THE RAILROAD WEEK IN REVIEW

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"If the cash from operating activities is consistently greater than the net income, the company's net income or earnings are said to be of a "high quality". If the cash from operating activities is less than net income, a red flag is raised as to why the reported net income is not turning into cash. Accountingcoach.com

CSX once again leads off Earnings Week and once again follows their own guidance: rate increases of 4-6 percent on modest volume deltas. Perpend: Freight revenue was $2.9 billion, an increase of 5.6 percent over first quarter 2011. Revenue units were up just 0.6 percent to 1.6 million; average RPU was up 4.9 percent to $1,851. Merchandise carloads (all but intermodal and coal) increased 2.6 percent to 671,000; revenues for the sector increased 9.8 percent on an average 7.0 percent RPU gain.

Operating income rose 10.7 percent to $856 million as operating expense came in 3.6 percent higher for an operating ratio of 71.1, a respectable 135 basis point improvement year over year. Fuel expense was the outlier, up 10.4 percent; equipment rents were unchanged and labor expense increased 0.7 percent. Not bad considering gross ton-miles increased only 0.8 percent and revenue ton-miles were down 0.7 percent.

Below the line, per-share earnings grew 20.8 percent to 43 cents, though absent the $300 million share repurchase program, the eps would have been 40 cents, a more modest delta of 13.7 percent. Moreover, cash from operations was less than net earnings (it really wants to be more) and wasn't enough to cover capex, meaning dividends and share repurchases came from cash, asset sales or borrowed money. The fact remains that $275 million in "contributions to qualified pension funds" was the main culprit.

The second quarter and rest of the year do not look particularly exciting. Though "the economic backdrop is favorable for 2012," I really didn't detect any indication of even mid-single-digit volume increases going forward. If "volume outlook stable to favorable for 90 percent of the traffic base,"and "utility coal weakness is expected to continue," then short lines doing business with CSX had best focus on service levels to lower customer supply-chain costs.

Even though coal and intermodal seem to capture most of the sell-side analysts' attention, the merch carload sector remains the core business to CSX, representing 59 percent of RTMs and 58 percent of revenues. Coal represents 31 percent of RTMs and 29 percent of revenue and intermodal is 10 percent of RTMs and 13 percent of revenues. Moreover, even though coal vols were off 5.3 percent year-over-year, merch vols were up 9.8 percent with particular strength in metals (auto and energy), forest products (packaging, some housing) and automotive (trading down to more fuel-efficient vehicles).

In terms of revenue units, the merch carload group is 41.9 percent of the total *vs*. coal (including coke and iron ore) at 20.7 percent and intermodal at 37.5 percent. Note that intermodal is more than a third of the revenue units, only 13 percent of revs and earns about a third of the system average RPU per box. However, at an average 1.7 boxes per carload equivalent and no terminal switching or intermediate yard costs, one can see an immediate avoidable-cost advantage that goes right to operating income.

Finally, CSX is clearly running a faster, smarter, safer railroad. On-time departures increased 35 percent and on-time arrivals increased 31 percent as yard dwell improved to 24.0 hours from 26.6 hours. Average road train speed (local freight and yard jobs are excluded from this AAR metric) improved 9.0 percent to 22.3 mph from 20.5 mph. Best of all, the FRA reportable personal injury index dipped another one percent to 0.78, which tells me the T&E, mechanical and engineering forces are looking out for themselves and each other.

Union Pacific printed record first quarter revenue of $5.1 billion, up 13.9 percent, on 2.2 million revenue units, up 1.3 percent. Operating income grew 32.8 percent to $1.5 billion; the operating ratio came in at 70.5, a remarkable 422 basis-point improvement. Net income was up 35.1 percent to $863 million; eps increased 38.6 percent to $1.79 (after a 2.6 percent share buy-back) for a best-ever first quarter.

The automotive and industrial products commodity groups led the increases, up 14.6 percent and 10.3 percent, respectively. The former has a 58-52 product mix, finished vehicles over parts and vols in the latter -- where short lines have their auto play -- were up 16 percent. The non-met minerals segment of the minerals and consumer group was up 36 percent mainly on frack sand; the met-minerals group vols jumped 48 percent with a big boost from export iron ore. Coal, down 8.0 percent and intermodal, up 1.0 percent, rounded out the picture.

The point was made repeatedly during the call how customers' perceived relative value of the UP transportation product is driving increased sales, with the proof of that particular pudding being the quarterly record score of 93 (out of 100) for Customer Satisfaction. That helps explain the 12.1 percent system RPU gain where industrial products scored a 13.4 percent increase. Coal and intermodal saw similar upticks.

For the rest of the year, UP sees the economy in a "slow recovery." But with specific growth in commodities related shale- and oil-drilling, increased small-vehicle production and highway conversions continuing to push intermodal vols, UP's "strong value proposition" will drive revenue growth through aggressive pricing and superior service.

