

THE RAILROAD WEEK IN REVIEW

July 26, 2013

“We’re giving our marketing team a hell of a product to sell and they’ve got to go out and convert it in the marketplace.” -- Keith Creel, CP Chief Operating Officer

Canadian National revenues for the second quarter were up five percent to nearly C\$2.7 billion. This was a record quarter for rail freight revenues, gross ton-miles, revenue ton-miles and carloads. All in all, revenue-unit volume was up 2.4 percent and RTMs up five percent. Ops income was a quarterly record C\$1.0 billion, up six percent versus last year, as ops expense was held to a four percent increase. CN’s operating ratio was 60.9 percent in the quarter, which represents an improvement of 40 basis points versus last year.

Reported net income for the second quarter is C\$717 million, up 14 percent; reported diluted EPS stands at \$1.69, up 17 percent versus last year. Excluding the impacts of a deferred income tax expense and the gain on the exchange of easements, the adjusted diluted EPS stands at \$1.66 in 2013, which represents an 11 percent year-over-year increase.

CN is a carload-intensive railroad and runs like one. Merchandise carloads -- all but coal and intermodal -- account for 67 percent of RTMs and 70 percent of revenue. Within the group, vols across the individual commodities ranged between up two percent and down one percent yet merch average RPU went up seven percent, taking up total revs for the group a seven percent as well. Intermodal once again takes the brass-ring on vols, up six percent; grains and ferts brought rear, down four percent. Coal vols were up a point.

As for chems, AAR data shows the group up 5.4 percent, with STCC 28 chems running 2:1 ahead of petroleum. CN reports pets and chems up two percent on a third lower vols; I suspect the spread is chemical fertilizers in the grains and ferts group. As such, CN reports chems group revs including crude-by-rail up 17 percent on two percent more units.

Two threads are at work here. On the revenue side, same-store pricing, including coal, was up three percent. On the expense side, strict expense control continues to carry the day. Train productivity improved by 1 percent, allowing more traffic to be moved on the same number of trains. Cars handled per yard switching-hour improved by 10 percent. Terminal dwell also improved by 1 percent. GTMs per available horsepower was up slightly and car-miles per day improved four percent.

Even with smallish volume deltas, CN once again proves that if you truly understand the value of end-to-end railroading in the supply chain, you can generate faster equipment turns with shorter dwells and faster trains. In turn, you get better train and yard productivity. And once again CN proves that it costs less to run an efficient railroad. The 60 OR speaks volumes.

Norfolk Southern's second quarter revenues declined three percent to \$2.8 billion on two percent more revenue units and a five percent drop in system RPU. Operating expense increased one percent as comp and fuel each rose just three-tenths of a percentage point. Operating income declined 11 percent to \$836 million and the OR gained 266 basis points to 70.2. Net income of \$465 million was down 11 percent and diluted EPS was \$1.46, down nine percent.

Coal continues to be the culprit. Carloads dropped four percent as declines in export, domestic met and industrial coals more than offset the three percent uptick in utility coal. Weaker steel production, the overhang of the RG Steel bankruptcy, global competition in the export markets, and sluggish industrial demand were the main contributors. Moreover, utility and export lanes shifted to more short haul which in turn limited RPU gains. Illinois Basin and Northern App coal increased as percentages of the whole; Central App, Southern App and PRB coal did not.

As one has come to expect, Intermodal once again is the volume hero, up five percent on domestic traffic gains from new Crescent Corridor Lanes and continuing highway conversions. The percent of containers on stack cars stands at 95 percent, up four points in the year and the five percent volume increase took only two percent more crew starts.

Three out of five merch carload commodity groups were down -- three out of four if you exclude automotive, which really isn't a single-carload commodity anyway. Met-con was off five percent; ag and paper were off one percent each. Chems increased 16 percent thanks to 20,000 carloads of crude oil, dropping pure STCC 28 carloads to ten percent gain, but they still represent 82 percent of the reported chems vols.

The second half of the year doesn't look much improved, though ag products will pick up on better crop yields, housing and construction shows some life, chems including crude oil and plastics round out the non-auto carload sector upside. Coal will continue to drift downward across all four segments; steel -- and consequently scrap and metallic ores -- will remain in a funk and frack sand vols may soften, though not necessarily in all markets.

