THE RAILROAD WEEK IN REVIEW

February 10, 2012

"Based on the presentation made at today's town hall meeting and the spoken remarks made by Bill Ackman, Chief Executive Officer of Pershing Square, Mr. Harrison and Pershing Square's director nominees, it appears that Pershing Square still has no plan or clear timetable to improve CP's operations." -- Canadian Pacific statement, Feb 6

Canadian Pacific got quite the scolding from Pershing Square's Bill Ackman and former CN President Hunter Harrison during Monday's Town Hall webcast. Ackman opened by asking, "If CP had no CEO, whom would you pick?" From there he launched into a litany of things wrong with CP. He said up front he seeks no change in control, and has no intention of selling the railroad after a number of years. His whole spiel was they needed a stronger board and a CEO that can lead CP to the performance levels the plant is capable of delivering. He took 60 minutes and 90 slides to do it.

Ackman then settled down into an armchair opposite Harrison to toss out questions submitted ahead of time by members of the 300-strong audience. Saying at the outset that CP has "a great franchise," Harrison noted there are "structural problems" that management is paid to fix, the CEO must set the stage for the whole company, and "CP may have some confusion about what it really wants to do." Then he cited CN's Five "Guiding Principles" (see Harrison's book, *How We Work and Why*, page 7) -- Service, Cost Control, Asset Utilization, Safety and People -- and how they would apply at CP.

He talked about how it all starts with customer service: doing what you say you'll do and getting paid for it. As for achieving an OR in the 60s, he said if you serve the customers, turn the assets, and do these things safely, a lower OR naturally follows. Re CP's long train strategy, he says you need to have passing sidings as long as your longest train and even gave a demonstration of how trains "saw by" each other when sidings are too short. And though the conversation was long on ideas, it was short on specifics: get terminal dwell to x, cars on line to y, average train speeds to z, and so on.

As I reviewed my notes from the two and a half hour call, I pulled together some recent CP operating and commercial performance data and found myself saying, "Not so fast." On our June, 2010 Investors Day train ride Calgary to Field, we were treated to a series of presentations on what CP is doing to take out operating cost and time. And, absent the dismal first quarter 2011 performance, I have to say we have a railroad on the mend.

The chart below leads me to conclude CP is getting its arms around things like train speed and yard dwell; they're just not charging enough. After all, the denominator of the operating ratio equation is the revenue line and if it's not going up faster than the numerator -- operating expense -- operating income and the operating ratio will suffer.

But as the chart shows, train operations measures are heading in the right direction. Starting with the 2010 fourth quarter, average train speed is up eight percent, terminal dwell is down 20 percent, average daily cars on line are down 14 percent and car miles per day is up 20 percent, even as revenue-ton-miles have increased two percent.

	4Q2010	FY2010	1q2011	2q2011	3Q2011	4Q2011	FY2011	FY chg
Ops Ratio	77.0	77.6	90.6	81.8	75.8	78.5	81.3	-4.3
Revs	$ 1,294	$ 4,981	$1,163.0	$1,265.0	$1,342.0	$ 1,408	$ 5,177	3.9%
Ops Income	$ 298	$ 1,116	$ 109	$ 230	$ 325	$ 303	$ 967	-13.4%
MRTM	32,883	126,428	29,684	32,223	33,068	34,084	129,059	2.1%
$/MRTM		$39.16					$40.11	2.4%
MGTM/gal		841					853	1.4%
Avg Train Speed	21.7		19.8	20.0	22.1	23.4		7.8%
Avg Term Dwell	22.2		23.7	20.1	18.5	17.7		-20.3%
Avg Dly cars	54,100		55,100	54,200	49,600	46,700		-13.7%
CMPD	152.7		137.9	154.3	168.7	183.5		20.2%

Source: CP financial reports

The downside is the revenue line. Total FY 2011 sales increased less than four percent over the 2010 number and dollars per thousand gross ton-miles increased less than two percent. This in an era when all the class Is are talking about "inflation-plus" pricing -- four to six percent or more in practice.

Harrison was right when he talked about the link between "precision railroading" and pricing. These quarterly trends tell me the CP team is in fact getting more precise and adding value to the transportation product in the bargain. Higher rates and a lower OR will follow.

The DM&E also came in for some strong words Monday. During his critique of CP operations and activities, Paul Hilal, a business partner of Ackman at Pershing, said the DM&E acquisition "was a mistake." He called the $1.5 billion purchase price a "high valuation" of 18 times ebitda, calling it "an extremely expensive option to be the third carrier in the PRB."

