THE RAILROAD WEEK IN REVIEW

January 25, 2013

"The test for Warren Buffett is whether company management can transform each dollar of earnings retained into no less than a dollar of market value." -- www.buffettsecrets.com

Kansas City Southern did much better than that, creating $8.46 in 2012 market cap for every dollar of retained earnings gain. Even as capex grew nine percent year-over-year and the first full year of common-share dividends took a 23 percent payout, net cash flow after capex and divs was a solid $47 million in the black. Cash from operations -- as in 2011 -- was nearly double net income, and quarterly net income, after backing out debt-retirement costs and some foreign exchange wobbles, increased 20 percent to 92 cents a share on net income of $92 million.

Fourth quarter sales increased seven percent to $568 million on two percent more revenue units and a nominal five percent RPU gain, and coal plays a smaller part. If you combine utility coal, industrial coal and pet coke, these three were more than 13 percent of FY 2011 sales and a hair under 11 percent in FY 2012. A point and a half of the revenue delta went to intermodal and the rest to the merch carload sector, putting annual sales up seven percent to $2.2 billion.

During the earnings call, marketing and sales EVP Pat Ottensmeyer (get the slides, please, and listen to his comments) said that fourth quarter non-utility coal and coke, crude oil and frack sand made up for $12 million of the $13 million utility coal shortfall in the sector. Cross-border sales jumped 22 percent ex-ag and minerals (two percent with them), with cross-border intermodal revs up 70 percent to $12.3 million on 14,000 units, up 74 percent.

What Pat calls the five "Strategic Growth Areas" -- crude oil, cross-border intermodal, frack sand, the Lazaro Cardenas Port itself and automotive -- accounted for 19 percent of Q4 total freight revenue and grew 19 percent year-over-year. The end result is that KCS is morphing into an international railroad not entirely dependent on domestic coal or grain (this last was flat in revs and down four percent in carloads) and doing more point-to-point train ops. I'm modeling five-year forward earnings growth of 15 percent and a near doubling of stock price assuming Treasury notes remain in the two percent range. Shares closed 2012 at $82.06, up 21 percent for the full year.

Operating income rose 15 percent to $174 million for a 69.5 operating ratio, down better than two points year-over-year. Fuel was the second biggest expense increase after comp and benefits yet fuel burn went down two percent on less than a point decrease in GTM. Comp and benefits came down three points in the quarter, and purchased services another two points. Total ops expense less fuel was up less than three percent. So, even though 2013 is shaping up to be another slow grower, KCS is clearly positioning itself for a different world.

Canadian National President and CEO Claude Mongeau opened Tuesday's call citing records in revenue-unit volume, earnings and operating ratio for the year as all commodity sectors turned in positive year-over-year deltas at low incremental cost ($148 million new revs on $74 million new expense yields an incremental OR of exactly 50).

I have long maintained that CN is a financial company that masquerades as a railroad, and the 4Q2012 results support that argument. Revenue increased seven percent to C$2.5 billion on 1.3 million revenue units (up three percent) -- even with RPU down three points. Ops expense gained five percent, helped by a ten percent drop in compensation and benefits, CN's largest expense line by dollars. Operating income was up ten percent to C$922 million, taking the operating ratio to 63.6, down another point.

Below the line, net income rose by three percent to C$610; EPS adjusted for some small one-time oddities increased eight percent to C$1.41 a share. CN's share price closed out the year at C$91.01, up 20 percent, for a market cap of C$39.3 billion, up $5.4 billion. Retained earnings increased by C$789 million, so every dollar increase here became C$6.82 in market cap. Finally, the low OR also gets CN to a respectable net margin of 24 percent and a 22 percent return on equity.

The low OR comes from making better use of the assets, especially in first-mile, last-mile service and collaboration with the customer. COO Keith Kreel's slide 7 takes you through six operating measures, every one of which can be used on your short line. In his remarks on the call he mentioned "customers and supply chain partners" many times and how said collaboration has enhanced car-order fulfillment, now running at 94 percent, up 12 points in the last year.

Chief Commercial Officer Jean-Jacques Ruest says CN is "*the* [emphasis his] long haul crude-oil carrier among Class I Railroads" with more than C$50 million incremental revenues in the quarter on 9,000 carloads. Large and small diameter pipe for energy drilling helped the metals sector to a five percent volume gain. US grain vols helped push ag revs up 11 percent and intermodal box-counts increased seven percent.

CN expects "modest growth" in North America for the coming year (2012 same-store sales increased four percent) with three-to-four percent revenue-unit growth and RTMs running ahead of that, signifying longer hauls and heavier cars. The operating and net income lines will again see "high single-digit" expansion and free cash flow in the $C800-900 million range.

