THE RAILROAD WEEK IN REVIEW

April 26, 2013

"Our ability to handle peak volumes in a difficult winter period is a very positive statement on the way we create value for our customers and shareholders." -- Claude Mongeau, CN

Six Class Is have reported first quarter earnings and I have car-counts from the seventh. I track year-over-year percentage changes in nine metrics: railroad revenues, revenue units, RTMs, merch carload revs including auto, merch carload vols, merch RPU, operating expense, operating income, operating ratio and point change in operating revenue. They rank as follows.

BNSF was best of class in revenue unit change, up 4.2 percent, a number one gets from bnsf.com and is the only metric you get until the Berkshire 10-Q comes out later in the quarter. UP came in last, down 2.3 percent. CP, thanks mainly to its more aggressive pricing (I have long maintained they were under-pricing), won the honors in railroad revenues, RTMs, merch carload revs, merch carloads, merch RPU, operating income and OR improvement.

CSX won operating expense change; CN did best in OR and worst in ops deltas for ops expense, ops income and operating ratio point change. KCS got four worsts: RTMs, merch carload revs, merch carload count and RPU. NS took last place in total revs change; UP was worst in total revenue unit change. It's kind of ironic that CN and CP should exchange best and worst for changes in operating income, operating ratio and OR point change. I guess what goes around comes around. On to the the specifics in the order presented Monday-Wednesday.

Canadian National first quarter operating income was C$780 million, down 1.6 percent against 1Q2012 even though revenue units increased 2.2 percent and RTMs were up 3.1 percent. Total freight revenues increased 5.5 percent to C$2.3 billion though operating expense increased 8.6 percent due mainly to the cascading weather-related service interruptions on the west end, pushing the OR *up* 217 basis points to (gasp!!) 68.4, a number other roads are striving for on the down side.

Below the line, net income was $C555 million, off 28.4 percent because of "other income." Last year CN sold properties worth C$293 million and only did C$42 million this year. Common shares garnered C$1.30 apiece, down 25.8 percent vs a year ago; the smaller spread owes to a 3.4 percent decease in diluted share count. Absent asset sales, earnings per share came to C$1.22, up 3.4 percent.

The merch carload group including automotive posted a 5.5 percent gain in RPU; all commodity groups save chems posted single-digit gains in revenues and revenue units were flat to down. Crude-by-rail and intermodal saved the day in both revenue and units yet at quarter's end system average RPU was off 3.2 percent. CN had its second-heaviest quarter ever in terms of RTMs.

Throughout the call, every speaker starting with CEO Claude Mongeau talked about how a particularly nasty winter impeded free movement for this particular outdoor sport -- railroading. Six operating metrics tell the tale. Train and yard productivity (GTMs/train mile and cars per yard switching hour) both improved sequentially and year-over-year. However, hours of yard dwell, trailing GTMs per available horsepower, car velocity in miles per day, and system average train velocity did not. But here's where resiliency pays off: just 17 days into the second quarter all four quarterly laggards had recovered to meet or exceed previous quarter and year-ago numbers.

Chief Commercial Officer J.J. Ruest says volume and mix accounted for about half the revenue increase; price was the other half. The impact of foreign exchange and fuel surcharge was "negligible;" same-store price increases hovered around 3.5 percent. Crude-by-rail revenues were up four-fold. Mets and mins revenues increased on frack sand, pipe and steel. Lumber and panel to the US housing market increased though Canadian grain vols and revs both dropped 13 percent. US grain revs increased 6 percent on no vols change. Soy bean and fertilizer carloads were strong. Crude-by-rail leads the outlook for the merch side of the house with what JJ calls "energy consumables" --frack sand, pipe, construction aggregates -- as back up; building materials posted smallish gains.

Norfolk Southern reported first quarter revenues of $2.8 billion, down 1.8 percent year-over-year on 1.8 million revenue units, up 3.1 percent. System RPU declined 4.7 percent, largely on coal's shift to shorter-haul moves and borne out by the 4.8 percent gain in RTMs and the 4.4 percent GTM increase. Operating expense was unchanged so the revenue decline put ops income down 7.2 percent and the operating ratio gained 147 basis points to 74.8.

Below the line, net income was an all-time best, $450 million, up 9.8 percent thanks to a $99 million property sale gain plus another $36 million other income. [*Note to PWX-watchers: <u>this</u> is where you put property sales, not above the line. -- rhb*] The diluted share-count dropped 4.4 percent; eps gained 14.9 percent to a buck-forty-one. CEO Wick Moorman said in his opening remarks that the quarter was "second best-ever first quarter in revenues, operating income, net income and earnings per share."

