THE RAILROAD WEEK IN REVIEW

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"Having the right resources in place to run the network drives service and velocity, which not only delivers a superior service product to our customers, but also drives productivity to the bottom line." -- Mark Manion, Chief Operating Officer, Norfolk Southern

We've now heard from all the Class Is plus RailAmerica, and the carload results are uniformly encouraging. Yes, coal vols were off big time in the US as utilities took advantage of low nat gas prices for off-peak burns and the decent weather, but growth in commodities from finished autos to frac sand and crude by rail more than offset the coal losses. And all the roads reporting to date saw the returns from running faster, smarter railroads.

Manifest carloads -- everything but coal and intermodal but including automotive -- gained from three percent (CSX) to eight percent (CP). Operating incomes grew by double-digits, mostly in the 20s. Operating ratios improved across the board with positive deltas from one point (CSX) to 11 points (CP). Capex remains at an elevated level, averaging about 16 percent of net income. Not a bad quarter, considering.

As you go through the railroad commentaries, please remember these are written mainly for owners and managers of short lines where commodity carloads other than coal and intermodal are the prime concern. I mention below the line stuff mainly to round out the picture, not in an attempt to value one railroad over another as an investment vehicle. On to the specifics.

Canadian National increased revenues by 12.6 percent to C$2.3 billion on 1.2 million revenue units, up 5.1 percent. Operating expense increased only 7.9 percent for an operating income of C$793 million; the operating ratio was down 2.85 points to 66.2, yet another industry low. Net income was C$775 million, up 16.0 percent, a loonie-seventy-five per share, up 19.9 percent.

Coal (mostly thermal) was down 10.9 percent, though at only nine percent of revenue units, and was handily offset by the 40,000 carload increase for mets/mins. Grains and ferts came down 17,000 units, 10.6 percent, yet the total merch group was up 3.7 percent to 700,000 units. Putting it all in perspective, Chief Commercial Officer Jean-Jacques Ruest said on the call:

> Q1 2012 was a record first quarter for CN. Revenue was up 12.8 percent versus last year. The breakdown is as follows: About 5.5 percent came from volume; our carload volume was up 5.1 percent, but our revenue-ton-mile volume was up 6.3 percent; same-store price came a bit more than 4 percent, slightly better than the prior quarter, consistent with our stated plans to secure sustainable, above inflation increase; 3.3 percent came from fuel surcharge; mix was overall flat; and finally, we gained 1 percent from the foreign exchange as the Canadian dollar was $0.016 weaker this year.

Note JJ talks about revenue ton-miles. With heavier loading cars and improved car-turns, RTMs give a better idea of how much freight is moving and revenue per ton-mile nails the best-yielding commodity O-D pairs. RTMs increased 6.3 percent, 120 basis points better than the revenue unit gain. CN averaged C$4.38 per RTM in the quarter: auto was the highest, C$19.40, and coal the lowest, C$3.03; merch carloads as a group earned C$4.53 and intermodal $4.59.

Looking across commodity lines, CN sees improving fertilizer, wheat and canola demand partially offset by weaker US grain exports. Lumber is regaining its footing on stronger US and Asian demand while shale-drilling, raw steel and auto sales gains are benefitting the merchandise carload mix.

CN consistently shows improved results in the operating metrics with year-over-year gains in GTMs per train-mile, cars per switching hour in its class yards, terminal dwell, trailing GTMs per available horsepower (I'd like to see short lines measure this), car-miles per day and system average train speed. Says Chief Operating Office Keith Creel,

> To support our operational service excellence mandate, we have to continue to invest surgically to create the capacity to handle our significant growth opportunities efficiently. We're running longer trains, which has allowed us to respond efficiently to growth opportunities. By the fourth quarter of this year, we will have seven additional long sidings in service, increasing by half again our capacity to handle longer trains. This in turn will give us new levels of train speed performance with the associated benefits of locomotive and car productivity.

Kansas City Southern logged a 12.5 percent gain in total sales to $547.5 million on 508,100 revenue units, up 7.2 percent, at an average RPU of $1,041, up 4.9 percent. For the first time, KCS broke out commodity lines for frac sand, crude oil and plastics, giving one a little more color than one ordinarily gets in these quarterly sessions. Another first is breaking out GTMs, RTMs, gallons of fuel consumed and price per gallon, all useful in trying to see how well the railroad is running.

Operating expense rose just 8.0 percent, propelling a nice 23.5 percent operating income gain and an OR of 71.2, down 267 basis points. Fuel expense rose 11.1 percent with the price per gallon up 8.0 percent; burning only 3.0 percent more fuel on 5.6 percent more GTMs and increasing GTMs per gallon by 2.6 percent is worthy of note.

Part of the reason is longer hauls, explained thus by KCS President Dave Starling:

> Cross Border traffic represents some of the longest lengths of the haul on the KCS network and that drives not only our revenue, but profitability as well. Cross Border volumes increased 78 percent year-over-year and revenues increased 87 percent. A 26

> percent increase in Cross Border grain revenues and an 87 percent increase in Cross Border Intermodal were key contributors.

As noted above, KCS has changed the way it reports commodity revenue and carloads. A new "Energy Business Unit" replaces the Coal group and brings in crude oil by rail and frac sand while breaking out utility coal and industrial coal and pet coke. So now we have chemicals and petroleum (all the STCC 29s ex-crude, the 29 117s), industrial & consumer, ag & minerals, energy, auto and intermodal -- a much more functional arrangement. All were up *except* energy as the utility coal downdraft of 6,000 units dwarfed the crude oil double and frack sand up 25.5 percent on a total 2,100 unit gain.

