THE RAILROAD WEEK IN REVIEW

April 30, 2010

"Volumes continue to gain momentum, strengthening on a sequential basis from the fourth quarter -- almost unheard of in our industry." -- Wick Moorman, CEO, Norfolk Southern

The theme of strong railroad earnings and smart employment of assets continued this week. Short lines ought to be particularly encouraged because the merchandise carload sector where so many short lines live and die is definitely on the mend. I'm not so concerned about the ISS roads because they share in any revenue gains by dint of their divisions. But where car-counts fall handling lines and switch carriers see revenue off as well as they are paid on per-unit.

The first quarter of 2009 was the second of a series of weak quarters, starting with the fourth quarter of 2008 when car-counts dropped precipitously across North America. We're just now getting back to the late-2008 levels but we're getting there with better operating ratios, improved yields and fewer assets in place to move the volumes. Herewith the catch of the week.

Canadian National's total revenues for the quarter came in at C$1.965 billion, up 6 percent on 1.1 million revenue units, up 16 percent; average revenue-per unit declined 9 percent. Merchandise carloads (defined as everything but coal and intermodal) increased 18 percent; revenues did not hold as revenue per ton-mile dipped in every commodity group but intermodal. System RPU came down 9 percent and merchandise carload yields sank 13 percent.

On the other hand, if we look at year-over-year dollar changes in what EVP and Chief Marketing Officer Jean-Jacques Ruest calls "constant currency" (without the impact of fluctuations in foreign currency exchange rates), the picture is encouraging. Using these rules total revenues increased 17 percent with upticks in every commodity group and double-digit gains in the shortline strongholds of metals/minerals and grains/fertilizers.

With respect to this last CN's focus on first-mile-last mile service and close customer coordination has boosted the grain car order-fulfillment rate to 96 percent as promised from 60 percent in January, 2010. Merchandise order fulfillment also hit 96 percent, up ten points from its late-2008 low point. During the call CEO Claude Mongeau said CN is growing merchandise market share "one carload at a time." This kind of reliability works.

Operating expense actually decreased 1 percent even as gross ton-miles jumped 14 percent. Fuel expense was the main culprit, up 31 percent on a 21 percent increase in price-per-gallon. Fuel burn was up 7.1 percent; GTMs per gallon increased 6.7 percent. Operating income was C$603 million, up 25 percent and the operating ratio came down to 69.3, better by 4.8 points.

Net income was C$511 million, up 20.5 percent, and earning-per-share increased 19.9 percent to C$1.08 from $0.90, though it gets better if you back out one-time events -- "items that do not necessarily arise as part of the normal day-to-day operations" in the words of CN's "non-GAAP" hand out. Take out the 2010 Oakdale subdivision sale, the 2009 EJ&E acquisition costs and the

2009 sale of the Weston subdividion and you get C$0.80 per share for the current quarter vs. C $0.64 a year ago, a nice 25 percent gain.

Wrapping up, Mongeau said the focus is on CN customers' end markets, building momentum on the economic recovery and continuing "the legacy of operational excellence" that Hunter Harrison began. Ruest says he expects to see the present trends continue in grain and iron ore, increases in aggregates and frac sand, and even an uptick in lumber and panels due in part to changes in Asian building practices.

Lastly, a nod to Mr Buffett. Just looking at retained earnings from year to year, CN over the past 12-month created C$8.91 in market cap for every dollar increase in retained earnings.
It's a theme that CSX began on their call, $8.49 to $1.00 and which UP continued at a $3.82 to $1.00 ratio.

Kansas City Southern more than doubled first quarter operating income to $108.2 million, up 127 percent. CEO Mike Haverty said in his opening remarks that it's rare to have first quarter results beating out fourth quarter results, yet that was exactly the case. Revenue increased 7 percent on 1 percent more revenue-units and operating income jumped 17 percent over fourth quarter 2009. Year-over-year comps have revenue up 26 percent and revenue-units up 15 percent. Operating expense grew only 10 percent in the quarter, (5 percent ex-fuel); the Operating Ratio shed nine (!!) points to a record low of 75.2.

