THE RAILROAD WEEK IN REVIEW

June 7, 2013

"Our stake in CP has grown to approximately 26% of the combined assets of our funds. Given that increased concentration, portfolio management considerations have driven our decision to trim our holdings." -- Bill Ackman, CEO, Pershing Square Capital Management, L.P.

Pershing said on Monday it plans to sell up to seven million shares of Canadian Pacific common stock starting June 10. They will conduct the sales through "unsolicited broker transactions" on the NYSE and the TSX in amounts that will not exceed 10 percent of the combined NYSE and TSX volume for the CP common shares on any day of trading. It won't be a fire sale, however, as they're spreading the sales out over the next six to twelve months.

Say they do it in six. CP shares change hands at the rate of half a million a day, so it's not like there's going to be a rush for the exits. Figure the float is 150 million shares so this sale is a mere five percent of that. If the average sale price is $120 and the average share appreciation is $50, there's a cool half-billion profit. The railroad has a viable franchise, has a distinct competitive advantage in bulk commodities, and as vols come back the HH efficiencies will translate into higher margins, lower operating ratios and improved shareholder returns.

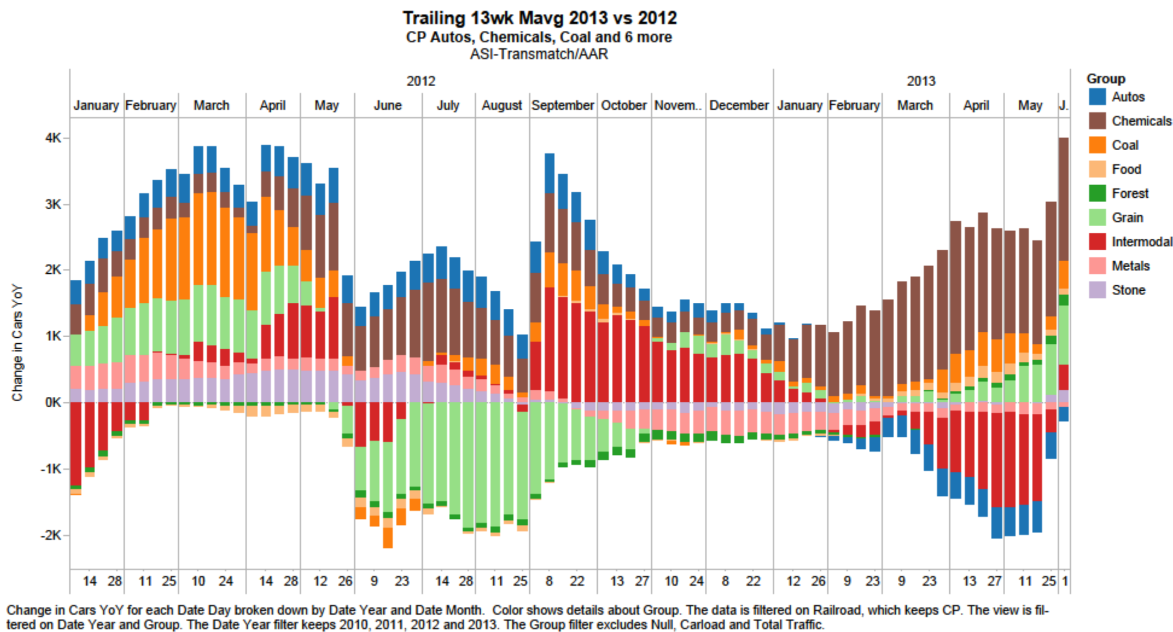
Ackman attributes the reason for his decision to reduce his holding in the company to the share price doubling over the past year. CP shares now represent more than a quarter of the combined assets of his funds and so, it is argued, it is prudent to rebalance holdings in the name of "portfolio management." Quoth Zacks,

> Having said this, we wonder that if portfolio readjustment is the only reason why Pershing Square is giving up stakes in a high potential stock, which tripled in its market value in past one year. Canadian Pacific is experiencing financial growth from volume addition, safety, efficiency and, cost metrics. Additionally, pricing above inflationary levels (3–4% year over year growth) is expected to aid revenue growth in 2013 and beyond.

Makes me wonder, too. With all these superlative forward metrics, what else is going on? When AXP, KO or WFC increases in price, does BRK sell to maintain "portfolio management considerations" or some such? I think not. Buffett's forte is buying companies he likes and holding them "forever." Pershing rode into town vowing to fix the railroad and save the shareholders. If Ackman's selling off a chunk now that he's got some gains (even Cramer will tell you "taking some off the table" after a run up is sound), does he know something I don't?

Once again it must be said that revenue-unit volumes drive freight sales revenue, and revenue changes have a bigger effect on operating income than expense changes. So you can't save your way to prosperity if units sold and market share are not improving. I tend to look not only at

year-over-year comps but also at sequential comps, and it's here Drew Robertson's 13-week moving-average charts are especially valuable.



