Con-way

4Q Shows Weak Tonnage but Still Solid Pricing; LTL Demand Remains the Key EPS Driver in 1H13

Underweight

CNW, CNW US

Price: $31.97

Price Target: $33.00

Airfreight & Surface Transportation

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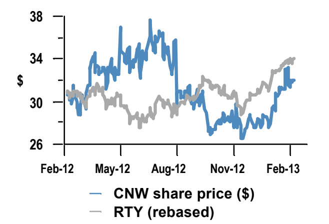
On Wednesday night CNW reported headline 4Q12 EPS of $0.26, which was below consensus of $0.28, but CNW had a few items that were headwinds in 4Q, including a $2.3 mm rise in bad debt expense at Menlo and $2.2 mm in additional vehicular claims. The combined EPS impact is $0.04-0.05, and while these items are a part of doing business, the size was greater than normal in 4Q. It appears that LTL demand was soft in 4Q as tons/day for CNW fell 3.5% y/y, but January has improved somewhat with tons/day -1.2% y/y. We believe that LTL demand is likely to remain a headwind in 1H13, but looking to 2H13 CNW has potential for its lane-based pricing and line haul utilization initiatives to provide a margin tailwind.

- **4Q broadly in line after considering bad debt and vehicular claims.** CNW's 4Q EPS of $0.26 was below consensus of $0.28 and our forecast of $0.30, but if we consider that bad debt expense at Menlo and an increase in vehicular claims in TL were somewhat unusual, then we believe 4Q could be viewed as in line or modest upside. CNW's 4Q LTL performance appeared to reflect a soft market as tons/day fell 3.5% y/y and CNW's OR improved only 10 bp y/y to 97.4%.
- **LTL pricing was solid; 4% rise in length of haul provided a boost.** Revenue per hundredweight ex fuel rose 4.2% y/y, which was above our forecast of 2.5% and also improved vs. the 3.4% growth in 3Q. However, we note that the 4% rise in length of haul provided a greater boost in 4Q compared to a 1.8% rise in LOH in 3Q. We believe that the LTL pricing environment remains stable.
- **Tonnage progression was weak in 4Q; January showed improvement.** Tons/day for CNW was -3.1% y/y in October, -2.1% in November, and -5.7% in December. Following the weakness in December CNW did see a bounce back to only a 1.2% y/y decline in tons/day in January.
- **Productivity initiatives have potential to provide a boost in 2H13.** In our view, the economy and LTL demand trends are likely to remain the key drivers of CNW's EPS performance in 1H13. Looking to 2H13 we believe that CNW's lane-based pricing and line haul density initiatives will be sufficiently rolled out so that, if successful, they should provide a boost to margin and EPS performance.

Price Performance



	YTD	1m	3m	12m
Abs	8.9%	8.7%	7.3%	3.4%
Rel	4.6%	5.0%	-3.1%	-6.6%

Bloomberg **JPMA WADEWITZ**<GO>

Con-way (CNW;CNW US)

FYE Dec	2011A	2012A	2013E *(Prev)*	2013E *(Curr)*	2014E
EPS - Recurring ($)					
Q1 (Mar)	0.24	0.46	-	0.39	-
Q2 (Jun)	0.52	0.66	-	0.70	-
Q3 (Sep)	0.52	0.45	-	0.67	-
Q4 (Dec)	0.26	0.26	-	0.44	-
FY	1.54	1.82	2.25	2.20	2.75
Bloomberg EPS FY ($)	1.63	1.85	-	2.30	2.91

Source: Company reports, Bloomberg, and J.P. Morgan estimates.

Company Data	
Price ($)	31.97
Date Of Price	06 Feb 13
52-week Range ($)	38.78 - 25.97
Mkt Cap ($ mn)	1,806.35
Fiscal Year End	Dec
Shares O/S (mn)	57
Price Target ($)	33.00
Price Target End Date	31 Dec 13

See page 6 for analyst certification and important disclosures.

