

# THE RAILROAD WEEK IN REVIEW

## FEBRUARY 5, 2010

*“The likelihood of extremely wet field conditions late February through the end of April is growing more likely.” – Department of Agriculture Economics, Kansas State University*

**Corn futures** are trending decidedly lower. Near months from March through September 2010 are all taking a haircut. Since hitting a peak north of \$4 a bushel in Jan midweek this week farmers were getting fifty cents less on normal daily trading volumes. The Department of Agriculture Economics at Kansas State University projects total unharvested corn production for the top 18 corn-producing states to be in the range of 630 million bushels or five percent of the USDA’s 2009 corn harvest.

An exacerbating problem has been higher than usual precipitation making it tough to get out into the wet fields to harvest. That in turn cascades into delayed spring planting. Moreover, late corn harvested when wet begins to spoil in storage when the weather starts warming up. There are also reports of “widespread low corn test weights” leading to more bushels going into animal feedlots and ethanol production.

Into the mix comes Russia’s state-owned United Grain Company seeking to obtain a nine percent share of the global grain market by 2015. Under the strategy, the company plans to increase its grain exports to 16 million metric tonnes by 2015, while Russia’s total grain exports in the 2015-2016 agricultural year are planned at 37.8 million metric tonnes. In 2010, the company’s grain exports are expected at 4 million metric tonnes. But it isn’t going to happen overnight.

According to postings at [blackseagrains.net](http://blackseagrains.net) hitting these levels “would require that both Russian ports and the company itself drastically increase grain handling capacities, and includes a strategy to raise its capabilities to 16 metric tonnes annually in 2015, compared to 3.6 million presently.” The total investment needed is right at \$100 billion rubles (\$3 billion), of which six percent has to go for a fleet of rail cars.

Still, it’s out there. Dennis Gartman writes in Monday’s *Letter*, “The problem is that for corn there are only worse times ahead, for the acreage that was taken out of wheat last year will make its way into corn and/or soybeans in the upcoming crop production year... Friday’s close was nothing short of horrid for corn. One of the oldest rules that the legendary Richard Dennis used so effectively was to buy new high closes on Friday, or to sell new low closes. Friday we closed at a new low. It is probably to be sold.”

The Kansas State University corn map ( [www.agmanager.info/marketing/outlook/newsletters](http://www.agmanager.info/marketing/outlook/newsletters) ) shows the wettest corn states to be North Dakota, Iowa, Nebraska, Illinois, Missouri, Arkansas, Alabama and Georgia. Short lines in those states might well start lining up cars to get this corn out of the silos before (a) the weather warms and it starts rotting and (b) prices fall further.

**Kansas City Southern brought up the markers** for the Class I railroad earnings season with some numbers that were decidedly “less worse” than the other Class Is and boding well for the coming year. To start with, KCS is the only Class I actually picking up a point in revenue-ton-miles as opposed to being down anywhere from one to 11 percent and an 80 basis-point positive operating income delta compared to negative double digits elsewhere.

Total fourth quarter sales decreased four percent (actually up a point ex-fuel surcharge) from a year ago to \$407 million on one percent fewer revenue units (note: more RTMs on fewer revenue units is

a good sign in itself). Operating expense dropped five percent (another good sign – faster than operating income *or* carloads) for operating income of \$92 million. The operating ratio came down 107 basis points and was down 70 BP from the third quarter of 2009. Not bad, especially with revenue per unit up three percent over the previous quarter.

There were several drivers behind these gains. CEO Mike Haverty cited better results from Mexico and an improved outlook for 2010 from that part of the KCS system. Railroad President David Starling said they're running trains 13 percent longer and they increased revenue ton-miles per employee 14 percent compared to the 2008 fourth quarter. Finishing the Rosenberg shortcut now gives KCS a highly competitive Mexico to Atlanta service of six days and the addition of the new high-horsepower locomotives gives KCS one of the youngest fleets in the industry.

Same-store pricing was up four percent and the corresponding line-haul rate per mile was taken up six percent. Commodity revenues increased in chemicals (STCC 28 *and* 29), auto and intermodal; merchandise carload average revenue per unit increased three percent. Mexico showed the stronger rebound in the second half of 2009, up 45 percent trough to base vs. 20 percent for KCS north of the Border. Below the line, net income drifted south \$4.5 million or 12 percent largely on higher interest payments. That's a pretty small negative in what I'd call an otherwise stellar quarter. And, just to put the cherry on top, every dollar increase in retained earnings for 2009 created \$23 in market capitalization. Warren Buffett would be proud.