CSX is still suffering from its coal hangover. Revenues for the quarter and year were $2.9 billion and $11.8 billion, down two percent and unchanged, respectively. Operating expense actually came down a tad both periods, yielding operating incomes of $804 million and $3.5 billion for the quarter and year, off four percent and up one percent respectively. The quarter's OR gained 62 BP to 72.1; the year's OR came down 30 BP to 70.6. Net income after one-time items was $443, down three percent, for the quarter and $1.9 billion, up two percent, for the full year. Safety did really well, however: a record low of 0.54 reportables per 200,000 hours worked.

Q4 merchandise carloads held steady at a bit more than 600,000 units in spite of a 12 percent drop in ag vols (ethanol and feed grain), a six percent decline in metals (steel-related) and off six percent in "emerging markets" (aggregates, road salt and paper). Coal tonnage was down 20 percent and carloads declined to 26 percent of total revenue units from 31 percent a year ago.

Commodity revenues followed the same pattern, though, as Chief Commercial Officer Clarence Gooden put it on the call, "Core pricing, on a same-store sales basis, remained solid across nearly all the markets. Recall that the same-store sales are defined as shipments with the same customer, commodity and car type, and the same origin and destination. These shipments represented approximately 80 percent of CSX's traffic base for the quarter." And since this is where most Class II and III railroads live, it's a positive message.

Progress in CSX operating metrics also bodes well for the non-Class I roads and gives them some targets to shoot for. CSX matched its previous on-time departure high of 94 percent (and that's to the minute, not something else) and set a new record for OT arrivals, 84 percent. As a result, terminal dwell times are down and merchandise velocity (as well as coal and intermodal) is up. System car cycle-time is down 15 percent and merchandise car-cycle time is eight percent better, meaning CSX is making more final deliveries to more customers on time and requiring fewer local motives, cars and crew starts to do it. Short lines, please note.

In sum, perhaps COO Oscar Munoz put it best: "We have recognized there is uncertainty in the marketplace and CSX remains committed to providing flexible solutions for customers to enable growth and drive significant long-term value for share owners."

Norfolk Southern fourth quarter revenues drifted south four percent to $2.7 billion as revenue units came down 0.8 percent to 1.5 million; system RPU dipped three percent to $1,500. Coal, once again, was the culprit as revenues dropped nearly $200 million to 25 percent of total revenues from 30 percent a year ago; coal carloads fell 13 percent in the bargain. Operating expense actually came down a point and operating income was off 11 percent to $714 million. As in Q3, the drastic coal revenue haircut was the sole cause of a two-point OR gain to 73.4.

Fuel expense was down two percent even though the price of diesel fuel was up four percent; burn declined five percent on a two percent GTM drop and GTMs per gallon increased four percent. Which tells me the railroad is running better, and CEO Wick Moorman's opening remarks on the call bear out that thesis:

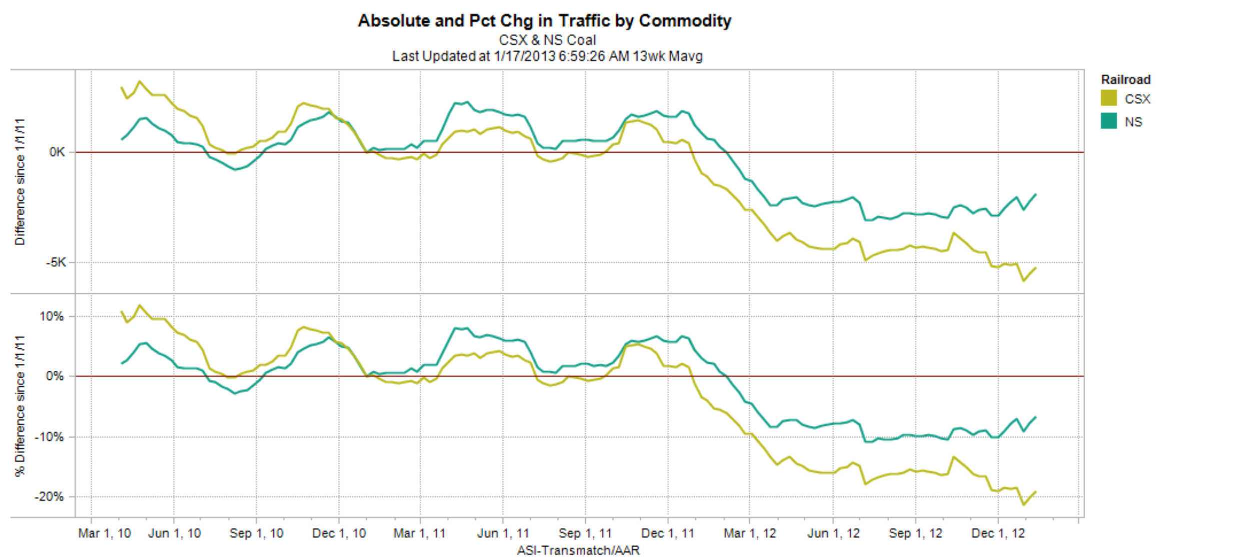
> We have maintained superior service levels throughout 2012 and we saw a continued improvement in our network velocity and terminal dwell during the fourth quarter. These items were a big driver in our ability to maintain an average composite service index at an all-time high of above 83 percent. And as we have mentioned, an efficiently-run network helps in our efforts to keep expenses under control. In 2013, we'll continue our focus on improving customer service in running our network efficiently.