Investment Thesis

LTL tonnage trends were soft in 4Q12, and the 97.4% Freight OR that CNW reported shows that margin performance remains depressed relative to prior cycles. We believe that the pace of growth in the economy and in LTL demand are likely to remain primary factors driving CNW's operating margin and EPS performance in 1H13. CNW's rollout of its lane-based pricing and lane density improvement initiatives, which began in December 2012, should be broad enough to provide meaningful support for margin improvement in 2H13. However, it remains difficult to anticipate how significant the impact will be from these two initiatives. Lacking clear visibility to stronger LTL demand and also to the success of its productivity initiatives, we elect to stick with our cautious view and UW rating. However, we recognize that CNW is a name with significant leverage to a potential turn in tonnage, and there is also potential for the productivity initiatives to have a meaningful effect if CNW executes well.

Valuation

We are maintaining our December 2013 price target of $33 for CNW, which is based on applying an unchanged 12x target P/E multiple to our 2014 EPS estimate of $2.75. Prior to the sharp falloff in CNW's earnings in 2009, CNW's average historical forward P/E range was roughly 10-16x. We believe that an EPS multiple at the lower end of this historical range (i.e., 12x) will be appropriate at the end of 2013 given that 2014 EPS should be back in a more normal range and closer to a cycle peak than a cycle trough.

Risks to Rating and Price Target

A stronger and quicker move up in CNW's LTL pricing is a source of potential upside risk to our EPS forecast, price target, and Underweight rating on CNW. A significant acceleration in the economy and in LTL demand growth are also sources of upside risk versus our cautious view. If CNW executes well on its productivity initiatives, the resulting margin improvement could drive upside risk versus our UW rating.

Key Points

Slight downside 4Q EPS miss, with EPS roughly unchanged y/y

On Wednesday (02/06) evening Con-way reported 4Q adjusted EPS of $0.26. The result is a slight miss relative to the Street consensus forecast of $0.28, as measured by Bloomberg (note: average of those estimates published in the last month was also $0.28) and relative to our estimate of $0.30. The EPS result amounts to about -1% y/y contraction. The adjusted EPS of $0.26 excludes about $0.04 of certain abnormal tax items including increased state and foreign income taxes as well as discrete tax items. We do believe that vehicular claims expense of $2.2 million in the Truckload segment and reserves for international bad debts expense of $2.3 in the Logistics segment were headwinds to EPS, so the miss may be fairly viewed roughly in line if these items are adjusted for.

Freight segment pricing growth in 4Q was relatively consistent with 4Q11-3Q12

Pricing growth in the Freight segment in 4Q (note: revenue per hundredweight excluding fuel was +4.2% y/y) was broadly consistent with 3Q (+3.4%), 2Q (+3.2% y/y), and 1Q (+4.1% y/y). Our forecast was +2.5% y/y, but we note that length of

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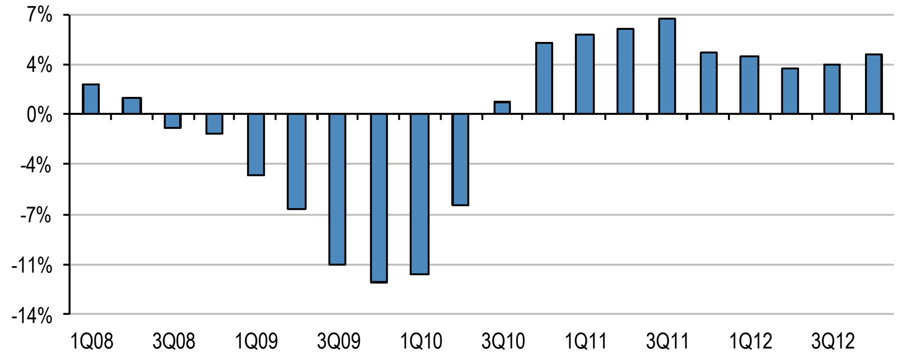
haul was up more in 4Q (+4.0% y/y) than in 3Q (+1.8%) or 2Q (+0.3%), which may have been a contributing factor to the variance relative to our forecast. We believe y/y pricing growth was consistent through the quarter (note: CNW declined to give precise figures) and that this consistency continued into January. With respect to pricing, we note that revenue per shipment excluding fuel was +5.3% y/y (note: versus JPMe at +3.5%) and revenue per shipment mile excluding fuel was +1.3% y/y (note: compared to 3Q12 at +4.3%).