**A common thread throughout** this season's earnings calls conveyed a general distaste for and frustration with the Washington scene. There may be some encouraging news after all. Tony Hatch, long a frequenter of those hallowed Halls on the Hill (and himself a denizen of that neighborhood before migrating to The Big Apple) writes, "After it truly looked like war was the future it now amazingly seems as if peace pipes are being smoked with 'constructive dialogue' the phrase *du jour*. The word is trickling out that in Washington there was a conference with top rail leaders, their political and legal advisors, labor and members of the Senate Commerce Committee staff that could turn out to be critical in deciding the next course of action for the railways in regards to the rereg fight in DC.

"The rails took the 'opportunity' of the Q4 2009 earnings calls to unanimously express their disapproval of the Bill (the STB Reauthorization Act) that passed out of the SCC last month... and it seems as if that was heard loud and clear by the SCC staff. The rails feel increasingly that the *undefined nature* of the costs (on bottleneck and other access issues – essentially caps on rates and returns) of the Bill, are overly dependent on undefined *future* decisions by a larger Surface Transportation Board (especially in light of what some on Wall Street are seeing as increasingly hard-to-defend decisions by the current Board); and the Bill comes without enough compensating 'wins' (such as in the critical area of replacement costs as stressed by UP's CEO Jim Young in last week's Q4 call) or *defined future benefits* on funding for PTC or other areas of infrastructure with public benefits.

"It now appears that hardened attitudes have softened, and the arms & armor put away (for now) in favor of a return to 'constructive dialogue,' surprising both the Doves and the Hawks in the rail delegation. Will it last? *Two events in the near future may have some bearing* on that, as well as the ongoing busy calendar in DC, the eventual election cycle (and the possibility, even if remote, of changed leadership), the impact of the unions (and their own negotiations), who have been active participants in the dialogue so far." I sure hope you're right, Tony. The last thing we need is capex cut back to "repair and replace" with no budgets for capacity expansion.

**We're getting mixed signals** from the coal mines. A note from Jeffries & Co this week suggests coal equities are over-sold and shares are under-priced. "Late last week we attended and presented at the 10th Annual Coaltrans America Conference. Our discussions with key producers, buyers, traders, exporters and consultants reflected a more positive view on the global met coal market, a more visible global thermal market, but still some hesitancy on the timing of a US thermal recovery. As the risk trade comes off, we would add to positions in select coal equities with **attractive met coal** exposure." [*Emphasis added and I might include Class Is with major met coal exposure -- NS and CP come to mind. – rhb*]

Turning to company specifics, Jeffries singles out Arch Coal's "disappointing year-end results yet sequentially stable margins. We believe supply cuts, capital expenditure discipline, and an eventual improvement in utility and **steel utilization** will improve coal industry fundamentals and support a share recovery [even though] fourth quarter results missed consensus expectations." [*Again my emphasis added and it supports the above re met coal. – rhb*]

**Supplier stock tips as outlook indicators** Two notes from Janney here in Phila cast some light on the rail industry outlook. **Wabtec NEUTRAL.** "Wabtec is not banking on a robust economic recovery in 2010, but is instead planning for a slow, modest recovery -- stable transit business, modest growth in freight aftermarket, and continued pressure in Freight OEM." [*Take-away: Increased railroad freight volumes wear out brake shoes and running gear faster but they're not building that many new cars. —rhb*]

**L. B. Foster BUY.** "For 2010, we are looking an improved outlook for several businesses within both the rail and construction related businesses, which will be offset by lower gross margins. Despite continued softness in certain businesses, the company has done an excellent job capturing new sales, maintaining profitability and maximizing free cash flow generation." [*ARRA money to rebuild so-called HSR corridors will benefit companies in this space, Koppers for example. -- rhb*]

**BNSF President Matt Rose** holds forth in a remarkable interview with *Railway Age* Editor Bill Vantuono interview in conjunction with Rose being tapped Railroader of the Year by the magazine. You'll hear Matt talk about the importance of advances in railroad technology, how the Berkshire transaction came about, passenger on freight as a means to promote freight benefits, the need for a healthy rail supply industry, and ways to improve the positives of the industry on Capitol Hill. It's all at [www.railwayage.com](http://www.railwayage.com) and shame on the shortliner who does not dial in and take heed.