Canadian Pacific's second quarter is an unbroken series of operating performance superlatives that made significant revenue gains possible. GTMs up ten percent, average tonnage of through trains up 12 percent as train lengths increased eight percent, average terminal dwell down 11 percent, GTMs per active horsepower up 32 percent, GTMs per gallon of fuel up eight percent.

Total revenue was C\$1.5 billion, up ten percent, on four percent more revenue units with system RPU up six percent. Operating income shot up 76 percent to C\$420 million thanks to a four percent drop in ops expense. The CP income statement is a classic example of how strict expense management affects operating results: comp down seven percent, car hire down 21 percent, purchased services down nine percent. The result is a thousand-plus basis-point drop in OR, to 71.9 from 82.5 a year ago.

Net income was C\$252 million, one and a half times what it was a year ago; EPS was C\$1.43, up 139 percent due to a two percent increase in shares. Market cap increased 69 percent or C\$8,760 -- 20 times the year-over-year delta in retained earnings. Operating cash flow was up 49 percent; free cash flow after dividends was C\$162 million vs. negative C\$100 million a year ago.

CP posted double-digit revenue gains in the grains, sulfur/ferts, forest products and industrial/consumer commodity groups. Auto was down nine percent, coal down three percent and intermodal was unchanged. Three out of four carload commodity vols increased double-digits; sulfur/ferts was unchanged. Auto and coal vols were both down, intermodal up less than a point. System RPU gained six percent with gains in all groups save intermodal and forest products.

The operating performance was outstanding. Even as some 40 washouts in Southern Alberta and BC took out core Calgary-Vancouver routes, CP recovered in a day and still took the OR down ten points. What this takes is leadership -- boots on the ground. Here's where the Hunter-Creel show shows its stuff. Read what Creel says about leadership out on the railroad:

Our "white-board" sessions with each of the regions are comprehensive operations critiques of each element that goes to the movement of the railcars, the customers' lines of business, sidings, car fleets, locomotives, yards, terminals and mechanical aspects. Hunter and I get to communicate directly with more 200 members of our operating team, to explain face-to-face, eyeball-to-eyeball what precision railroading is, what it means to us. At the same time, we can quickly evaluate the operational team and their abilities and to learn the network. Once they know the railroad we can focus on cost take-out and service performance improvements.

Nothing equivocating about that. And that's the way it should be. The railroad is an environment of absolute: trains and cars are either where they are supposed to be or they are not.

Management by absolutes is the only way to go.

The railroad industry's minuscule deltas in carload raw materials this quarter set a worrisome trend. You read in the papers about the huge cash hoards companies are building and about reticence to hire. Both stem from a lack of confidence about what the business will look like tomorrow. You build inventories today on the bet that you'll have customers for your widgets tomorrow. If you're very confident, you'll build inventory a hundred tons at a time. If you're not so sure you'll build inventory in smaller increments, say 25 tons at a time.

Inventories are current assets, like accounts receivable. Like accounts receivable, they represent corporate loans on future receipts. Accounts receivable represent cash that you can't use until you collect it, and to the extent customers are stringing you out, you're making loans to them in the amount of their unpaid bill. Inventory is cash tied up in what you hope to turn into receivables and then cash. Cash now is money in the bank, completely fungible, and usable as needed, where needed.

Intermodal transportation services providers are the soonest winners in this environment. And though we can't say definitively that Customer A is shifting goods from boxcar to truckload, we can see where Customer A's balance sheet shows lower daily inventories per daily sales. For railroads to survive, then, they have to match inventory in to sales out. CN alone has positioned itself as a "supply chain enabler, connecting the dots between innovation and collaboration." And they do it with a 60 operating ratio. Enough said.

A parting shot. You'll note that my quarterly earnings reviews emphasize volumes more than revenues; the merch carload sector over auto, crude, coal and intermodal; and operating income and operating ratio over what's below the line. I also get into *why* stuff happens.

My reasoning is simple: non-Class I railroads live in the single-car, mer carload world. Those that understand what their Class I connections are doing and why are in a much better position to, as Wick Moorman said recently, skate ahead of the puck. In other words, stay ahead of their Class Is in shaping the franchise for maximizing carload velocity and operating income yield. CP's second-quarter story couldn't be more clear in what they're doing and why and how CP's feeder network can build on the CP example.

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