Figure 1: CNW's Y/Y Pricing (rev./cwt excl. fuel) by Quarter

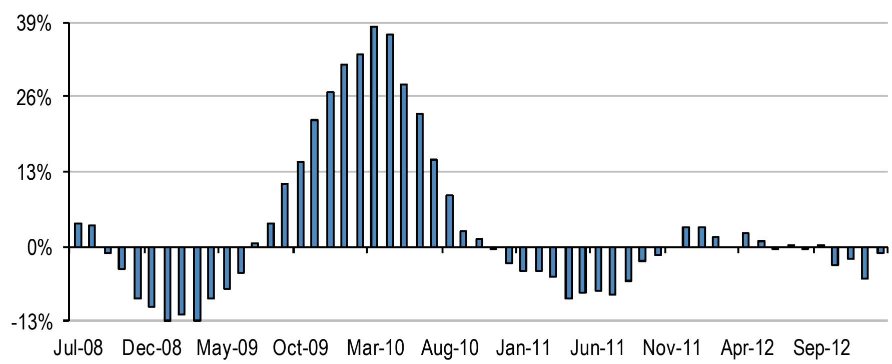


Source: Company reports and J.P. Morgan estimates.

Y/Y change in tonnage/day decelerated but was in line with our estimate

CNW's tons/day was down -3.5% y/y in 4Q compared to our forecast of -3.0% and the result in 3Q of -0.2%. We believe y/y tonnage growth in 4Q weakened somewhat through the quarter before turning somewhat less worse in January. October was -3.1% y/y, November was -2.1%, December was -5.7%, and January was -1.2%. That said, on a two-year stacked basis the trend appears somewhat more consistently better as October was -4.5% measured over two years ago, while November was -2.1%, December was -2.6%, and January was +2.3%. While price is a stronger driver of incremental margin performance, we believe CNW will do better in an environment of solid pricing and modestly growing tonnage (versus an environment of essentially no growth to slight contraction, which CNW is in now).

Figure 2: CNW's Y/Y Tonnage Trend by Month



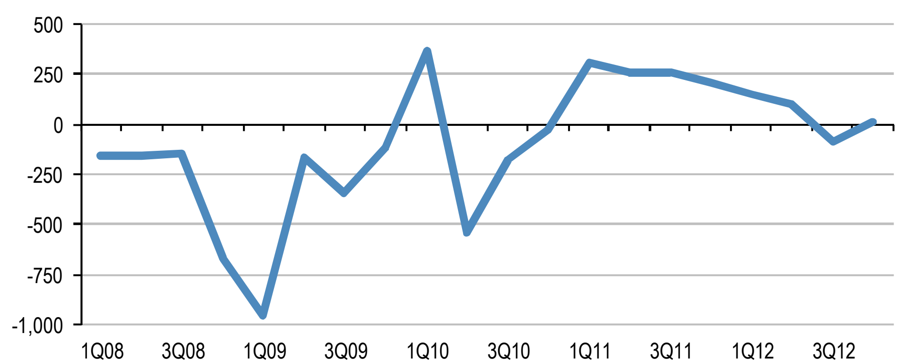
Source: Company reports and J.P. Morgan estimates.

Freight segment OR was essentially unchanged y/y

The Freight segment OR was roughly unchanged in 4Q12 as it was only 10 basis points better y/y. Before digging into the specifics of the profitability we step back to analyze the balance CNW is striking between volume growth and pricing growth. Within the Freight segment, tons/day was down -3.5% (note: 3Q was -0.2%), while revenue per hundredweight excluding fuel expanded +4.2% y/y (note: 3Q was +3.4%). The contraction in tons/day was 50 basis points more than we anticipated, while the increase in revenue per hundredweight excluding fuel was 170 basis points more than we forecasted. When we combine the tonnage and pricing growth, revenue per day excluding fuel of +0.7% was better than our forecast of -0.5%, though it decelerated from +3.2% y/y in 3Q and +4.1% y/y in 2Q. And keeping in mind the incremental margins of pricing relative to volume, our sense is that the incremental profit opportunity from top-line growth alone (i.e., excluding cost side productivity/efficiency) was roughly equal in 4Q relative to 3Q and 2Q. In summary, we believe CNW is striking a stable balance (from 2Q through 4Q) between volume growth and pricing growth to drive profitable revenue growth.