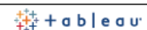
Merchandise carloads and automotive were up a point and a half; ag products turned positive as beans and feed gains offset declines in corn and ethanol. Only the metals/construction group saw a negative year-over-year delta -- mainly due to one plant closure. The merchandise outlook is for more of the same, with growth in three out of five business groups: chemicals, automotive and housing related materials. Metals/construction and agriculture will most likely start out flat to down in the first half, turning around in the second half.

I was particularly pleased to see NS putting numbers on productivity gains. COO Mark Manion says better management of T&E overtime, crew-starts, re-crews and velocity-driven car hire was worth $40 million while getting four percent more GTMs per gallon of diesel fuel was worth $17 million. Returning all the service-recovery leased power saved another $12 million, for a total of $69 mm across these half-dozen items. Manion says they aim to save another $100 million this year with more of the same.

Once again, NS is very clear about what it's doing to make the railroad run better and be a value-added supplier for its customers. I'm looking at 2013 in terms of carload sector growth in crude oil, plastics, steel, housing-related commodities and auto but a reduced U.S. corn and soybean crop, which carries its own ethanol baggage. However, realizing carload growth depends on providing a superior transportation product, and the NS Class II and III connections must perform to the same standards as NS.

I'm hopeful we'll begin to get out of these dismal CSX and NS coal comps in 2Q2013. As you can see from Drew Robertson's chart, the bottom fell out in 1Q2012. Both roads have been making marked improvements in their service design and delivery, positioning themselves for better days in the merchandise sector come spring.





Union Pacific broke records for fourth quarter and full year results. Total revenues for the quarter increased three percent to $5.3 billion and seven percent for the year to $20.9 billion. For the quarter, revenue units slipped two percent with coal's 17 percent volume decline the main cause. As noted above for the eastern roads, UP coal comps ought to start turning around in the first half (see slide 6 in the Q4 presentation). Ag products vols came down nine percent as corn took a weather hit and ethanol vols fell due to lower gasoline consumption -- more efficient cars, less joy-riding and fewer long trips.

Crude-by-rail is the big winner in the chems group with loads up 69 percent; industrial chemicals, plastics and export soda ash propelled the chems group to a 14 percent volume gain. Carload vols in the Industrial Products group -- construction, minerals, forest products and metals -- were unchanged year-over-year as declines in hazmat waste (uranium, mainly), steel, scrap and export ore negated gains due to increased construction and housing starts.

Finished vehicles were up seven percent and auto parts 13 percent thanks to pent-up demand, improved consumer credit and year-end incentives, pushing up total auto vols nine percent. Intermodal surprised, however, with vols up just two percent as international went nowhere and highway conversions were up four percent. The 2013 volume outlook calls for growth in industrial chems and crude oil, housing starts, metals, minerals, auto and export coal out of Utah and Colorado.

Fourth quarter operating income increased seven percent to $1.7 billion as ops expense was held to a one percent gain; the OR dropped 120 basis points to 67.1, a fourth quarter record. Net income was up eight percent in the Q and EPS increased ten percent thanks in part to a three percent drop in diluted shares. Fuel expense came down two percent and fuel burn dropped four percent, even with a three percent increase in fuel price.

COO Lance Fritz showed how to improve first-mile, last-mile performance by getting rid of slow-orders, decreasing car-cycle times and matching resources (active T&E crews and power) to volumes. Shortline readers who were at last October's meeting in Omaha will recall this thread in the operations presentations and these strong quarterly results assure us the momentum remains.

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