THE RAILROAD WEEK IN REVIEW

May 6, 2011

"On a non-seasonally unadjusted basis, 15 of the 20 commodity categories tracked by the AAR saw carload gains on U.S. railroads in March 2011 compared with March 2010." -- AAR

The quarter now has ended and the patterns begin to emerge. Let's look at March, 2011 for starters using my favorite treasure trove of rail and economic data, the AAR's *Rail Time Indicators*. Combined US and Canadian revenue units were up five percent year-over-year and 14 percent against March, 2009. Traditional carload freight including grain and coal but excluding intermodal increased three percent in March, 2011 over the prior year and 13 percent over March, 2009.

The chemicals commodity group was up 10 percent in March, 2011 over the previous March and -- including petroleum products -- accounted for a little more than half the carload increase 2010-2011; it was March, 2011's third largest volume producer after coal and ag products, both STCC oh-one and 20. Coal has been a disappointment, up one percent over March, 2010 and two percent over the same month in 2009. March 2010 ag products actually slipped three percent vs. March, 2010 but were up six percent over March, 2009. The metallic ores and minerals group, representing about ten percent of merchandise carloads, has come on strong, now 55 percent ahead of where it was in March, 2009.

To which *Rail Time Indicators* adds, "Chemicals carloads for March, 2010, posted the highest weekly average for any month in history. Ethanol (which the AAR considers a chemical) is part of the reason, having increased from fewer than 40,000 units in 2000 to more than 280,000 units in 2009 (the most recent full year for which data are available). In 2009, ethanol accounted for 1.1 percent of US rail carloads, up from 0.1 percent in 2000."

Turning to the longer view, the April *Rail Trends Indicators* shows that year-to-date average weekly US plus Canadian revenue units still lag 2006, the year the AAR has pegged as the "peak year." Weekly loads came to just under 700,000 in March, 2006 whereas March, 2011 only produces something on the order of 640,000 revenue units. True, the Jan-Feb-Mar curves for 2010 and 2011 mirror the 2006 curve, just at lower levels with the 2011 curve about midway between the other two.

Which brings us back to first quarter, 2011 revenue-unit counts. All the Class Is save CP were up year-over-year, though not by huge margins; call it mid-single digits. Where it gets interesting is in comparing sequential quarters, first quarter 2011 vs fourth quarter 2010, and so on back for six quarters. I'm finding the rate of change between 4Q2010 and 1Q2011 to be less than between 3Q2010 and 4Q2010, and that was mostly less than between 2Q2010 and 3Q2010. It seems 2Q2010 was sort of a high water mark since 4Q2009 with rates of change slowing since then.

Which leads me to relative Class I railroad performance over the past few years. What triggered the thought was this week's CSX announcement of a three-for-one stock split, a 38 percent

increase in the quarterly dividend on its common stock, and a $2 billion share buyback program. The new quarterly dividend of $0.36, or $0.12 on a post-split basis, is payable on June 15, 2011 to shareholders of record at the close of business on May 31, 2011. The stock split will be for all shareholders of record at the close of business on May 31, 2011 with a distribution date of June 15, 2011. The new share buyback program is authorized to begin immediately and is expected to be completed by year-end 2012.

CSX has certainly been on a roll with its share price exactly doubling over the past four years as 2010 revenue was up 11 percent over 2006 and operating income rose 57 percent even as 2010 revenue units lagged the 2006 numbers by 13 percent. Below the line, 2010 net income was up 19 percent over 2006 and earnings-per share increased 44 percent, thanks in large measure to share buy-backs. And oh, yes: the OR dropped 8.6 points to close at 71.1 on Dec 31.

To put CSX's performance in perspective, I looked first at its closest neighbor and competitor, NS and then extended my view to the UP and the two Canadian roads (no full BNSF comps due to the Buffett buyout). Looking at 2010 vs 2006, I found NS revenues were up one percent on 14 percent fewer revenue units, yielding less than a five percent operating income gain. Net earnings increased one percent while earning per share grew 12 percent. The OR shed one point, 72.8 to 71.9 and the share price as of Jan 1, 2011 had gone up 30% over four years.