In any event, with the incremental profit potential from the revenue side about stable and with healthcare relatively more stable y/y than it has been, our sense is that efficiency gains have yet to be felt as y/y profitability was roughly unchanged in 4Q. We assess this based on the fact that the Freight segment operating ratio (as a proxy for total company) improved only 10 bps y/y (to 97.4%). Meanwhile, the total company operating ratio of 97.2% reflected 26 bps of deterioration on a y/y basis.

Figure 3: CNW Freight Y/Y Operating Ratio Improvement
basis points



Source: Company reports and J.P. Morgan estimates.

Truckload segment underperformed in 4Q

In terms of the Truckload segment, the operating ratio of 94.5% was 60 bps worse y/y and 150 bps worse than our 93.0% forecast. The vehicular claims expense of $2.2 million that we mentioned earlier was a roughly 140 bps headwind. Importantly, base revenue per loaded mile in the Truckload segment was +2.3% y/y in 4Q compared to +2.0% y/y in 3Q and +3.0% y/y in 2Q. The rise in fuel prices in 4Q12 was a headwind to margin performance but less so than in 3Q. In 3Q, net fuel expense (total fuel expense less fuel surcharge revenue) as a percentage of base revenue improved 55 basis points y/y, but in 4Q the net fuel expense drove 178 basis points of y/y improvement.

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Con-way: Summary of Financials

Income Statement - Annual	FY12A	FY13E	FY14E	Income Statement - Quarterly	1Q13E	2Q13E	3Q13E	4Q13E
Revenues	5,580	5,725	6,078	Revenues	1,381	1,486	1,460	1,398
Total operating expenses	5,355	5,465	5,770	Total operating expenses	1,331	1,407	1,384	1,343
Operating income	225	260	308	Operating income	50	79	76	55
Operating ratio	4.0%	4.5%	5.1%	Operating ratio	3.6%	5.3%	5.2%	3.9%
Margin improvement (bps)	29	51	54	Margin improvement (bps)	(45)	3	128	116
Interest expense	55	54	52	Interest expense	14	14	14	14
Other income - net	(3)	(3)	(3)	Other income - net	(1)	(1)	(1)	(1)
Total other income	52	51	49	Total other income	13	13	13	13
Income tax expense	(64)	(78)	(97)	Income tax expense	(14)	(25)	(24)	(16)
Effective tax rate	38.5%	38.5%	38.5%	Effective tax rate	38.5%	38.5%	38.5%	38.5%
Net income - continuing	103	124	156	Net income - continuing	22	40	38	25
Net income - GAAP	105	124	156	Net income - GAAP	22	40	38	25
Diluted shares outstanding	56	57	57	Diluted shares outstanding	57	57	57	57
EPS - continuing	1.82	2.20	2.75	EPS - continuing	0.39	0.70	0.67	0.44
EPS - GAAP	1.85	2.20	2.75	EPS - GAAP	0.39	0.70	0.67	0.44
Volume growth	(0.3%)	(1.9%)	2.5%	Volume growth	(3.0%)	(2.0%)	(1.5%)	(1.0%)
Yield growth	4.4%	4.0%	3.5%	Yield growth	4.0%	4.0%	4.5%	3.4%
D&A	211	224	244	D&A	56	56	56	56
EBITDA	436	484	553	EBITDA	106	135	132	111

