THE RAILROAD WEEK IN REVIEW

January 31, 2014

"It is rather unusual to have snow in New Orleans and to have Winnipeg with the coldest month of December since 1879." Canadian Pacific CEO Claude Mongeau

Canadian Pacific's fourth quarter results go to show what happens when one gets one's operating house in order. Freight revenue increased seven percent to C$1.6 billion on five percent more revenue units (686,000) averaging six percent more dollars per unit, generating five percent more ton-miles.

Grain vols slipped one percent though revs rose eight percent and RPU gained nine percent mainly on Vancouver exports. Ferts and sulfur vols and revs each dipped five percent on a late harvest and late nutrient application window. Frac sand and crude oil helped propel the industrial & consumer group up 23 percent in revs and 12 percent in vols with RPU up 10 percent. Forest revs gained six percent on 14 percent greater RPU, masking a six percent vol dip.

Operating expense (before one-time items relating to the DM&E sale) came down six percent as payroll dropped nine percent, fuel increased two percent on four percent more GTMs, rents shed 19 percent, and purchased services dipped 12 percent. As result, operating income was C$547 million, up 45 percent. The operating ratio dropped an industry-best nine points to a highly respectable 66. Net income (again, before items) leapt 51 percent to C$338 million.

Three things are going on here. First, CP is finally getting RPUs where they need to be. The railroad is running better, implying more reliable service that customers perceive as worth more. Second, CP is moving more freight with fewer assets and consumables. Third, assets are turning faster, reducing car hire and loco lease expense per revenue unit.

On the call, Marketing EVP Jane O'Hagan said grain ought to be up this year as US conditions normalize and Canadian demand strengthens. Domestic ferts are looking up with exports more like they were in the 2013 first half. Crude-oil customers continue to expand facilities (they did 90,000 cars last year) and CP has three new Wisconsin frac sand loaders. Jane expects 2014 rev growth of six to seven percent.

The balance sheet is improving as well. Even as net long-term debt remained at C$4.4 billion year-over-year, net debt-to-equity dropped to 62 percent from 85 percent and net debt to capitalization stands at 38 percent, down 780 basis points. The 49 percent gain in share price drove a 52 percent market cap gain, worth C$9.1 billion. Retained Earnings gained C$629 million in the same period, so every dollar RE went up was worth $14 in market cap. Return on equity using the DuPont calculation (margin times yield times leverage) is 12 percent.

Canadian National total Q4 revenue increased eight percent to C$2.7 billion; operating expense was C$1.8 billion, up ten percent, partly on weather-related items like fuel and overtime. Revenue units grew three percent to 1.3 million, system RPU rose six percent to $1,904 and the operating ratio shed 116 basis points to 64.8, lowest among the Class Is reporting to date. Operating income was C$967 million, up five percent.

Intermodal was the biggest growth factor - vols increased eight percent. Petroleum/chems vols grew six percent with a 25,000 car run rate for crude oil (75,000 for the year) thanks in part to a number of new loading sites. Metals and minerals vols were unchanged; the forest products group was off a point, mostly related to U.S. housing stock, while Canadian housing stock and exports were flat to down. Grain revs were up two percent on unchanged vols though US and Canadian grain exports were up. Fertilizer loads fell seven percent.

As we saw from our Canadian train ride earlier this month, the CN main, especially from Edmonton to Winnipeg, is a very full railroad, and a real dispatching challenge to keep moving. The sub-zero temps didn't help. Dwell times the last week of December averaged 23 hours system-wide, up from 15 hours the last week of November. Average train speed sank to 23 mph from 27. Thus it was not surprising to hear COO Jim Vena say on the call,

> The story of the fourth quarter can be divided into two parts: October and November, when our velocity was up by six percent, and December, which, I'll have to admit, was difficult. But we ended up with GTMs per mile up one percent, cars switched per yard-hour up eight percent, and car-miles per day up two percent. [*He didn't mention trailing GTMs per available HP up one percent, but I will. - rhb*] Car velocity, as most of you have heard me say, is the single biggest metric that I use to see how fast we are moving the cars.

