THE RAILROAD WEEK IN REVIEW

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"The turn around at CP has the potential to be the most significant investment opportunity in railroads for the next 3 years." -- Morgan Stanley, "The Last Great Rail Turn Around," September 24, 2012

Canadian Pacific seems once again to be in Morgan-Stanley's good graces. Bill Greene writes, "We are resuming coverage of CP at Overweight and adding it to Morgan Stanley's Best Ideas list. We believe the turn around at CP led by CEO Hunter Harrison, who arrived in July, could be the most compelling railroad investment opportunity for the next three years." Greene's message is that Hunter is The Man to turn CP around with fewer employees, locomotives and freight cars. Faster turns of what's left will improve service levels that will permit CP to raise rates where they have lagged CN on a revenue/RTM basis. As to numbers of revenue units,

> Volume growth can be GDP+ for the next few years. Based on our estimate, CP's traffic mix is one of the least economically sensitive. We estimate that only 30% of the company's book of business is directly related to North American economic growth. The remaining 70% is either unrelated to North American GDP (export bulk traffic such as potash, coal and grain) or, if related, benefits from secular growth drivers (intermodal). We conservatively estimate that every 100bps of volume growth can come at an incremental margin of 50%. This implies that an additional 100bps of traffic growth can add ~3% to EBIT vs. the 2011 baseline.

What this begins to look like to me is more emphasis on on long-haul core trains and less emphasis on branch line single-car operations. We're already seeing signs of this philosophy in Wisconsin (see Hapag-Lloyd rail-to-truck conversion announcement), New York and Pennsylvania with local ops changes even as Bakken Crude unit trains increase over the D&H. And if the PNWARS comments hold (see below), less local service means less core volume in the merch cartload sector, which, for what it's worth, has been growing by double-digits YTD, faster than either ag or intermodal but slower than coal.

I am not as bullish as Greene. He says CP will trade at a "premium to historical range for its turn around story." He cites "secular volume growth opportunities from its bulk franchise and broader pricing opportunities as service levels improve." The bulk of the bulk is in export met coal and fertilizer, both dependent on overseas economies and other variables and there can't be that much new volume even with service improvements.

Now don't get me wrong about Hunter: I've known the man personally for years and have always admired the way he railroads and manages a company. But IC was a north-south railroad in an east-west world and CN was a Crown Company taken private for the first time. Cleaning out CN's government bloat was a big help in his taking the OR down from the 90s in short order. His mandate to run a faster, smarter railroad was worth still more points. He's going to do OK with CP but I'm afraid Greene has put him on too high a pedestal.

Norfolk Southern has taken some heat for the recent cut in expected third quarter earnings. The press release said simply, “Earnings are expected to be in the range of $1.18 to $1.25 per diluted share.” The midpoint -- $1.22 -- is down 23 percent from the $1.59 earned in 3Q2011 and implies $398 million in net income, off 28 percent year-over-year.

In his next-day presentation at the 2012 Citi Global Industrials Conference, CFO John Rathbone said revenues would be off about $200 million -- $120 million due to commodity mix and another $80 million in lower fuel surcharge revenue -- vs. 3Q2011. He also said total revenue units would be down in the neighborhood of two percent and gave line-by-line commodity specifics.
From these comments, one can estimate revenue unit volumes and -- using the same RPUs as last quarter (John said price was not an issue) -- get an idea of the revenue hit.

For the sake of argument, I left commodity RPUs and expense line amounts (here again, John says it’s all about volume and revenue) unchanged from the 2012 second quarter. Metals/construction, the largest merchandise group by volume, will be off eight percent year-over-year in carloads. Ag/consumer/government commodity carloads will be unchanged, chems will actually be up five percent, paper/clay/forest down by an equal amount and auto (a non-event for most short lines) will be up eight percent.

Net-net, merch carloads represent a third of all revenue units and are expected to be down one-to-two percent. Coal is the big drag -- 20 percent of revenue units and down nearly 14 percent -- while intermodal remains a bright spot -- up four percent and representing 48 percent of total revenue units. (During the Q&A John was quite emphatic that intermodal growth is off the highways, not from “cannibalizing” carload traffic.)

My impression -- from actually being out on the railroad watching the trains go by -- is one of a fluid railroad. And as vols have gone down, train starts have not gone away proportionately and the stats in Rathbone’s slide deck support that impression: system average train speed and yard dwell are both improved year-over-year and quarter-to-quarter. Ditto the NS “composite service performance” index, hitting an all-time high quarter-to-date.