KCS reporting gets a bit "noisy" below the line what with separate items for debt retirement, foreign exchange gains (losses), non-controlling interest and preferred dividends. Boil it all down and net income to common shareholders grew 19.6 percent to $74.9 million; eps increased 16.9 percent to 68 cents per ticket. And to wrap it all up, KCS will pay a 19.5 cent per share quarterly dividend with a record date of Mar 30 and representing a yield of 1.1 percent on the current share price. Small, perhaps, compared to the 2.7 percent at NSC, but it's a start. And that's to the good.

Norfolk Southern grew quarterly sales to $2.8 billion, up 6.5 percent, on just 1.1 percent more revenue units as coal loadings dropped 11.6 percent against double-digit gains in metals/construction (thank you, frac sand and short lines) and auto; intermodal saw a more modest 5.1 percent volume gain. Total revenue units came to 1.7 million of which nearly 600,000 were in the manifest category and represented a growth rate of 5.1 percent.

Paper and ag were the only two volume decliners (4.0 and 2.1 percent respectively), however that wasn't enough to prevent the merch group from enjoying a 13.4 percent revenue gain to $1.5 billion and a 7.9 percent RPU increase. The auto group was up on increased light-vehicle production, metals/construction increased on domestic steel demand and nat-gas drilling commodities, and growth in plastics (cheap nat gas helps) and crude oil (Bakken to Philadelphia, e.g.) offset declines in rock salt. A slow-down in ferts and paper did in paper and ag.

Operating expenses were held to a 1.2 percent gain for a 24.2 percent jump in operating income to $745 million; the operating ratio dropped 381 basis points to 73.3 on a 2.0 percent drop in fuel burn against a 1.4 percent GTM decline. GTMs per gallon of fuel increased 0.6 percent. As noted above, running a faster, smarter railroad drives efficiency. NS Chief Operating Officer Mark Manion put it thus on the call:

> Train speed for the first quarter improved 2.5 miles an hour or 12 percent over the same period last year. Again, we're approaching our record-setting second quarter 2009 velocities, but with significantly more traffic. Like train speed, terminal dwell showed a significant improvement in the first quarter compared to first quarter last year, a reduction of 4.4 hours or 17 percent and equal to our 2009 performance.

> All of these service improvements equate to greater velocity and consistency, and in turn, drive productivity. Train and engine service overtime has been reduced 15 percent. Re-crews have been reduced 35 percent. The portion of [car hire] driven by velocity has been reduced by nine percent. Locomotives in service have been reduced by three percent. Fuel consumption was reduced by two percent. Gross ton-miles per gallon improved one percent and gross ton-miles per train hour has improved four percent.

Net income was up 26.2 percent to $410 million and earnings per share increased 36.6 percent on an eight percent decrease in shares outstanding. The cash flow statement is particularly impressive. Cash from ops is $1.035 billion, 252 percent of net income, enough to finance $461 million in capex, $155 million in dividends and $400 million for stock repurchases without going to the bank. How did they do it? See Manion, above. QED.

RailAmerica reported total sales of $143.4 million, up 18.5 million or 14.8 percent for the 2012 first quarter with freight revenues up $10.2 million or 10.4 percent and non-freight sales up 8.3 million or 30.5 percent. Thus the growth in non-freight sales accounted 45 percent of the total revenue growth, largely on the Port of Miami construction project and on increased car-storage fees, with out-of-service coal sets a major contributor.

Total carloads (RA has no intermodal) increased 3.2 percent to 215,741 on double-digit growth in metallic ores and minerals, forest products, waste/scrap and motor vehicles -- this last in large measure due to increased production at the Indiana Honda plant. Coal vols dipped 7.1 percent, mostly on lower Illinois Basin loadings (I suspect the ISRR) and to a lesser extent on PRB coal (the maps suggest the power plant on the north end of the MNA), leaving carloads ex-coal up a respectable 5.7 percent.

Operating expense was held to a 10.8 percent gain, yielding a 32 percent ops income gain; back out the 45G credits (there were none this year vs. $4.1 million last year) and asset sale gains and the pure railroad operating income growth rate jumps 56.5 percent to $31.7 million and the operating ratio drops 590 basis points to 77.9 from 83.8 a year ago. As one goes down the expense lines on the income statement, one is struck by the fact that diesel fuel expense drops 5.2 percent even as gross ton-miles increased some five percent.

On a pure GAAP basis, RA had to report a net loss of $40.2 million -- $0.80 a share -- due strictly to refinancing and other charges of $53.2 million (that in this quarter alone reduced interest expense by nearly a third, call it $5 million). Strip out these fees to get at the railroad returns and the net becomes $13 million, $0.26 a share, double last year’s non-GAAP adjusted net of $0.12.

For the balance of the year RA forecasts carload growth including acquisitions in the three to five percent range with core pricing around five percent, roughly in line with the Class Is and not surprising because a large portion of RA cars move on ISS divisions. The operating ratio is expected to finish up in the high 70s (calendar 2011 closed at 77.9) and non-freight revs ought to be in the $154-158 million range, again including acquisitions, vs the $140 million in 2011.

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