# RAILROAD WEEK IN REVIEW
## NOVEMBER 10, 2006

*"We remain more bullish on fundamentals for the Class I rails relative to the shortlines as the larger rails have a pricing and productivity story outside the economy." – Bear Stearns note on GWR Q3 results.*

**Shortline railroad operators** need to watch the truckload sector as well as their own. We all know that how the truckers price determines in large measure "market prices" that railroad marketing managers try to match or beat. Transportation industry analyst reports are an excellent source of intelligence and JP Morgan's Tom Wadewitz is one of the best. He writes, "Despite the pressures arising from weak truckload demand in August and September, 3Q reports for most of the TL names were above our and Consensus expectations and showed yoy growth." We remain cautious on this group due to a combination of weak TL demand and soft macro-economic data."

In other words, there's a lot of competition out there and the pricing power trucks used to have may be waning. Tom observes that "revenue per loaded mile results were mixed across the carriers" with prices dropping as much as 4% in Q3 and into year-end as "the near-term demand outlook is weak. The recent macro economic data (Sept IP and Oct ISM) also point to a slowing economy. Sentiment on the group is very poor and short covering rallies add volatility. However, lacking signs of improved demand or an indication the Fed is close to easing, we suspect risk reward for the TL group is likely to remain unfavorable."

Now pair that with what Clarence Gooden, EVP Sales and Marketing at CSX, said about truckload pressures during the third quarter conference call Q&A: "There remain considerable pressure points on truckers – hours of service, high fuel costs, driver retention, congestion, etc. All of which creates a positive pricing environment for rails."

Meanwhile, over at Bear Stearns, Ed Wolfe opines that, based on what he saw and heard at the recent American Trucking Associations annual conference in Dallas, "the truckers' debate is about whether or not the current sluggish truck freight demand environment will pick up in the coming months" from now into 2007. Ed continues, "Some truckload companies suggested that volumes had been soft recently because of shippers drawing down inventories, and later in 4Q:06 and 1Q:07 shippers would need to replenish those inventories with stronger volumes."

That was subject to further debate as retailers had different outlooks as to inventory levels after the holidays. He concludes, "Our view is that increased truck capacity from record builds, diversion to intermodal movements, deeper penetration by smaller, mid-sized carriers, and brokers, and greater reliance on in-house fleets has reduced demand [for individual] large truckload carriers, rather than a full scale demand slowdown." And the Owner-operators are filling the gaps, shippers tell me.

**Taking trucks off the highways** seems to be the standard railroad mantra these days but unless they do a better job in the merch carload sector it ain't happening. Norfolk Southern's cute tree-with-intermodal box TV ad notwithstanding, any intermodal container has to hit the highways someplace. The only way you get trucks truly of the highways is to avoid the highways altogether by stuffing individual carloads at origin and unstuffing them at the final destinations – transloads don't count.

Regular WIR readers will recall my remarks about a distressing trend among shippers to use less rail and even to re-source raw materials to avoid what they perceive as incessant high double-digit price increases coupled with mediocre and inconsistent service delivery. Yet the Class Is posted double-digit revenue increases in the third quarter on GTM deltas ranging from BNSF plus 7% to CP minus 1%. Merch carload volume deltas ranged from BNSF plus 4% to CSX minus 2%. In other words, more money for about the same work.

More worrisome still is the yoy ops expense delta ex-fuel. With the exception of BNSF where ops expense ex-fuel was down and GTMs were up, it appears that on some roads ops expenses ex-fuel are increasing faster than GTMs or revenues. If that's the case there could be an argument that the Class Is are becoming *less* efficient.

The table following the disclosure tells the tale. The revenue line contains fuel surcharge because the way it's reported (or not) it's impossible to get all players on the same page. But it's safe to say that roughly a third of the yoy revenue increase is FSC. The real meat is the spread between the GTM delta and the ops expense delta ex-fuel. Fuel is a killer across the board, so taking it ourttells us how well they're doing with expense control everywhere else. CN is a real surprise as their ops expense went up faster than their GTMs; BNSF takes the brass ring as GTMs were up 7% and ops expense ex-fuel came down 8%.

Finally, as ops become less efficient and merch carload service deteriorates, it bodes ill for the "trucks off the highways" mantra. In fact, a Bear Stearns report dated Nov 2 says that they have seen "increased capacity entering the truckload market at a rate faster than the still healthy demand." And that's just the public companies like JB Hunt and Arkansas Best. Add to that all the OOs cluttering the Interstates and you begin to get the picture.

If it's an equipment question, the shortlines can help – another recurring WIR theme. Writes one long-time reader with a background in marketing and ops on Class Is and shortlines, "At times it is more difficult to sell an idea to the Class Is than it is to the customer. The Class Is have a greater need than ever to increase capacity and anything short lines can do to pick up capital costs will help to get joint projects approved. Leasing new equipment and even locomotives for low-rated or short haul commodity unit trains can make the difference in gaining Class I approval for a project. For example, short lines can work with Class Is to take older equipment that is out-of-service for minor repairs and repair them or have them repaired and assigned to short line customers.

"On a broader thought - I have felt for many years Class Is' fixed costs are too high. Most of the costs of trucking are variable and I think that historically allowed truckers to easily figure revenue vs. cost enabling even unsophisticated truckers to take high-rated traffic from the rails. Anything short lines can do to take out capital costs and make their traffic more variable cost will do the Class I's a huge favor." He's nailed it perfectly IMHO.