UP was another big winner, increasing share price 111 percent as revenues were up eight percent and operating income jumped 73 percent even though vols slipped 11 percent. Net earnings jumped 73 percent though earnings per share slipped six percent. Canadian National 2006-2010 saw shares rise 56 percent as earnings per share grew 15 percent on essentially flat net income and operating income while units slipped three percent and revenue increased just over seven percent. The OR increased three points in the bargain.

Canadian Pacific was the laggard in share price gain, up 18 percent on nine percent more revenues, two percent more revenue loads and a one percent drop in operating income. Net income dropped 18 percent in the four-year interval with earnings per share losing 23 percent. The operating ratio worsened by three points.

One last thing: to sanity check current stock prices, I do a quick risk-adjusted "intrinsic value" calculation using the past year's earnings per share, the anticipated growth rate, and a "risk free" rate where I follow Buffett's lead and use the ten-year treasury yield, now 3.2 percent. Then I take the share price as a percent of the intrinsic value and subtract that from one to tell me what sort of a discount off the intrinsic value today's price represents. Using share prices as of Dec 31, 2010 I find NS with the steepest discount, 33 percent, followed by CN (28 percent), UP (27 percent) and CSX (23 percent). CP, alas, is trading at fair value.

As it happens, Peter Nesvold, the lead rail analyst at Jeffries & Co, sent out a note last week commenting on Norfolk's hockey-stick stock price rebound since the earnings call, citing an "enormous sentiment swing over the past two weeks." Here's where I turn to the NS earnings call transcript to see what might be going on.

The NS first quarter presentation was, I think, a superb call that had more movement and transparency than they have had for a long time or maybe even ever. I'm not alone in that sentiment, either, based on recent conversations with a few analysts who were on the call. And let's face it: how the Street perceives a company based on the quarterly calls creates momentum, and, as we're reminded daily, it's the institutional investors who do 85-90 percent of all trades. If they're not trading a stock there's no momentum.

A good place to check the impact of momentum is the Charles Schwab "Equity Rating Report." These six-page notes are 100 percent quantitative, so peer comps are all based on the same numeric ratios. So to sanity-check my momentum thesis, I brought up the Schwab Equity Report on NSC and found they have upgraded NSC to Outperform from Market Perform and momentum was the driver.

Says Schwab, "The Momentum Component uses several measures of short-term changes in investor expectations, including the sentiment of brokerage firm analysts and the overall market. Momentum grades can change at any time and will generally change more frequently than the grades of the other Components." Completing the circle, if Schwab upgrades on momentum and my Intrinsic Value screen shows NS with the largest discount, it could be we're on to something.

Now back to the transcript (it's clearly marked on the investors page at www.nscorp.com). CEO Wick Moorman sets the scene right away: "We anticipate that our continued focus on service delivery will result in customers moving more traffic on our system. This in turn makes our railroad more efficient, which then leads to our ability to generate more cash to invest and provide superior returns to our owners." My immediate take-away is that short lines can do a lot to enhance the NS line-haul product with crisp first-mile, last-mile performance.

In my channel checks I've found a number of short lines critical of NS pricing practices. Here's what Chief Commercial Officer Don Seale has to say: "Over the long-term, revenue per unit is as good an indicator of where our business is going as any; we haven't changed our philosophy about pricing at all." And this may explain why some short lines have seen price hikes that may not have been in the best interest of some customers: it could be NS has other customers that can use the same equipment at higher rates of return.

And here's a tidbit from COO Mark Manion in the context of a thousand new T&E hires: "The new hiring isn't just for the new traffic growth we're experiencing now. This is the traffic growth we are projecting a year from now." Does that mean volumes in first quarter 2012 will begin to approximate what vols were in first quarter 2008? The present quarter was 1.7 million units; the 2008 first quarter was north of 1.8 million units, suggesting a seven percent increase over the next three quarters. That's perhaps the best take-away of all.

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