Chief Operating Officer Dave Starling noted a "significant reduction" in variable cost, $4 million in reduced operating expense thanks to the new Victoria-Rosenburg short-cut and the ability to realize margins of up to 50 percent on incremental business. Bigger trains with no change in crew starts mean the railroad can now handle about 180,000 revenue units a month with little or no increase in the asset base.

Pat Ottensmeyer, EVP Sales and Marketing, said same-store pricing reclaimed the 6 percent level after having dipped to less than 4 percent in the 2008 fourth quarter. Line-haul revenues were up 6 percent, the best ever, in March ex-fuel surcharges and foreign exchange. Every commodity group reported revenue gains north of 20 percent with the merchandise carload groups accounting for 76 percent of total freight sales. This is really good business for KCS as it accounts for slightly less than half the total revenue units and carries an average RPU of $1,437 -- half again the system RPU of $945.

Net income available to shareholders of the common stock was $32.6 million against an $8.1 million loss a year ago. Earnings-per-share came in at $0.34 vs. a loss of $0.09 a year ago. The adjusted eps was $0.44 (after adding back the one-time charge of $0.10 for debt retirement in the present quarter), which compares favorably with the $0.34 eps in the prior quarter. Retained earnings increased $81 million year-over year while the excellent stock price performance added $2,336 to the market capitalization. That's a $28.76 to $1 return. Nice.

Norfolk Southern's first quarter year-over-year results include a 45 percent operating income gain on 9 percent more revenue units, 15 percent more revenue and operating expense increase held to 9 percent (2 percent ex-fuel) for a best-since-Conrail first quarter operating ratio of 75.2,

down five points from the 2009 first quarter. The sequential story deserves special mention. Revenues and revenue units were up every quarter from the low posted in first quarter 2009 and revenue per unit increased every quarter since the second quarter 2009. Net income and diluted earnings-per-share both rose 45 percent.

Here again volumes grew without a corresponding hike in train starts, down a point year-over year though increasing every quarter since the low of 5,500 starts per week posted in June of last year to 6,000 starts at the beginning of March 2010. The harshest east coast winter in recent memory did not seriously degrade car-miles per day, handlings per car, or cars per day between OD pairs. (During the Q&A Wick said the average merchandise train runs 73 cars and they can go to 90 without pushing the asset envelope.)

This kind of performance pays off in merchandise carloadings as customers see increased reliability and predictability in their supply chain. This commodity group represents 54 percent of total freight sales for NS Revenues, up from 50 percent a year ago, directly offsetting the 3 percent dip in coal (more on that in a minute). Total merchandise revenues increased 23 percent on 16 percent more loads, pushing a respectable 6 percent gain in RPU. Every merchandise commodity group, paper-clay-forest excepted, posted double-digit volume gains.

On the call during his formal remarks EVP and Chief Marketing Officer Don Seale pointed to 52-week volume highs in every commodity but automotive; the agriculture group produced the second-highest quarter thanks to ethanol (up 23 percent), export grain (up 5,200 loads for a whopping 450 percent gain) and fertilizers (up 128 percent). Intermodal and paper shipments took a small hit from over-the-road truck competition and shorter hauls in the mix -- paper's RPU skidded 3 percent).

The decline in domestic steam coal just since the 2008 first quarter is the major headache here. Two years ago NS moved 46 million tons of coal of which 76 percent was for domestic utilities. In the quarter just concluded NS hauled 40 million tons of which 70 percent was steam, a 22 percent decline in tonnage.

Export metallurgical coal, however, is now 15 percent of the total, up from 12 percent two years ago. Moreover, it's up 39 percent year-over-year due to the 30 percent jump in global steel production in the quarter. Said Seale, "Coal through our Lambert's Point facility was up 25 percent, while the Baltimore volume was up 125 percent in the quarter. Volume growth was driven by continued port congestion in Australia, strong Asian demand, and China's exit from the export Coke market, which continued to create opportunities for Coke producers in other countries."