It's been amply shown over time that the shortlines are best-suited to increasing merch carload vols. However, having the opportunity cut short with over-zealous pricing and uneven service diminishes the value of the shortline contribution. I've sent a note out to my shortline sounding board asking for feedback on the theme; WIR readers are invited to send comments on the trends you're seeing in the merch carload (ex-coal and IM) business on your road, off the record and not for attribution.

**If there was one theme** running through both the CN and BNSF shortline meetings concluded last month, it was carload velocity in miles per day and how to get that number up. This YTD alone BNFS has increased freight velocity by 7% to a record 196 miles per day. However, there is still ample room for improvement, especially in the "first-mile, last-mile" arena, the shortlines' bread and butter. In their presentations BNSF staffers drilled down to specific actions and responsibilities for itself and its shortlines, which, if properly implemented, will effectively wipe out differences between the way shortlines and BNSF do the gathering and distribution.

CN has boosted freight car velocity by 13% to 178 miles a day from 2Q05 through 2Q06. Here again, CN seeks to have the shortlines run to the same "precision railroading" discipline. What we're looking for is what CN's Ed Harris calls "unconstrained capacity," realized by generic fleets, faster car turns, routing protocols and appropriate customer behavior.

I can honestly say the shortline community is divided between those that Get It and those that don't. The former group includes the Top 20 from my June 2006 TRAINS article plus a handful of independents – maybe 150 properties in all. The rest will find themselves "priced around" as CP's Fred Green put it at least year's analyst meeting in Vancouver.  Remember, demurrage is not a car-hire offset; it's a penalty assessed for not moving the asset. Car hire reflects turn time, and the less of it the better. Masking real car hire expense with demurrage offsets can mask car cycle problems.

**At the recent ASLRRA Eastern Region** meeting we heard from MIT's Car Martland, a chap who's been working on freight car velocity for years. Larry DeYoung, a fellow writer and shortliner, was there as well and he writes, "I noted one thing in Carl Martland's presentation: 11 turns a year on merch cars. Interestingly, that was the average for the Conrail Covered Hopper and Tank Car Business Group when I first became its service analyst, in 1978!

We had yet to bottom out in terms of the problems inherited from PC et. al., yet, in effect there has been *no change* in equipment utilization in 28 years. That stinks, and is a total squandering of a significant part of the invested asset base. No wonder there are not enough freight cars to go around, and even with the manufacturers' backlog, the fleet continues to age." And prices go up to reflect constrained capacity?

**American Railcar Industries** (NYSE: ARII) managed a 40% yoy eps gain in 3Q06 to 51 cents a share on $150 mm in sales, same as 3Q05. Not bad, considering their main tank car manufacturing plant in Marmaduke AR had been shut down since the April 2006 tornado hit and not reopened until the present quarter. As it was, ARII turned out 1,309 covered hoppers, 236 tank cars and one three-platform intermodal prototype in the quarter, 95% of what they did a year ago.

Jim Unger, CEO, and his tem gave a great call on Thursday – no hype, just the facts, ma'am. Said Q4 tank car construction ought to around 550 units, besting the record 528 units out-shopped in 3Q05. Repair work ($12 mm in Q3) can reasonably be expected to increase as the US rail fleet ages. ARII is acquiring parts-makers and building their own to vertically integrate that process. The manufacturing backlog stands at 18,144 units, up 42% yoy from under 13,000 units, of which some 10,000 are tank cars, 60% of which will be suitable for ethanol.

The balance sheet shows no LTD to speak of, ARII having paid off more than $7 mm in the past year. Unger says they intend to increase gross margins (now at a respectable 10% of sales) through economies of scale and manufacturing efficiencies. If 2007 is sold out, and if cars for 2008 delivery are to be built over the next 12 months, and if ARII is now taking orders for 2009 delivery, and if tank cars suitable for ethanol are a growing part of the mix, then the outlook is rosy indeed. Unlike certain other car-builders, ARII is not in the leasing business. They are in business to sell to the leasing companies, and, said Unger, they do not want to go into competition with their customers. Fair enough.

**Sample Class I spreads between and among revenue, volume and expense ex-fuel.**

| Metric | BNSF | CN | CP | CSX | NS | UP* |
|---|---|---|---|---|---|---|
| Railroad Revs 2Q06 | $ 11,103 | $ 1,981 | $ 3,393 | $ 2,418 | $ 7,088 | $ 3,983 |
| YOY Pct. Change | 18.8% | 9.4% | 4.2% | 13.8% | 11.0% | 15.1% |
| MGTM 3Q06 | 287,318 | 88,880 | 59,102 | 116,600 | 95,800 | 270,000 |
| MGTM 3Q05 | 269,596 | 84,384 | 59,511 | 113,700 | 96,100 | 263,400 |
| YOY Pct. Change | 6.6% | 5.3% | -0.7% | 2.6% | -0.3% | 2.5% |
| Ops exp ex-fuel 3Q06 | $ 2,227 | $ 902 | $ 693 | $ 1,629 | $ 1,421 | $ 2,457 |
| Ops exp ex-fuel 3Q05 | $ 2,040 | $ 964 | $ 713 | $ 1,576 | $ 1,438 | $ 2,333 |
| YOY Pct. Change | -8.4% | 6.9% | 2.9% | -3.3% | 1.2% | -5.0% |

*Source: Class I quarterly reports*

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