THE RAILROAD WEEK IN REVIEW

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"We are going to go back to the government and we are going to say, you either align the supply chain on an incentive basis or you regulate, and if you regulate, you should regulate it all." — Claude Mongeau, CEO, Canadian National

Mongeau made no bones about it on Tuesday's call. Excerpts:

> I believe the Canadian government effectively gave super priority to the grain business... I am hopeful that some will be wise enough to engage in the debate so that it's not just the railroad talking; that customers from all sectors will be saying, [we're] trying to make trade-offs, manage priorities, and use our normal commercial incentives… Certain customers that are more regulatory-bent are using regulatory leverage to jump the queue, getting a better deal, and making the railroad become a taxi as opposed to a bus service.
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> I think [non-grain] customers are going to see the government allowing others to jump the queue and get a better deal by going to Ottawa. I believe this was not a good decision. I think it was made in the heat of the moment for the wrong reasons and we are going to explain to stakeholders, our other shippers, and the regulators that there is a much better approach: to encourage supply chain collaboration to have the sound policy that builds on commercial incentive. [*Transcript courtesy seekingalpha*]

He concludes citing 500 grain cars sitting stock still in Vancouver over the three-day Easter weekend, not being unloaded because the receivers had those days off. I'm hopeful no CN short lines are complicit.

CN posted C$2.6 billion in first quarter revenues, up ten percent (all Canadian dollar figures are as reported, before any adjustment for foreign exchange variations), up 10 percent on 1.2 mm revenue units, up one point. Only the petrol/chemicals commodity group posted a volume gain, up seven percent, on crude oil, LPG, industrial chemicals and plastics. All other merch vols were off, pulling the group down six percent. For the rest of the year, housing, energy, automotive, grains, fertilizer, domestic, thermal coal, iron ore, intermodal, all are looking solid. Export coal looks weak; pet coke and sulfur also look weaker.

The frack sand outlook is particularly strong in western Canada. Whereas 50-car blocks are the norm now, eventually it'll be 100 car trains serving high-volume, high efficiency loop-track terminals. Moreover, lots of cheap nat gas means petrochemical manufacturers from Alberta to Louisiana can churn out more product at higher margins. Ditto fertilizers.

Operating expense was up 11 percent; operating income was C$820 million, up 5 percent, and the operating ratio came in at 69.6, up 118 basis points. Though operating metrics - train speed, terminal dwell, and car velocity - were somewhat degraded by the weather, Chicago area improvements paid off. The EJ&E gets CN trains around Chicago better than the other guys and the Kirk Yard investments added capacity. They also moved Class I interchanges out of Chicago where possible to more fluid locations like Memphis or Salem.

Regarding the call itself, Cherilyn Radbourne at TD Securities in Toronto writes, “We see CN as a relatively high-quality, low-risk industrial stock, which boasts an outstanding franchise that offers good leverage to the North American industrial economy.” Can’t argue with that.

Canadian Pacific first quarter revenues increased one percent to C$1.5 billion; grain and industrial/consumer products carried the day with revenues up four percent and 11 percent respectively. Revenue units declined six percent all-in; there was not a single positive delta in any commodity group. At least RPUs were up everywhere, pushing system RPU up eight percent. I’ve long maintained CP wasn't charging enough, however with volumes down across the board, I hope they weren’t pricing outside the perceived-quality envelope.

Grain carloads were off six percent, though the 11 percent RPU gain pushed revenue up four percent year-over-year. On the call Jane O’Hagan said exports over Vancouver made the difference and she expects high single-digit year-over-year growth in the second quarter. Sulfur/ferts took a bath in revs and vols, off 12 percent in both, due to “a late harvest and narrow application window.” The outlook is for better days to come in Q2.

I’m skipping intermodal and coal except to say both were down in revs and vols. Industrial and consumer — carloads of everything but coal, ag, ferts, forest, and auto — gained 11 percent in revs while vols drifted south two percent. Jane didn’t talk about much but crude and frack; Wisconsin sand mines will be up double-digits in Q2 from 2013’s 33,000 unit run rate.

Operating expense came down four percent with double-digit cuts in comp and rents. Fuel expense was flat: burn was down 10 percent on 8 percent fewer GTM; GTMs per gallon crept up two percent. Operating income was C$423 million, up 17 percent, for a 72 OR, down 383 BP. Keith Creel gave us a taste of how cold it was out there: Canada’s coldest Dec/Jan in 70 years; Chicago’ third snowiest winer on record with nearly six feet falling, and the third coldest winter on record; in Minnesota the sixth coldest ever. We’re taking temps of minus 16 fahrenheit, capable of cutting safe train-lengths in half. And still they cut ops expense by four points.

Below the line, net income was C$254 million, up 17 percent. Debt-to cap a healthy 38.7 percent, free cash flow after dividends, while small, wasn’t negative, FCF after share repurchase *decidedly* negative. To paraphrase Nathan Lane in *The Producers*, "Never, never, never [borrow money to repurchase shares].” My trailing five-year CAGR plus today’s dividend yield implies

an intrinsic value of $161. Stifel's John Larkin in Baltimore suggests $156. Neither of these numbers float my boat. Remain on the sidelines.

Norfolk Southern brought up the markers on the Class I quarterlies on Wednesday. Winter weather was once again a central theme and, compared with the other roads reporting thus far, it was neither the best of class nor the worst of class for NS. I must say at the outset, however, that listening to the call I felt an energy that was contagious.

Yes, it snowed and we had a crummy winter, but we learned a lot and used the forced slow-down to tweak what we have now to run better later. I get the sense that the NS network is rapidly regaining its operating feet as the weather warms, and the NS discipline in managing resources and costs in the worst of times will pay off in better times.

Take the matter of pinch-points. Essentially, there are none because the Thoroughbred Operating Plan (TOP) can identify potential trouble spots before they become troublesome, letting NS put the non-fungibles in place ahead of time — doubling Bellevue's size is a good example. Ergo no pinch points. Similarly, the TOP says they can easily expand today's 5000-foot merch trains to 8,000 feet in the same crew and power footprint. That's why I say NS is regaining its traction.

First quarter revs slipped two percent to $2.7 billion on revenue units down one percent to 1.8 million. All commodity groups but chems were down, the latter saved by crude oil and NGLs. Straight STCC 28 chemical carloads were down a point per the Week 13 carload report; petroleum products (STCC 29 plus crude) were up 28 percent. Lumber and paper went south by three and six percent, respectively. The agriculture/consumer/government group was off off half a point -- remember ferts are are in Ag at NS. Outlook is positive for crude oil, NGLs and energy-related metals/construction commodities, beans and corn.

Network velocity, yard dwell and train speed all took hits, as did safety in personal injuries and train incidents. Crew-starts were down on lower vols (Seale says they lost 30,000 loads to weather effects though they expect to regain half of that directly). Manion says they're still on schedule to bring in $100 million in operating efficiency gains this year.

Net income was down 18 percent, partly due to a $135 million land sale they had last year. Still, quarterly capex remained at the $380 million level, and free cash flow after dividends was positive, though down $147 million YOY. Debt is a comfortable 40 percent of capitalization and CFO Marta Stewart drilled down into how NS is managing debt to minimize interest expense -- interest coverage 5x in the Q, e.g. Shares closed Wed at $95, off the $98 52-week high. With a 2.2 percent dividend yield and a 17 percent CAGR-5, I can see NS at $115 and change. Larkin and Radbourne are talking $110. Time to buy on the dip?

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