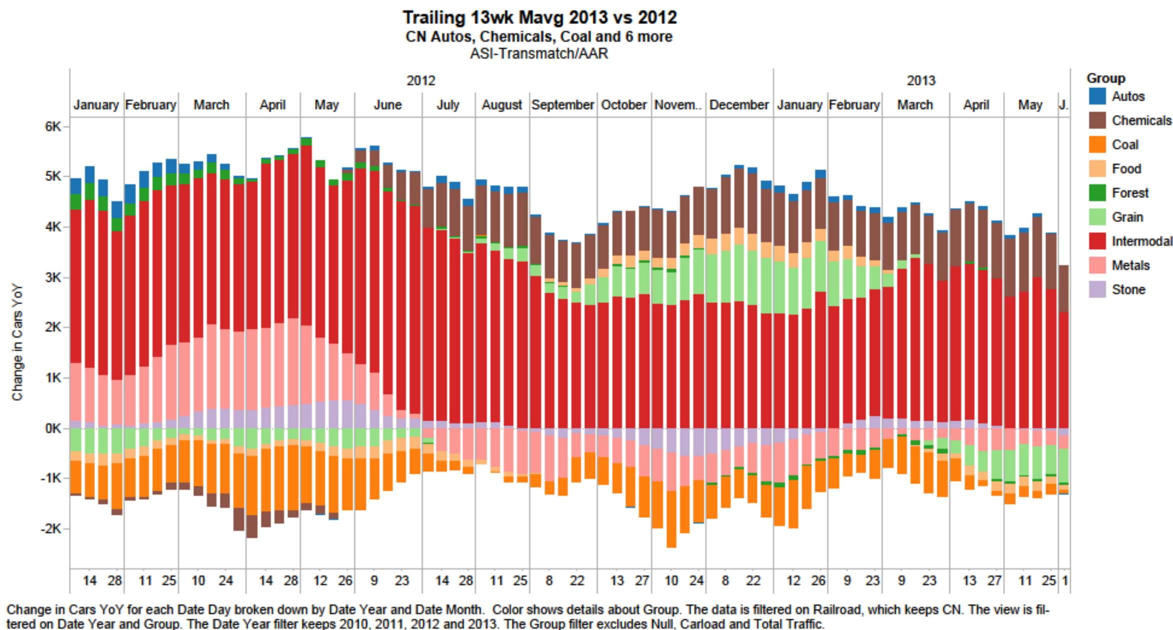
Change in Cars YoY for each Date Day broken down by Date Year and Date Month. Color shows details about Group. The data is filtered on Railroad, which keeps CP. The view is filtered on Date Year and Group. The Date Year filter keeps 2010, 2011, 2012 and 2013. The Group filter excludes Null, Carload and Total Traffic.

The right-most bar compares the 13 weeks ending June 1, 2013 with the like period a year ago. That first bar in June, 2012 shows a 13-week moving average of, say, 1,500 units with autos, chems (mainly crude oil), and stone making up most of the upside with intermodal and grain dominating the downside.

Now jump to the most recent bar. Total units are double and you can see the upward trend that pulls the moving average. There are more commodities above the line than below. Chems (mainly crude oil) is nearly half the upside volume with grain in second place. Intermodal and coal have turned the corner but automotive has slipped to the down side. And crude oil has displaced coal as the volume leader.

In comparison, CN shows no such volatility, just a continual slide in total units June-June. A year ago, crude oil had only just begun to move the chemicals needle, intermodal was the volume leader and coal (only eight percent of revenue to CP's ten) had started to turn positive. Over the next 12-months, CN's moving average for units and commodities drifted downward, reflecting an uncertain economy and a softening of demand across its franchise.

More important, especially to beneficial owners, receivers and share-holders, you can see clear continuing trends in the intermodal and chems moving average bars remaining above the line with stone, coal and now grain lagging. Lacking is the barbell shape that formed for CP Sep 2012 to now. And CN's intermodal leadership is significant.



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CP and the long-gone Rock Island are similar in that every place they go, somebody else goes there better. Two out of every five revenue dollars on CP are bulk-related: coal, grain, sulfur/ferts. Moreover, the same percentage of freight revenues are "global," which I take to mean beyond North America since CP provides a separate break for "cross-border" to the US. Which tells me 40 percent of revenue dollars depend on the kindness of overseas governments and where coal, grain and potash can come from Australia or Indonesia rather than Canada.

Finally, HH made a point re acquiring short lines during his lunch-time Q&A at Wolfe last month. His point is well taken: why should I pay a short line 20-30 percent of my revenue to support an OR in the 90s or worse when I can keep all the revenue and see only 70 percent or less go up the stack in ops expense? That's what he did at CN and led to the acquisition of the Quebec Central's three lines in 2008 and the Athabasca & Northern in 2007, among others.

If I had a CP short line, I might see what my operating income would be if I had an OR of 70 and then run the numbers to see what it would take to get it there. If it turns out I have a railroad that would work better with fewer fixed assets and employees on the books and I have a solid 25-mph railroad where a mechanized track maintenance "blitz" could keep me there for less, I might have a story for HH. If not, at least I'd know more about my own competitive advantage.

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