And make no mistake: this is a carload railroad. The manifest sector (all but coal and intermodal) represents 45 percent of revenue ton-miles and 61 percent of sales for a 1.35 revenue/RTM ratio. By comparison, coal is 41 percent of RTMs and generates only 19 percent of sales (0.50) and intermodal has 14 percent of RTMs and 19 percent of sales (1.31). And I wouldn't shed too many tears over coal. As we see here, the 8.0 percent dip in coal vols was mostly covered by gains in manifest carloads with intermodal more than covering the balance.

Cash from operating activities was $1.4 billion, more than enough to support capex of $804 million and $289 million in dividends, with the balance plus $122 million in cash covering the share buy-back program. Debt is 41.8 percent of equity and 32.0 percent of capital.

Canadian Pacific completely blew the lights out with revenue units up 8.3 percent, RTMs up 10.8 percent, car-miles per day up 51 percent, operating ratio down ten points and terminal dwell down by 6.4 hours to an industry-leading 17.3 hours. I could go on, but you get the general idea.

The Green Team has been saying for months that the Multi-Year Plan is working to produce a better, smarter, faster and safer railroad. On the call COO Mike Franczak pointed specifically to improved first-mile, last-mile performance (that's you, short lines) and a 1.25 personal-injury ratio, a 30 percent year-over-year improvement. Let me suggest you download the slides as you follow this thread. See http://www.cpr.ca/en/invest-in-cp/earnings-releases/Documents/cp-2012-q1-presentation.pdf .

Total revenues increased C$213 million to C$1.4 billion, up 18.1 percent. Operating expenses increased only C$48 million to C$1.1 billion, up 4.6 percent, more than doubling of operating income to C$274 million, up 151.4 percent, and taking the 2011 first quarter operating ratio down nearly 11 points to 80.1 from 90.6. Now, I'm sure some will say, ah, but it's still too high and last year's rotten winter weather gave CP some easy comps. Perhaps. But the denominator of the operating ratio is revenue, and that's a direct function of the number of revenue units moving. Recall that CP handled some 676,000 revenue units in the 2011 fourth quarter making today's number 97 percent of that. I'd say that's a pretty full recovery.

Three out of five merchandise commodity groups -- grain, industrial/consumer and auto -- posted double-digit volume gains while forest was flat and sulfur/fertilizer was down 14.3 percent on purchase-timing; the merch group as a whole was up 7.9 percent in units. Coal was actually *up* 30.0 percent while intermodal tagged along at plus 3.3 percent. Every manifest carload commodity group ex-sulfur/ferts posted double-digit revenue increases, putting the carload group's sales gains at 20.9 percent (the third consecutive quarter with double-digit merch rev gains) with RPU up 12.0 percent. System RPU increased 9.1 percent, giving the lie to my earlier comment that perhaps CP wasn't charging enough. That said, Chief Marketing Officer Jane O'Hagan says to expect merch vols to keep expanding at a rate two to three times GDP for the rest of the year with a particular nod to the industrial products group (short lines again).

CFO Kathryn McQuade was ahead of the curve on "easy comps” -- see slides 32-37. Whereas I just went back to 4Q2011, she goes back to 2010 and shows this quarter's operating income was up 32 percent and the ops ratio is down 2.2 points since then. Coming back to present cases, Kathryn takes apart the income statement line-by-line to show the gains. It's an impressive array and shows clearly why the Green Team knows what it's about. Her wrap: "We’re clearly making progress and remain committed to an operating ratio of 68.5 to 70.5 for 2016." And though they may not get ten points in the next twelve-month, I have to believe they're on their way. (See road map, slide 44.)

As a fitting segue from the CP story, the *Railway Age Newswire* brings us the news that eleven short lines in Saskatchewan will divvy up some C$700,000 in grants from the Provincial Shortline Railway Sustainability Program. This figure represents a 40 percent increase over the 2011 program for provincially-regulated short line railways to use for ties and surfacing or bridge repairs.

The largest grant, C$205,791, went to the Great Western with Carlton Trail, Red Coat Road & Rail, Great Sandhills, Last Mountain and Stewart Southern receiving sums ranging from C$47,739 to C$78,458. Additional grants of C$35,000 each were parceled out among five smaller properties spread around the province.

This is most encouraging. I first learned of these lines when I was doing my homework for "The Short Lines of Canada" (*TRAINS*, June, 2011). I wrote, "Saskatchewan is contributing some C$500,000 to assist in nine cooperative railroad start-ups. However, one source told me of complaints that the 'rules of their *ad hoc* funding program are blurred, not well-known ahead of time, and appear to be entirely at the discretion of the provincial powers that be.'" The present $700,000 commitment says to me the situation has changed dramatically, so these properties, many former CP lines, will benefit and contribute still further to Jane O'Hagan's strong grain story.

The ASLRRA kicks off its 2012 Annual Festivities on Saturday at the Indianapolis Marriott. Southwest Air is supposed to have me there five-ish. Let's raise a glass for old times, absent friends and particularly for the speedy recoveries of UP's Jim Young and Berkshire-Hathaway's (and BNSF's) Warren Buffett.