The Railroad Week in Review
January 22, 2010

"The law of supply and demand is not to be conned. As the supply of money increases relative to the supply of tangible assets in the economy, prices must eventually rise." -- Alan Greenspan, Gold and Economic Freedom, 1966

Warren Buffet has famously said that his bet on BNSF is a bet on America. And yet there is no shortage of funds and traders who are looking for ways to short the US dollar against other currencies. Even as CNBC's Mark Faber has said shorting the dollar today may be premature, he does not say it's out of the question. He says the "PIIGS" countries -- Portugal, Italy, Ireland, Greece and Spain -- that lived on borrowed money in boom times are having a tough go of it today and in the next few years those troubles could doom the euro. We may be next along with Japan, he says.

It's just a matter of time, Faber writes, "The US crisis won't hit us this year or next year. But within five to ten years, the US will be forced to quietly default on its debt, most likely by printing money and destroying the value of the currency." Faber is not alone here. Contributor Jake Towne writes at www.seekingalpha.com, "Sound money not only disciplines government from committing reckless spending but, more importantly, prevents these gross economic imbalances from ever occurring. The United States does not have sound money, despite the fact that the Constitution, the supreme law of the land, mandates this. Today the dollar is a bill of credit not backed by gold or anything else - even though the Constitution still forbids the right to emit bills of credit for use as money."

Nothing new here. Alan Greenspan wrote 40 years ago, "When business in the Unites States underwent a mild contraction in 1927, the Federal reserve created more paper reserves in the hope of forestalling any possible bank reserve shortage... The excess credit which the Fed pumped into the economy spilled over into the stock market creating a fantastic speculative boom... By 1929 the speculative imbalances had become so overwhelming [that they] precipitated a sharp retrenching and a consequent demoralizing of business confidence."

Is it deja vu all over again? Possibly, and I'm not holding my breath for any rapid recovery in shortline carloadings. As for the Class Is, Jason Seidl at Dahlman & Rose writes, "Although rail volumes have made a notable recovery in the second half of 2009 from the historically low levels seen earlier that year, the improvement was largely attributable to the easiest year over year comparisons in decades... Improvement will occur slowly and gradually in 2010 and rail traffic growth may fall short of some investors' expectations... The year 2010 is unlikely to be the banner year needed to erase memories of the late 2008/early 2009 nightmare."

CSX once again was the lead-off batter for this season's earnings calls. Some headlines would have you believe it was a winning quarter based on better earnings-per share, 77 cents vs. 63 cents year-over-year but if you back out discontinued operations and last year's "other income" it's a different story – EPS down 16 percent from 92 cents. Total revenue was $2.3 billion, down 13 percent. Operating income for the core railroad business dropped 16 percent thanks to seven percent fewer revenue units and 12 percent lower ops expense, a third of which came from the 25 percent decrease in fuel expense.

The usual commodity suspects hammered both car counts and revenues – forest products, metals, coal – however there was good news in that the sequential quarter-to-quarter rate of decrease is lessening. Look at metals where full-year loads were off 40 percent but half that in the quarter, or chemicals – down 14 percent for the year improved to down 4 percent in the quarter. Revenues and units were up 135 and 225 basis points against Q3 but are still down 22 and 14 percent from their 3Q08 levels. During the call Chief Commercial Officer Clarence Gooden said nine of the ten commodity groups are "favorable" for 2010 with coal the only outlier.

This was COO David Brown's first appearance on a quarterly call and he did a masterful job. Starting with safety, FRA reportables for personal injury and train accidents were at four-year lows for both the year and the quarter. The percentage of on-time arrivals was the same as the percentage of on-time departures – 79 percent, a complete reversal of the Q4 trend since 2006. System train velocity also hit a four-year best, however Brown conceded that cutting train-starts to match car-counts increased yard dwell times slightly. As a result, CSX handled the incremental business increase within the present service plan thanks in part to the ability to bring back furloughed T&E crews, restart stored locos, and put stored cars (mostly coal, auto racks and metals-carriers) back in service quickly.

The last big take-away is CSX' success in making fixed costs variable. Combined short-term (fuel, car hire, unit train T&E) and long-term (terminal ops, local and network T&E) variable costs dropped a combined 31 percent to another Q4 low while fixed costs came down just nine percent. To be sure, short lines running a train day lack that kind of flexibility, but it's something to shoot for. CSX this quarter has shown once again it's a Work in Progress and the company is recovering nicely from both the business downturn and some of the management mistakes made years go. Norfolk Southern, CSX is on your case. (Disclosure: I am long CSX but short the Feb 55 calls, ditto NSC.)

