak, a friend of some 20 years going back to his industrial development days at Conrail, tells me he now hangs his hat in Austin, Texas with the Center for Lifelong Engineering Education at the University of Texas.

He's now embarked on a three-part series on *The Fundamentals of Railroads and Rail Transit* and writes, "Please let your colleagues and network know about the free webinar that is being offered regarding the railroad and rail transit short course and certificate program at UT. I will be doing a live session on February 1st, 4:00 p.m. CST. Interested participants will need to logon 10

minutes before the start time." To get to the webinar, please go to the following link on the CLEE website:

http://lifelong.engr.utexas.edu/clee_em/12_epd/railway_webinar.html

Jim McClellan, retired SVP for Strategic Planning at Norfolk Southern, has just released Volume I of his upcoming five-volume *My Life With Trains* series. Jim's another 20-year friend and with whom I worked as a consultant at NS during the Conrail transaction. Now he is putting down in book form more than sixty years of train photography, what he learned working for such railroad notables as Bill Brosnan, Al Perlman and David Goode, and even some of his own oil paintings.

Jim and I are contemporaries as Men Who Love Trains, to coin a phrase, or railfans to use the vernacular. Though much of Volume I is western, he also covered a lot of my eastern milieu from NYC T-motors to N&W Ys to the Seaboard and ACL. To be sure, a fair amount of this may be ancient history to today's younger fans, but, as Jim is fond of saying, things are they way they are today because of the way they were put together back in the day. And to get oneself up to speed on the institutional knowledge of railroading -- or just to relive some favorite moments, *My Life With Trains*, Volume I is a great place to go.

To whet your appetite, consider Chapter I, Volume I. Jim opens with his mid-1950s pictures of the Santa Fe, MOP, Southern Pacific, Katy, Frisco, the Rock and even the Dallas Union Terminal Seven-Spot, an oil-fired 0-6-0 of obvious SP heritage. This is primarily a picture book with enough copy to provide some space-time narrative, sparing you pages of text waxing eloquent on the virtues of the Pullman Palace cars. Chapter II takes us to the Rockies, KC and -- yes! -- Roanoke and by Chapter III we're in Philadelphia, not a mile from where I'm sitting now.

Now go to Jim's website, www.mylifewithtrains.com , get out your credit card and order Volume I through Pay Pal. At $49.95 plus $5.50 for postage etc, it's truly a labor of love, and what goes around comes around. To wit, Jim was in Dallas last month as the keynote speaker of the Southwestern Rail Advocates annual meeting, back where those pictures from the fifties were taken. But the Seven is long gone, along with all those name trains. Volume I had me digging out my Seven-Spot photos; I bet Volume I, *My Life With Trains,* will make you do the same.

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe click on the Week in Review tab at www.rblanchard.com. The Blanchard Company, © 2011.