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## Fourth Quarter 2009 Class I comps

### Class I Commodity Carload Comps

Quarter ending **12/31/09**

### Revenue and income in \$millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	\$ 3,681	\$ 1,882	\$ 1,122	\$ 2,320	\$ 407	\$ 2,106	\$ 3,754
<b>YOY Pct. Change</b>	<b>-15.8%</b>	<b>-14.5%</b>	<b>-15.9%</b>	<b>-13.2%</b>	<b>-4.0%</b>	<b>-15.8%</b>	<b>-12.4%</b>
Revenue Units (000)	2,112	1,077	620	1,498	437	1,567	2,052
<b>YOY Pct. Change</b>	<b>-12.3%</b>	<b>-0.1%</b>	<b>-6.8%</b>	<b>-6.6%</b>	<b>-1.2%</b>	<b>-9.2%</b>	<b>-4.9%</b>
RTMs	150,047	41,819	28,874	51,600	11,273	40,900	123,527
<b>YOY Pct. Change</b>	<b>-7.3%</b>	<b>-1.3%</b>	<b>-5.4%</b>	<b>-10.9%</b>	<b>7.8%</b>	<b>-9.7%</b>	<b>-8.6%</b>
Carload revs (2)	\$ 1,641	\$ 1,216	\$ 687	\$ 1,288	\$ 299	\$ 1,119	\$ 2,092
<b>YOY Pct. Change</b>	<b>-12.3%</b>	<b>-16.4%</b>	<b>-15.4%</b>	<b>-9.0%</b>	<b>-4.7%</b>	<b>-8.6%</b>	<b>-12.5%</b>
<b>System RPU Pct Chg.</b>	<b>-4.1%</b>	<b>-15.0%</b>	<b>-9.4%</b>	<b>-7.2%</b>	<b>-3.1%</b>	<b>-7.3%</b>	<b>-8.8%</b>
Pct carload	44.6%	64.6%	62.9%	55.5%	73.5%	53.1%	55.7%
Pct Intermodal	28.3%	18.1%	26.8%	14.7%	10.4%	19.3%	18.2%
Pct Coal	24.1%	6.0%	10.3%	27.6%	11.8%	27.5%	20.4%
Mdse Carloads (000)	628	643	295	609	212	542	790
<b>YOY Pct. Change</b>	<b>-9.1%</b>	<b>-1.2%</b>	<b>-5.8%</b>	<b>-3.8%</b>	<b>-7.6%</b>	<b>-1.7%</b>	<b>-6.3%</b>
Rev/CL x coal, IM	\$ 2,874	\$ 1,891	\$ 2,328	\$ 2,115	\$ 1,410	\$ 2,065	\$ 2,648
<b>YOY Pct. Change</b>	<b>-3.5%</b>	<b>-15.4%</b>	<b>-10.2%</b>	<b>-5.5%</b>	<b>3.1%</b>	<b>-7.0%</b>	<b>-6.7%</b>
Operating Expense	\$ 2,786	\$ 1,229	\$ 853	\$ 1,737	\$ 315	\$ 1,557	\$ 2,752
<b>YOY Pct. Change</b>	<b>-14.5%</b>	<b>-10.9%</b>	<b>-17.2%</b>	<b>-12.4%</b>	<b>-5.3%</b>	<b>-7.8%</b>	<b>-12.5%</b>
RR Operating Income	\$ 895	\$ 653	\$ 269	\$ 583	\$ 92	\$ 549	\$ 1,002
<b>YOY Pct. Change</b>	<b>-19.8%</b>	<b>-20.4%</b>	<b>-11.6%</b>	<b>-15.8%</b>	<b>0.8%</b>	<b>-32.5%</b>	<b>-12.2%</b>
<b>RR Operating Ratio</b>	<b>75.7%</b>	<b>65.3%</b>	<b>76.0%</b>	<b>74.9%</b>	<b>77.4%</b>	<b>73.9%</b>	<b>73.3%</b>
<b>YOY Point change</b>	<b>1.21</b>	<b>2.58</b>	<b>(1.17)</b>	<b>0.75</b>	<b>(1.07)</b>	<b>6.43</b>	<b>(0.07)</b>

(1) CN, CP in \$Canadian

(2) Excludes coal, intermodal

Source: company financials

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