There were two main themes on the Union Pacific call. First, the railroad can handle 10-15 percent more revenue units with little increase in expense beyond fuel and car hire thanks to better operating practices. Second, UP set records in safety, service metrics and the "value proposition" as measured by the Customer Satisfaction Index. During the Q&A it was remarked that the core railroad is still set for 200,000 units a week and that ops expenses came down 13 percent while handling only five percent fewer units. Total quarterly sales hit $3.75 billion, down 12 percent, and operating income was $1.00 billion, also down 12 percent.

COO Dennis Duffy said they're looking to increase the "average" train size, they should be at 70 percent DPU train starts in a year and that "duped" trains use four to six percent less fuel per GTM. CEO Jim Young added that UP has locomotive cars and track "sitting there depreciating" and he needs to get them back to earning their keep. Thus the ability to add volume at little incremental cost and why CFO Rob Knight said 80 percent of total expense is now volume-related. The biggest downside is in the re-reg threats that will limit the ability to make capacity investments and in unfunded mandates such as PTC. Said Young, if capex is legislatively limited UP will restrict capacity additions to those with the best returns.

Fourth quarter revenues, volumes and revenue per unit increased sequentially over the third quarter by two, one, and one percent respectively. Year-over-year deltas were down 12, five and nine percent respectively; going back six quarters including 4Q09 these numbers were down 23, 14 and 11 percent respectively. Recovering to those levels is not going to happen in the next four quarters – if ever. Year-over-year volume shortfalls in the industrial products group remain in double digits; chemicals was down only two percent and ag products were actually up three points on export beans and meal plus ethanol and DDGs.

A reversal of fortunes is at clearly hand. Full-year revenues and car-counts were down double-digits everywhere but ag products whereas in the fourth quarter the deltas had come down to single-digit levels everywhere but industrial products and coal; only coal was worse off in the quarter than for the full year. All of which says to me that volume growth opportunities exist across the board, UP's strong value proposition will protect pricing and yield, and -- barring Congress doing anything really stupid -- there will be continued efforts to add capacity by running trains faster and smarter and putting money in the ground where returns are assured by dint of new volumes. Not bad, considering.

BNSF reported freight revenues of $3.57 billion including a $388 million decrease in fuel surcharges, down 16 percent from the 2008 quarter. Revenue units dipped 12 percent, though the rate of year-over-year decline appears to be moderating. Freight revenue increased two percent vs. the third quarter though volumes were down a point. Revenue per unit increased four percent sequentially. Ag products was the hero here as elsewhere, actually up five percent for the quarter.

Operating expense dropped 15 percent, the biggest portion of which was fuel, down 33 percent on a 21 percent drop in the average cost per gallon, 14 percent fewer gallons used for an eight percent GTM decrease and consequent seven percent gain in GTMs per gallon. Operating income came down 20 percent and the operating ratio (I use the classic ops expense as percent of revenue whereas BNSF uses a slight variation on that) added a point to 75.7.

Agricultural products revenues dipped two percent to $822 million on improved unit volumes primarily driven by strong soybean exports; improved yields were more than offset by a decrease in fuel surcharges. Industrial Products revenues fell 21 percent to $722 million driven primarily by lower demand for construction and building products, partially offset by improved yields. Consumer Products revenues (intermodal and auto) declined 20 percent to $1.14 billion on lower volumes due to economic conditions, partially offset by improved yields. Coal revenues decreased 17 percent to $886 million on lower unit volumes driven by soft demand primarily due to economic conditions, low seasonal burn and weather-related challenges, partially offset by approximately $30 million for contract settlements and adjustments with specific customers.

As with CSX and Union Pacific, BNSF was pretty much able to keep operating savings in line with the decreases in revenue and volumes. Lower fuel surcharge revenue hurt RPU to be sure, however car-counts make or break the short lines. So as the operating discipline improves, so do yields and thus the chance for increased short line revenue per unit improves. The Berkshire transaction is bound to be good for and to BNSF short lines for this very reason. Run a solid business model and I think Dean Wise and his crew will be your strongest advocate.

The first Berkshire/BNSF shoe has dropped. Though BNSF reported forth quarter results on Thursday it did not hold a conference call. The reason most likely is that is the day Berkshire split its "B" shares 50-1 thanks to the "high ball" BRK shareholders gave the move at their meeting Wednesday. The Class B split was a key part of the BNSF deal when it was announced in December. Berkshire agreed to pay $100 per share in cash and stock for the 77.4 percent of BNSF shares that it didn't already own. (Disclosure: I am long the "Baby Bs.")

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