THE RAILROAD WEEK IN REVIEW

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“The general consensus is for stronger growth in the second half of the year and we actually share that view.” Union Pacific Chief Commercial Officer Jack Koraleski

CSX took its usual place at the head of quarterly earnings line Tuesday. As expected, total revenue units were up a mere three percent: merchandise carloads (all but coal and intermodal) were up three percent, coal was off three percent and intermodal was up eight percent. Total revenue increased 13 percent to $3.0 billion as system average revenue per unit (RPU) gained ten percent vs. what Chief Commercial Officer Clarence Gooden called “rail inflation” of 4.6 percent [*I’m not totally clear on what this is. Anybody? - rhb*]. The year-over-year revenue delta was $356 million of which $140 million was fuel surcharge.

Operating expense increased ten percent to $2.1 billion; operating income gained 21 percent to $924 million for an operating ratio of 69.3 vs. 71.2 a year ago and keeping CSX on trajectory for a “mid 60s” OR in due course. Net earnings increased 22 percent to $506 million; earnings per share went up 22 percent (helped in part by the four percent drop in diluted share count) to 46 cents a share vs. my previous guess of 44 cents.

Fuel burn increased 3.5 percent on 1.2% more gross ton-miles. Revenue ton-miles (RTMs)were up 0.7 percent even though revenue units were up 3.0 percent, indicating shorter hauls or lighter loads or both. The load factor (RTM/GTM) was off 20 basis points to 54.8 percent. There was no significant change in volume mix as merchandise units remain at 41percent of the total. Coal dropped 152 basis to 23.57 percent of total units from 25.09 percent of total units. Intermodal increased 163 basis points to 35.53 percent of total units, Domestic boxes accounted for 53 percent vs. 47 percent for international.

It was instructive to read how the analyst community continues to emphasize changes “at the margin,” meaning that yes, the merch business remains the dominant sector, consistently generating well over half total revenues, but share price changes occur “at the margin.” The coal story is instructive because at a third of revs, a quarter of the carloads and a third of RTMs, seeing total coal tonnage down 2.8 percent is an eye-opener. Utility coal dropped 12 percent to 27 million tons yet export coal jumped 30 percent to ten million tons, “at the margin.”

Overall, it’s safe to say volume deltas are underwhelming with the rate of revenue-unit increase more than four times the rate of RTM increase. So what they’re not making in volume, they’re making up in price -- system RPU up 10 percent, more than twice the rate of rail inflation.
In his wrap on the call, Gooden said he expects volume growth in the second half to “exceed GDP.” With that number now in the 2-3 percent range that’s not saying much, though his “core pricing to exceed rail inflation” will help ops income and eps. Meanwhile, short lines on handling fees and switch carriers whose rev steams are volume-dependent had best hunker down.

The Union Pacific call was very much of a piece with the CSX story: revenue up 16 percent (to $4.6 billion) on scant -- three percent -- gains in revenue-unit volume to a crumb over two million units. Merchandise loads including automotive increased eight percent led by chemicals at 13 percent and ag products at 11 percent; automotive and industrial both saw four percent volume increases. Coal carloads increased two percent and intermodal dropped a percentage point -- not all that bad; see Wadewitz' s take below.

Ag prods were up on export whole grains, ethanol and beer imports; auto parts and finished vehicles both increased; the chemicals group saw growth in crude oil, fertilizers (export potash, e.g.) and industrial chemicals; industrial products posted gains in iron ore exports to China, strong shale-drilling demand and liner-board for packaging. As for the second half of 2011, CFO Jack Koraleski sees "opportunities" for increased carloads in ethanol, autos and auto parts, oil-shale development, met and steam coal out of Colo and Utah, export iron ore, and liner-board for packaging.

All commodity groups posted double-digit year-over-year revenue increases; RPUs (UP calls it ARC, Average Revenue per Car) increased across the board: industrial products 12 percent, ag products nine percent, automotive ten percent, chemicals seven percent, coal 11 percent and intermodal RPU jumped 14 percent.

Operating expense increased 19 percent as high fuel prices (ops expense ex-fuel up a mere 12 percent) and midwest flooding (higher than usual deltas across all expense line items) took their toll. Operating income increased only nine percent to $1.4 billion and the operating ratio came in at 71.3, up 193 basis points year-over-year. On the call, CFO Rob Knight pointed out that it would have been 69.3 if fuel price had remained the same. Below the line, net income increased ten percent to $785 million and earnings per share gained 14 percent to $1.59 thanks in part to three percent fewer shares.

UP did an admirable job on fuel. I mean, $904 million (up from $608 million a year ago) in diesel fuel going up the stack ain't pocket change. So when I see the railroad moving 4.9 percent more GTMs on three percent more fuel, I have to take notice, especially as GTMs per gallon were up by two percent.

