THE RAILROAD WEEK IN REVIEW
January 6, 2012

"The uptick in economic growth has been fueled by a decline in the savings rate, which, without material income and employment gains, is unlikely to be sustainable as long-term credit growth also remains weak." Robert Prince, co-chief investment officer, Bridgewater Associates

Economists surveyed by *The Wall Street Journal* in December expect an unemployment rate of 8.5 percent at the end of 2012, just a tick below November's 8.6 percent, which represented 13.3 million jobless Americans. Including those who are underemployed and those who have given up looking, the November rate was 15.6 percent. Some 5.7 million people have been out of work for more than six months. Some of them never will work again, experts predict.

Midwestern states that depend on farming and natural resources are likely to maintain their healthy economies. Even as the West sees its employment picture improve, weak housing markets will weigh on job growth. In the Industrial Heartland, the trend is toward supply chain flexibility, meaning more suppliers closer and smaller shipments from each, hardly conducive to 100-ton carload lots of widgets.

What all this means to short lines is that money is likely to remain tight while customers are dealing with their own economic uncertainty by not hiring staff and keeping smaller inventories. Short lines' operating margins are going to be under the gun unless owners get a better handle on the costs of doing business by commodity OD pairs and specific customers.

For the latest on the Ackman/CP conversation, look no further than Thursday's note from Cherilyn Radbourne at TD Securities. What she calls "public letters" [*I have copies -- rhb*] have been exchanged between Pershing's Bill Ackman and the CP Board Chair John Cleghorn that reasonably lead one to believe there is "an increased probability" of a senior management change at CP and that Hunter Harrison, CN's ex-CEO may be the man. That would put the two former top CN ops guys in position to remake CP in CN's image, especially since Ackman writes, "Hunter's track record speaks for itself."

Radbourne says the impact on share prices may already be baked in. She maintains her Hold rating and a $67 target price. "With CP trading at 17.1x our CY 2012 EPS estimate versus CN at 15.2x and the U.S. rails averaging 13.1x, we recognize that CP's share price may overshoot the fundamentals in the short term." She calculates a 78 operating ratio for CY 2012 based on forward estimates, 76 in 2013 and something in the low 70s beyond.

My own back-of-the envelope look at 3Q2012 assumes revenues up seven percent year-over-year, expenses up three percent and operating income up 26 percent for a 79 operating ratio. I'm using the same below-the-line numbers as 3Q2011 and get earnings of $3 a share, up 45 percent, implying a $60 share price on a $4 full year eps and a 15 multiple. Shares nearly hit $70 this week. Looks to me like Radbourne is onto something.

Are you making any money? About a month ago *The Motley Fool* ran an item called "How Does Union Pacific Boost its Returns?" in which the writer extolled the virtues of calculating Return on Equity. Simply stated, it's the company's net income as a percentage of shareholder equity. The direct way of calculating it is to divide net income by equity. But that can be misleading -- it doesn't tell you where the money's coming from.

Enter The DuPont Formula, also known as the strategic profit model, for breaking down ROE into three important components. Essentially, ROE will equal the *net margin* multiplied by *asset turnover* (balance sheet assets divided by annual sales) multiplied by *financial leverage* (assets over equity). Deriving return on equity from these three elements makes it easier to understand changes in ROE over time.

The Motley Fool says high net margins are a measure of pricing power, something CSX talks about in terms of same-store pricing. Asset turnover measures how many dollars of revenue the railroad generates for every asset dollar and leverage factors corporate debt into the equation. In the shortline world, particularly the smaller independents, ROE is thin. Handling allowances don't allow much pricing freedom, poorly-performing power takes more loco assets to haul a given number of gross ton-miles, and bank loans in amounts equal to or greater than shareholder equity drag down that end of the equation.

What's needed is transparency. As regular WIR readers know, I've been a Buffett fan and Berkshire shareholder for years and take great stock in what he says about company finances and how you can't make stuff up and get away with it for long. For example, Buffett's 2010 *Annual Letter to Shareholders* has a section under the heading, "On Reporting and Misreporting: The Numbers That Count and Those That Don't." Here he inveighs against using using net income to value Berkshire Hathaway (or any company, for that matter). This is primarily because the company has the flexibility to allow net income to be any number, as it can realize gains by liquidating investments with large unrealized gains.

The link to the DuPont ROE method is knowing what drives operating income on Buffet's example or shareholder return in the railroad example. I use this very ROE model in my *Quarterly Railroad Performance Review*, wherein I relate carloads by commodity to revenues, revenues to expenses and operating ratios, net income to operating income, fuel consumption to ton-miles and ROE. Short lines can and should be doing it too. May I see a show of hands among readers as to who calculates ROE for each short line they operate?

D&H Redux. In WIR for Dec 16 I wrote, "My channel checks suggest DM&E or D&H are not running particularly well... the deplorable track condition on the D&H in the east can only be degrading fluidity...." One of my "channel checks" was an Amtrak ride over the D&H in November that seemed to have an unusually high number of slow orders and some freight train meets that appeared awkward. Some checking after the fact leads me to think that perhaps I over-reached. Perpend:

Going back to May, 2010 Amtrak gave me a cab ride south from Rouses Point to Albany to get a good look at the track prior to the June 2010 CP Investors Day program in Calgary. Suffice to say, I came away most impressed. (See my flickr.com photostream:

http://www.flickr.com/photos/rblanchard/sets/72157624051071901/).

Fast forward to November, 2011 and I have to report that the track conditions I saw out the Amtrak rear vestibule in both directions weren't all that different from what I saw in May, 2011; my "deplorable" comment had more to do with southbound delays that were in part due to a Sperry Car pass the day before. I've also since learned that CP's track standards are more rigid than the FRA's and what might pass muster on a US-based road might not on CP. Ergo the slow orders.

As for "running well," it's a fact that north- and southbound freight crews swap at Rouses Point (see opening shots in first photostream) and have been doing so for some time. New in the last 18 months are unit trains of Bakken crude oil and Iowa ethanol destined for CP's east end. Add those to a single-track railroad and you begin to run out of room in a hurry. Then add a customs stop that can take as long as an hour and a half each way and throughput comes down still further. I ought to have written, "The D&H is running remarkably well given the obstacles thrown at it."

Bottom line: The track is fundamentally better than I gave it credit for, making my use of the word "deplorable" just plain wrong. Traffic vols are up with the NS-CP-Pan Am Southern auto and intermodal trains on the south end, unit trains on the north end and more merch traffic everywhere. Can't do that if track isn't up to scratch. As for "running well," D&H could be a show-piece. CP gave the Investors Day crowd a great ride Calgary to Field in June, 2010. How about Albany-Rouses Point for Investor's Day 2012?

Union Pacific, Norfolk Southern and CSX will likely be star performers for the ninth straight year, says Rick Paterson at UBS. "In an effort to further clarify our pecking order, we have upgraded NSC to Buy. Key points are an expected first quarter 2012 fuel surcharge tailwind the other rails won't have, the lowest 2012 EPS growth expectations in the group, and the likelihood of materially better network performance this year."