Balance Sheet and Cash Flow Data	FY12A	FY13E	FY14E	Ratio Analysis	FY12A	FY13E	FY14E
Cash and cash equivalents	515	626	791	Sales growth	5.5%	2.6%	6.2%
Accounts receivable	650	681	712	EBITDA growth	9.1%	10.9%	14.2%
Materials and supplies	-	-	-	EPS growth	18.0%	20.9%	25.1%
Other current assets	121	124	127				
Current assets	1,286	1,430	1,630	EBIT margin	4.0%	4.5%	5.1%
PP&E	1,638	1,765	1,882				
Other assets	58	60	62	EBITDA margin	7.8%	8.4%	9.1%
Total assets	3,339	3,612	3,932	Total debt/total capital	47.3%	43.1%	38.8%
				Net debt / total capital	25.4%	15.5%	2.4%
Total debt	809	809	809	Total debt / total capital (ex-off bal sheet debt)	47.3%	43.1%	38.8%
Total liabilities	2,438	2,544	2,659	Net debt / EBITDA	0.7	0.4	0.1
Shareholders' equity	901	1,068	1,273	Interest coverage	4.1	4.8	5.9
Net income	105	124	156				
D&A	211	224	244	Pretax return on assets (ROA)	6.1%	6.5%	6.9%
Change in working capital	(20)	(20)	(20)	Return on equity (ROE)	12.6%	12.6%	13.3%
Other (incl. deferred taxes)				Return on invested capital (ROIC)	7.6%	7.7%	8.0%
Cash flow from operations	374	422	474				
				Free cash flow / share	-	-	-
Capex	(300)	(299)	(297)				
Free cash flow	89	138	191				
Cash flow from investing activities	(300)	(299)	(297)				
Cash flow from financing activities	(12)	(12)	(12)				
Dividends paid	(23)	(23)	(23)				
Share repurchase	**0**	**0**	**0**				

Source: Company reports and J.P. Morgan estimates.
Note: $ in millions (except per-share data).Fiscal year ends Dec

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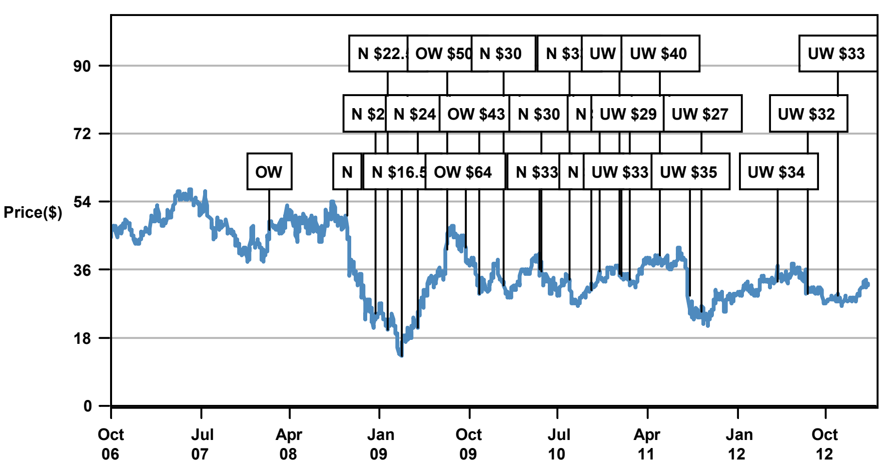
Con-way (CNW, CNW US) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Jan 29, 2008.

Date	Rating	Share Price ($)	Price Target ($)
29-Jan-08	OW	46.23	-
22-Sep-08	N	50.38	-
19-Dec-08	N	24.12	25.00
27-Jan-09	N	20.27	22.50
10-Mar-09	N	13.20	16.50
27-Apr-09	N	20.80	24.00
24-Jul-09	OW	41.26	50.00
22-Sep-09	OW	41.60	64.00
04-Nov-09	OW	29.33	43.00
15-Jan-10	N	31.48	30.00
06-May-10	N	36.12	33.00
12-May-10	N	35.23	30.00
05-Aug-10	N	33.37	33.00
13-Oct-10	N	30.68	38.00
04-Nov-10	N	35.31	39.00
05-Jan-11	UW	34.95	34.00
13-Jan-11	UW	34.56	33.00
03-Feb-11	UW	33.17	29.00
05-May-11	UW	39.54	40.00
05-Aug-11	UW	28.82	35.00
13-Sep-11	UW	24.63	27.00
02-May-12	UW	32.76	34.00
01-Aug-12	UW	29.55	32.00
01-Nov-12	UW	29.11	33.00

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