Then, almost on cue, comes a *Bloomberg* story Tuesday saying Pershing "would be open to having CP undo" what Hilal called a "blunder" in his remarks. Pershing's Ackman is quoted as saying his "proposed chief [Harrison] would consider selling the carrier." Not surprising. The bloom is definitely off the rose for coal and CP is limited in the number of coal-burning power plants it reaches directly. As for ethanol -- well, the bloom may be off that rose too. One must remember the Northwestern got off that line for a reason. Perhaps the reason remains valid.

Genesee & Wyoming reported fourth quarter consolidated revenues up 24 percent--seven percent same-store sales, excluding currency exchange rates -- to $210.4 million. Operating income grew 90 percent with an operating ratio of 78.4, down 7.5 from a year earlier. Diluted eps came in at $0.77, a company record and up 65 percent. The Arizona Eastern and FreightLink acquisitions were the big drivers.

Turning to North American operations, total sales were $140,172, up 11 percent, as non-freight (essentially the Rail Link division with its contract switching ops plus smaller non-contiguous short lines) dipped two percent to $41,529 against freight sales of $98,643, up 18 percent, on 194,217 revenue units, a gain of only three percent and about on a par with what the Class I roads have reported. Without the Arizona Eastern acquisition carloads were off less than a point. North American expenses were up 15 percent, pulling operating income down to a mere four-point gain at 31 million and pushing the operating ratio up 261 basis points to 77.9. Back out ops income credits and the OR is 79.7.

As one looks down the carload commodity breakout list, one sees coal units off 10 percent (mainly steam coal for electric power plants) and “other” (another name for overhead NS steam coal in eastern Ohio), down 12 percent. Offsets came in the form of aggregates, iron ore in Canada and metals for a plant expansion. Commodity sales increased across the board, again save steam coal. RPU increased 15 percent all-in to $508. This may seem high until you recall these numbers are on larger lines where divisions rule, not handling fees and switch charges as on the smaller names.

RailAmerica checked in Thursday morning, batting cleanup for the quarterly calls. Total quarterly revenues grew 15 percent year-over-year to $147.3 mm, a third of which was from the “non-freight” side of the house, chiefly Atlas (up 48 percent to $44 million) with a doubling of engineering services sales. Raw operating income was down 15 percent, though that’s misleading.

The entire 45G tax credit hit in the fourth quarter of 2010 whereas it was spread out more evenly in 2011. For a better apples-to-apples comp, I’ve stripped out the quarter’s 45G and asset sales delta and found year-over-year ops income *increased* 30 percent. The adjusted OR was 77.3 vs 79.9 a year ago. Below the line, net income dropped 16 percent to $15.0 million, 29 cents a share, from $17.9 million, 33 cents a share, again on 45G carry-through from a year ago.

Adjusting for 45Gs, it’s 33 cents, unchanged. You can see it better in the full-year earnings where RA earned 70 cents a share vs. 35 cents a year ago, putting both years’ 45Gs against each other *and* the six percent ops income delta *and* the four percent reduction in share count, worth by itself a nine-point gain in year-over-year earnings per share.

Out on the railroad, freight revenue increased five percent to $103.3 million on two percent fewer revenue units -- 211,848 carloads (RA has no intermodal). Average RPU increased seven percent to $488, a record high for RA, up for every commodity group but coal and paper-related. During the call, CEO John Giles cited commodity strength in construction aggregates, fracking sand, finished autos (Honda has added a second shift for export vehicles that will have to go by rail to the ports), steel and sheet metal, and even some lumber lanes. On the downside, RA saw a certain softness in steam coal, midwest grain, chemicals for paper-making and fertilizers.

The recent Marquette Rail and Wellsboro & Corning acquisitions are excellent tuck-ins for existing RA businesses. MRQ becomes part of RA's midwest region as an addition to its four existing Michigan properties; it's also a fracking sand originator that can feed other RA properties. The WCOR's $17 mm revenue stream is two-thirds transload sites in the eastern US, feeding RA'e existing transload footprint in the non-railroad revenue area.

One final note: the comp and benefits line dropped to 27 percent of revenues from 31 percent -- and seven percent year-over-year. Fuel burn was down 10 percent so both declines were greater than the carload delta, down two percent -- further proof of COO Paul Lundberg's skill at matching resources to the traffic available. This will be increasingly important in 2012's slow volume-growth environment (RA guides to low single-digits for the first quarter and double that for the full year). Core pricing may increase at a four percent rate so keeping ops expenses reeled in will be essential. Based on what we heard today, it's safe to say RA is on its way.

Week in Review will not appear nest week (Feb 17) as I'm spending a few days with CSX in south Georgia riding trains for a *Trains* magazine story.