The good news is, as I see it, that NS now has room for more cars per train- and crew-start so they can add cars back at very little incremental cost. And with the the performance metrics all heading in the right direction, incremental margins are bound to increase. Moreover, fewer coal trains to move means more assets are available to move intermodal trains over shorter distances, reducing dray time and improving dock-to-dock transit times by having those dray drivers spending less time in local traffic jams.

Providence & Worcester saw total revenue units increase 2.3 percent in the second quarter. Conventional carloads slid 8.7 percent to 8,605 units, the decline more than offset by intermodal's 35.5 percent gain to 4,234 units for 12,839 total revenue units. Total freight revenue was off 1.7 percent even though revenue per carload increased 8.7 percent to $811. Trouble is, each intermodal unit is worth only $73; viewed another way, carload brings home $96 out of every hundred dollars of freight revenue.

P&W is fortunate in that it has other "operating revenue" streams to bolster operating revenue -- what others might call non-freight -- what the 10-Q calls "maintenance department billings for services rendered to freight customers and other outside parties." That was a tidy sum of $928,000 for the quarter, pushing total operating revenue to $8.2 million, up 5.7 percent year-over-year.

Operating expense less capitalized costs were $8.4 million, up 16.5 percent, mostly on increased equipment maintenance and engineering support (half of which was capitalized). The operating ratio came in at 102.3, up nine points over last year's third quarter. P&W took a $193,000 second quarter operating loss vs. the $557,000 income posted a year ago.

Below the line, P&W took a $3.3 million gain on an Amtrak settlement concerning certain yard track use fees and trackage rights charges. (As usual, P&W posts these one-time items above the line as operating revenue and I put them back below the line). Interest and taxes bring net income to $3.1 million vs. $828,000 for the 2012 second quarter when there were no major below-the-line adjustments to income. Comp and benefits remain at an industry high -- roughly half of railroad operating revenue.

The Pacific Northwest Association of Shippers gathering in Eugene, Ore. last week was instructive, to say the least. I thought the session theme -- "What do you want your railroad to look like in five years?" -- was particularly fitting, given the slow volume improvement from the 2006-7 peaks and the better operating metrics over the same time. My main take-away, on the other hand, was not encouraging. Namely, that even though line-haul service out on the core routes is running very well, first-mile, last-mile is not.

As to the core railroad, BNSF Exec VP and Chief Commercial Officer Jon Lanigan said in his keynote talk at the opening session that it's been a "tortuous recovery" with coal and ag down thanks in part to cheap natural gas and a 50-year drought. However, there are signs of life in lumber due mainly to multiple-unit housing and in crude oil out of No Dak, where the outbound rail potential exists for a million barrels a day (1,400 carloads, more or less). International intermodal is flat to down though domestic is up double-digits on strong highway-to-rail conversions.

These are the facts: BNSF hit 200,000 revenue units in Week 37 (Sep 15), up 6.2 percent year-over-year. The four top commodity groups by volume -- 70 percent of non-intermodal units -- posted increases: coal up three-hundredths of one percent (not much, but at least not down), grain up 10.5 percent, chems 2.9 and motor vehicles 27.8 percent. Processed food, metallic ores, metals, waste/scrap of all kinds increased double digits with crude oil pumping up the petroleum line by 68.2 percent. The paper commodity group was the only significant downer.

The railroad is running better, too, confirming what PNWARS panelists said about core service (my petroleum specialty products panelist says he was able to reduce his lease fleet 25 percent while handling increased volumes). The ASI-Transmatch yard dwell charts show a steady improvement since January; third-quarter to-date system train-speed for "all trains" is off a bit after three successive quarters of improvement, though still better than in was at the end of 2011.

So the question remains: if the railroads are running well out where train speeds are counted for the AAR, what's going on at the local level? The shipper representatives on two separate panels cited consistency and communication as two areas needing improvement: be here the same time every day and, if you can't, let us know. Let the customer service rep look at the same data I'm looking at on the railroad customer service website and let the sales reps lear more about how my business works and be my advocate at the railroad.

The two rail speakers on my panel -- Kyle Hancock from CSX and Otis Cliatt, newly -- as of the day -- promoted president of Anacostia's Pacific Harbor Lines, said customers can do more to help themselves, from having doors and gates open to having cars cleaned, buttoned up and ready to go at train time. A recurring theme across several panels was the need to drill down to root causes of failure -- on both sides.

The PNWARS program was happily short in self-serving PowerPoint presentations and long on *information you can use* to get the railroad where you want it to be in five years. That is, providing a consistent and reliable service with no surprises and at a reasonable price. Frankly, we should have been there five years ago. What we need more of is blocking for the distant node, coordinating local switch times with core train schedules and web-based everything so you can do business with the railroad the same way you do business with Southwest Airlines. Then we'd be getting somewhere.