Net income increased four percent to C$635 million for per-share earnings of C$0.76, up seven percent on three percent fewer shares. Free cash flow after dividends but before share repurchases was C$851 million, up 26 percent. Adjusted debt is not even twice ebitda; debt-to-cap finished the year at 39 percent. And each dollar of retained earnings gain was worth nearly $15 in market cap.

In short, there was nothing flashy or exceptional about CN's fourth quarter results. What we see is a continuation of solid, predictable railroading even in the worst of times. JJ expects 2014 will see commodity growth across the board, including some 50,000 cars of coal going from haulage to line haul. Total revenue units will creep up another five percent or so with pricing gains in the inflation-plus range; I'd call it five or six percent. As a long-time holder of CN shares, I have to say I'm getting my money's worth.

A chorus of KCS doubters remains on stage, and perhaps it has partly to do with the recent hit "emerging markets" - of which Mexico is one - are taking on The Street. I'm not sure the link is warranted, based on this week's installment of *Barron's* annual Round Table discussion. It starts with Abby Joseph Hoffman of Goldman Sachs:

> When you expect economic improvement, you look for higher-beta securities within sectors [stocks that are more volatile and thus more likely to outperform]. For example, you look at consumer-discretionary, energy, and materials shares. This brings me to Mexico, which will benefit from the improvement in the U.S. Last year wasn't a good one for Mexico, but there now are signs, particularly in manufacturing, that things are looking up.
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> Government reforms could help the energy sector. Short-term interest rates are four to five percent, but close to zero in inflation-adjusted terms. Fiscal policy is becoming more expansionary. The Goldman Sachs forecast for Mexican GDP growth in 2014 is 3.3 percent and we don't see much change in the dollar/peso exchange rate. One way to gain exposure is through the iShares MSCI Mexico Capped exchange-traded fund, or EWW.

In other words, not all emerging markets are created equal. The EWW, in the company of the EWG (Germany) and EWP (Spain), remains a MarketEdge Long. On the other hand, the EWC (Canada) and EWZ (Brazil) are Avoids. For the nonce, it appears the BRICs have lost some luster. And that's another reason to cheer the KCS fourth quarter performance.

Indiana Rail Road and Pan Am Railways are the AAR's newest full members. By way of review, INRD is a privately-held, 500-mile freight railroad based in Indianapolis with a staff of some 200 employees. The road handles about 170,000 revenue units a year for a variety of consumer, energy and industrial products, serving customers in central and southwest Indiana and central Illinois. There are Class I connections at Chicago, Indianapolis, Louisville, and Newton, Ill. Tom Hoback is President and CEO.

Re AAR membership, Tom says, "Given the steady growth and diversification of our traffic in recent years, along with the challenges and incredible opportunities I foresee for Indiana Rail Road and the industry as a whole, I felt it was time for INRD to join the AAR and participate in industry dialogue at another level."

Pan Am Railways, a regional freight railroad system based in North Billerica, Mass., operates on 2,000 miles of track in south-central and northern New England, connecting with four Class I and 20 Class II and III railroads. Pan Am has a payroll of nearly 1,000 souls, moving more than eight million tons of intermodal and carload freight a year. Commodities include grain, coal, forest products, industrial chemicals, aggregates, metals and finished automobiles.

David Fink is President and says regarding their choice to join the AAR, "Pan Am's priority is to operate a safe, cost effective, service-oriented railroad, therefore it only makes sense to become a member of an association with that same commitment." Both railroads will participate in the

Safety and Operations Management Committee and the Policy and Advocacy Management Committee. These key AAR committees are charged with developing policies and practices to enhance safety, promote solid business practices and public policies, and provide quality customer service. Congratulations to both.

Florida East Coast Railway is adding 24 new GE ES44C4 locomotives to its road fleet for through-freight service on its 351-mile mainline route between Jacksonville, and Miami. The ES44C4s are part of GE's *Evolution* Series, designed to meet US EPA Tier 3 emissions standards that control nitrous-oxide and particulate matter emissions while lowering fuel consumption and operating costs.