As for the intermodal story, Koraleski talked about rates that are "re-investable," a laudable goal. JP Morgan's Tom Wadewitz writes,

> "A disciplined approach to intermodal is a positive. In contrast to a more typical pattern, UP's 2Q intermodal volumes (-1%) were weaker than total volumes (+3%) in 2Q. While the loss of a modest sized international contract was a headwind of ~1 percentage point to total intermodal volumes in 2Q, we believe there were greater factors holding back UP's intermodal volumes
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> "One was a new program to improve container utilization outside of peak and a very disciplined approach to pricing which supported 13.8% yield growth. Even though volumes may remain soft, we believe UNP's strategy in intermodal is positive for financial performance and the stock."

Kansas City Southern brought up the markers for the week, and what was particularly memorable was the way the team talked about fiscal responsibility and becoming "investment grade." Reminded me of a friend in the fixed income business who says sell-side guys want to see the price go up; bond guys want to be sure they get their money back. From the sound of things Thursday afternoon, Haverty et al are increasing the odds that one does.

Out on the railroad, KCS trounced the earlier presenters in the volume department -- up seven percent over the 2010 second quarter. Intermodal -- nearly 40 percent of total units -- was the big driver, up ten percent largely on the booming cross-border trade with Mexico. In his opening remarks, Executive Chairman Mike Haverty said it was the best quarter ever on many counts and the results that followed bore him out.

President and CEO Dave Starling said the 14 percent rate of growth would be bested in the second half, that the seven percent year-to-date volume delta might have been better save for late Q2 flooding and that the 110 basis point first-half operating ratio gain (to 72.7) came in spite of $8.6 million in fuel surcharge headwinds.

Merchandise carloads increased just two percent and coal five percent. The Industrial Products sector -- which I arbitrarily define as forest products, metals & scrap, ores & minerals, aggregates and "other" -- comprise 41 percent of non-coal or intermodal units and among them gained only one percent in car-count vs. the 2010 second quarter. Still, a nine percent gain in system RPU and an 11 percent increase in merchandise RPU helped KCS to healthy double-digit revenue gains across all commodities save only ag and minerals, where grain alone was off four percent.

Operating expense was up 16 percent, largely on fuel. It's the second largest expense after comp and benefits at 24 percent of total expense and was up 33 percent year-over-year. The fact that fuel burn increased 11 percent on only five percent more GTMs did not soften the blow of a 20 percent jump in fuel price. Second quarter operating income was $152 million, up 19 percent; the operating ratio came down 79 basis points to a respectable 71.7.

Chief Commercial Officer Pat Ottensmeyer said they see cross-border traffic gaining for all commodity groups with particular focus on intermodal truck conversions to build density. Victoria-Rosenburg volumes have increased in every quarter since they opened it, though the rate of increase slows as base gets higher.

The KCS outlook is for continued double-digit line-haul revenue gains: cross-border petrol and plastics gains in the chems group, paper in and appliances out in hi-cube boxcars in the IP group, and so on. Allison Landry at Credit Suisse sums it all up thus:"KCS confidence for the back half of the year stems from expected strength across all business groups, continued robust growth in the cross-border business and the fact that the Mexican economy is growing at a faster pace than the U.S. Furthermore, despite recent macro signals that point toward economic weakness at home, KCS says its customers expect growth in shipments for the balance of 2011."

From the Santa Maria Valley Railroad on the Southern California Coast comes word that this little hundred-year-old short line foresees better days ahead. My good friend Rob Himoto, himself an ex-finance guy and now President of the line, writes,

> Carload revenue increased three percent and 45 percent in the 2011 first and second quarters respectively. We found ways to slash expenses yet increase track maintenance and equipment maintenance. In other words, a higher percentage of our expense is going back into the railroad decreasing deferred maintenance.
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> There are three factors in our turnaround this year. First, Union Pacific Railroad's business development people have done a fantastic job of taking our leads and trying to turn them into business opportunities. Second, we are working with our customers to improve their service yet run more efficiently, setting us up to capitalize on the rapid deterioration of truckload service. With the predictability of UP service and working closely with the UP local crews, we can coordinate our spots with our customers so they can confidently arrange their work schedules to unload or load cars on schedule.
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> Third, our new Train Operations Manager, Al Sheff, is a former UP locomotive engineer who also has a small business background. He quickly recognized that we really needed a marketing blitz. He has talked to most of our customers looking for new opportunities and looking to see if we can further refine our service. He's gone to former customers and has already found one who is considering coming back to rail, last used us in 2005.
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> Al also is making his presence known with the city council and city officials and educating them the importance of a short line railroad in this community. We are finally getting recognized as the mayor issued a proclamation on the behalf of the city of Santa Maria for our 100th anniversary.
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> Our employees have responded and they in turn look for opportunities and look for squeezing more efficiency out of the railroad. The attitude is much more positive and they are willing to take on the challenges. I am really proud of this dedicated group of railroaders.

Thanks, Rob. And for more info on SMVRR, go to their Facebook page and "friend" them.

Q2 earnings continue next week with CN after the close Monday, NS after the close Tuesday and CP at 11 eastern time Wednesday. RA reports Thursday before the open and GWR brings up the markers August 2.

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