Finally, though my shortline readers don't really do much intermodal (which is a shame because they could facilitate a lot of truckload conversions for transportation buyers in their service areas), a word on the domestic-international mix that NS sees is instructive. A faster intermodal network necessarily connotes a faster carload network -- see car-miles per day, above. Total intermodal boxes grew 11 percent year-over-year with domestic up 23 percent and international gaining but 3 percent. Making domestic intermodal a more attractive option are - according once

again to Seale -- the tightening of truckload capacity, rising diesel fuel prices and less rate discounting.

NS sees the rest of 2010 as yet more year-over-year improvement with gains in agriculture (ethanol), steel (autos to appliances), met coal and industrial products while paper, lumber and building products remain under a cloud. The one thing I would have liked to hear more about is how NS is progressing with its corridor initiatives: Crescent -- northeast to southeast, Heartland -- Midatlantic to Midwest, and Mid-America -- midwest to south east (and with a short line in the middle).

Seale touched on them briefly in the Q&A but there's more. In his June 2010 *Trains* column Fred Frailey says the Crescent Corridor could be "Wick's crowing achievement." I agree and bet the Street would like to hear more about the effect on ops metrics, operating income, earnings and shareholder returns.

Canadian Pacific's first quarter results look one way under GAAP and quite another way in constant dollars. Starting with revenue units the theme of consistent quarterly improvement for four trailing quarters continues. GAAP revenues did likewise and system revenue per unit was the highest in three consecutive quarters.

Reported year-over-year revenue increased 6 percent (FX-adjusted 15 percent) to C$1.7 billion, operating expense came down 2 percent (3 percent ex-fuel) and operating income rose 55 percent to C$205 million, taking the operating ratio down 5.7 points to 82.4 in the bargain. Net income jumped 74 percent to C$100 million ($102 million ex-foreign exchange) and earnings-per share rose 66 percent due in part to a 5 percent growth in diluted shares.

Year-over-year revenue units increased 8 percent, gross ton-miles increased 15 percent and -- better yet -- revenue ton-miles jumped 17 percent due largely to long-haul export potash. Ray Foot, GVP for Sales, said in his presentation he sees strong grain demand and volumes in the US while trans-border lags, export coal volumes up 30 percent due to Chinese steel production and single-line ethanol from Canadian producers to markets in the US Northeast.

The forest products commodity group saw longer paper pulp domestic hauls and the auto group rang up a 60 percent volume increase on growth in cross-border and long-haul lanes. Intermodal units increased a scant 2 percent and sales were up 7 percent (11 percent FX-adjusted). Domestic box counts were up year-over-year for the quarter; imports through west coast ports increased as Canadian retailers replenished inventory.

As for the rest of 2010, Foot acknowledges the economy is improving but how fast is open to question. Grain loads look about like last year with some exports through the West coast. Fertilizer is having a good first half while the outlook for the summer months and beyond is murky. Coal for China is a bright spot while ethanol and autos will carry the day for the industrial products side of the house. With 63 percent of sales and 48 percent of revenue units coming from the carload commodities, the outlook for CP's short lines is encouraging.

Brock White, SVP Operations, said the 15 percent gain in GTMs required just 6 percent more train-starts, 8 percent more cars in use and 3 percent more locomotives while increasing train weight and gallons per thousand GTM 8 percent and car-miles per day 3 percent. Train speed was off 3 percent due to the mix of more bulk trains, some terminal issues in Vancouver and heavy snows in the US. Still, expense per GTM improved 11 percent, excluding fuel and FX.

CEO Fred Green wrapped up the presentation saying his crystal ball is cloudy beyond the second quarter and he's "looking forward to having a more fulsome discussion" with analysts at the CP Investor Day in Calgary June 2. I will be there.

I'm leaving write-ups for Genesee & Wyoming and RailAmerica for next week lest I turn this nominally three-page letter into a novel on the scale of *War and Peace*. Suffice to say for now that both turned in encouraging results that bode well for the shortline community as a whole. Both will be well-represented at the ASLRRA Annual in Orlando this coming week. Look at the presentations on the websites, download the supporting material and button-hole any one of their representatives over drinks. I wager you'll come away favorably impressed.

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