Merch carload vols were down half a point. Declines were in the mets/construction and ag/consumer commodity groups, though pricing helped the merch sector to a 2.3 percent revenue gain on 3 percent higher average RPU. Ag products were down 3 percent on lower raw corn vols and ethanol plant closures. Ferts will likely be up in the second half due to low carryover grain inventories and anticipated increases in acreage to be planted this spring. The STCC 24-26 group posted positives in dimensional lumbar and panels (up 11.0 percent) while printing paper remains in a funk. No comment on packaging.

Chems vols increased mainly on crude-by-rail (CBR) -- 13,000 units in the quarter. As the total volume delta in chems was 10,000 units, the CBR gain masks a 3,000 unit shortfall in the other chems commodities. Asked about growing the CBR business, Wick says service will always win because shippers are leasing some very expensive equipment and turn times can count for as much as or more than dollars per revenue unit. At the moment, crude is 65 percent unit trains, the rest manifest. That is bound to change to more unit trains as vols grow and turn times become even more critical.

Intermodal remains the bright spot, with vols and revs both up nine percent. NS is now running 95 percent of intermodal boxes in stack service, up five points since a year ago, and making it possible to add this level of volume on a mere one percent crew-start increase. Wick said during the Q&A that as they pick off the low-hanging fruit they will continue to reach for the higher branches with better and better service offerings. Read boxes per platform, per train start and per track-mile. Chief Operating Officer Mark Manion said they're reserving the longest trains for the Chicago-east corridors where they have multiple tracks and Rule 261 running. Elsewhere NS is finding 5,500-foot trains and 8,000-foot passing tracks are adequate.

The merch outlook is mixed with crude-by-rail goosing chems counts, more finished vehicles and continued housing-start growth. Mets/construction and ag products will likely have to wait until the second half to see any meaningful positive deltas. Coal is grim: nat gas eating into share in an already reduced power market, domestic and off-shore met coal sluggish. Says Chief Marketing Officer Don Seale, "Makes this market choppy and uncertain at best." Export thermal coal doesn't look much better.

My main take-away is that NS is cleverly using the change from a largely coal franchise to a merchandise and intermodal franchise to make the whole run better, faster, cheaper. The crude-by-rail and intermodal business models are winning converts on consistent performance and protecting the interests of those who have made significant investments in the rail aspects of their supply chains.

Canadian Pacific brings up the markers on the Class I earnings season. CEO Hunter Harrison's opening slide on the earnings call set the tone perfectly: in HUGE type, "Operating ratio -430 Basis Points, Earnings per share +51% ." All of which is true. Freight revenues increased 8.9 percent to C$1.5 billion and ops income hit C$362 million, up 32.1 percent as ops expense increased only 2.8 percent. The OR dropped to 75.8, a 4.3 point improvement over a year ago. Net income was C$217 million, up 52.8 percent; per-share earnings came to C$1.24, up 51.2 percent on a 2.2 percent diluted-share gain.

Played down was the lackluster revenue-unit performance, up half a point to 659,000 all-in, though RTMs were up 10.2 percent as system RPU gained 8.4 percent. Fuel surcharge fees added a point and there was little foreign exchange noise. Bulk commodity carloads -- grain, ferts and coal -- were up three percent and RTMs were up 11 percent as all took RPU increases. Intermodal lost four points in revs and vols and five in RTMs with no significant RPU delta.

The story repeats in the merch carload sector: carload vols up 3.1 percent, revs up 14.0 percent, RTMs up 14.8 percent. But if you break out the STCCs, you'll see auto vols off 16.7 percent, forest flat and industrial up 10.4 percent, mainly due to the rapid growth in crude-by-rail. On the call, Chief Commercial Officer Jane O'Hagan said CBR vols are up by more than a third and they expect a run-rate of 70,000 units per year. Frack sand is another double-digit grower.

There can be no doubt the railroad is running much better. Newly-tapped President Keith Creel says terminal dwell and train length both improved by nine percent and tonnage per train by 12 percent. Says he, "The key ingredient to railroad success is asset utilization. You can move more freight with the right-sized fleet, keeping the pipeline fluid rather than clogging it up with more locos and cars than it can sustain." For example, CP moved 13 percent more grain into Vancouver with ten percent fewer cars. That'll be useful in Q2 when CP expects to see double-digit year-over-year volume gains.

Among Class Is, CP was the third from bottom in revenue unit changes at down half a point. CSX and UP did worse, though the diversity of their respective franchises is considerably greater than CP's and with the stronger franchise goes better odds for faster recovery. I will need another quarter with similar gains and a clearer crystal ball for the second half and beyond. That said, CP's Class II and III railroad connections can help the supply chain picture by growing their higher RTM customers, pulling back from high -VC, low RTM business and turning cars faster.

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