THE RAILROAD WEEK IN REVIEW

August 12, 2011

"We strongly believe that businesses are 'hunkering down' and awaiting the elections next year before expanding their work forces materially." -- Dennis Gartman, The Gartman Letter, August 8, 2011

BNSF reported 2Q results in its own 10-Q and in the pertinent portions of the Berkshire Hathaway 10-Q released August 5. Total revenue increased 17% to $4.8 billion on 2.3 million revenue-units, up 3.3%. Operating income was up 11% to $1.2 million; the operating ratio increased 129 basis points to 74.9 largely driven by increased fuel, labor and materials costs. Below the line, BNSF increased pre-tax net income 10% to $1.1 billion; after tax income was up 14% to $690 million.

One must assume most of the increased operating expense was flood-related. An e-mail to customers from Chief Commercial Officer John Lanigan explains.

> Record snowfall in the northern part of our network last winter and record runoff from the Missouri and Souris rivers caused extraordinary flooding. In the most significant incident, one of our busiest corridors along the Missouri River, the St. Joseph Subdivision, was completely severed by the widespread flooding.
>
> In response to these challenges, BNSF team members and contractors have worked around the clock to lessen the impact of these floods on your service. We have rerouted as many as 40 percent of our trains and temporarily relocated up to nearly 500 train crew employees to handle rerouted traffic. We have undertaken extensive preventive and rebuilding efforts, including raising miles of track by amounts of up to eight feet, building levees and berms to protect the rail and repairing and replacing hundreds of miles of damaged track, bridges and structures."

(The photo was taken this month at Big Lake, Missouri, (c) 2011 BNSF)

Drilling down into the commodity groups, what BNSF calls "consumer," (essentially autos and intermodal) increased 7% while coal was off 9%. Ag was flat at up 1% while the industrial products group jumped 14% year-over-year. This last is a significant number because among the Class Is BNSF has the lowest percentage of first-half 2011 total revenue coming from non-consumer commodities or coal, 42%. And they did it with a modest RPU gain, less than 7%.

However, the volume deltas are downright depressing. Within the Industrial Product group, the only double-digit gains were metals (19%) and waste/scrap (12%). All the rest ran from plus 5%

(non-metallic minerals) to minus 18% (chemicals), with most deltas less than five percent one way or another.

On a more positive note, what particularly intrigues me is the way the BNSF shortline group has zeroed in on eliminating what they call “friction” between themselves and the shortline community. The ALIGN program is its core, and it follows very closely Buffett’s guidelines for companies he likes: sufficient size, consistent earnings, management in place and a simple business.

If you are all these things, and you want to reshape the terms of your BNSF relationship, then by all means start the ball rolling. As I said in WIR when I first wrote about this program nearly two years ago, BNSF is the only Class I railroad seeking to develop “adult” relationships with its short lines. We’ll hear more about this at the October 2011 BNSF shortline meeting, I’m sure. (*Disclosure: I am a long-time owner of Berkshire Hathaway shares and Warren Buffett follower.*)

The just-released AAR *Rail Time Indicators* through July picks 2006 as the “peak year” for US rail freight. Looking at July, 2011 vs July, 2006, we see industrial products loads off 4%, intermodal is also off 4%, and all revenue units -- IP plus ag plus coal plus intermodal -- are down 10%. And the AAR cites a “high inventory/sales ratio,” meaning companies have more goods on the shelves than they can sell -- hardly the impetus to order more stuff.

Not surprising. We’re in what I tagged a “90-percent economy” a year or so ago. Here’s why. Back in 2006 we were selling houses, cars and video games to everybody on credit, even to that 10% of the population that couldn’t afford these things. Then they lost their jobs and and eventually their houses. And now we have 90% of the workforce supplying goods, services and housing for 100% of the population. The other 10% remains unemployed, not ordering stuff, at least until the other 90% start buying more stuff rather than de-leveraging still further.

As for 2H2011, I do not see any big uptick in freight vols. At a Charles Schwab investors’ lunch this week, Chief Investment Strategist Liz Ann Sonders talked about GDP expansion at more than two but less than three percent. Based on comments from the Q2 quarterly calls, I’m guessing we’ll see rail revenue-units up that much or a little more. At that rate it’ll take a long time to get back to the 2006 freight vols. And growth is in energy, ag for food (not ethanol -- that’s an unnatural act fomented by the feds), and intermodal. Short lines not in these spaces will find it tough going.

Since the AAR calls 2006 the peak year for rail vols, I thought it might be instructive to see how short lines have fared YTD through Week 26 (essentially 1H2011) compared with the first 26 weeks of 2006. It’s not pretty. The attached tables based on the RMI RailConnect Index reports for the respective periods. The column headings -- consumer, industrial, ag and coal -- correspond to the BNSF groupings because I think it’s a good way to separate out the commodity groups where most short line names have the most exposure.

Total shortline revenue units are down 17.5% over the 5 years. Only five of 14 shortline commodity groups are up, but not by much. Of the four broad groups, only ag is up but we don’t know how much of this is ethanol-related -- corn in, DDGs out, e.g. The chemicals group

includes the ethanol itself, which may or may not be sustainable depending on the government and the oil companies.

Intermodal is odd because back in 2006 some short lines were counting containers, others were counting platforms and few names have any anyway. Lumber and paper are off 50% and 28% respectively. Metals and metal products dropped 32% and auto -- I suspect parts, mainly -- dived 32%. So even if the Class Is increase vols by 2-3% in 2H2011, and intermodal is a big driver of that, it's going to be a tough row to hoe for those short lines whose living depends on merch carloads.

And if that isn't depressing enough, now comes Morgan Stanley's take:

> Rails are pricing in a dramatic decline in volumes at current valuation levels. Assuming a deceleration in price growth from current levels to ~4% and flat OR ex-fuel surcharge, that suggests the Class Is are pricing in mid-single digit volume declines YoY in 2012. If one assumes the rails will maintain recent core price growth and productivity trends, one might reasonably conclude the Class Is are pricing in approx. double-digit volume declines YoY in 2012. Despite the fact that recent volume trends imply negative consensus revisions, what's currently priced into rail shares strikes us as particularly bearish.

On the truck side, however, M-S sees little upside to margins as "downside risks to margins seem more likely given upcoming cost headwinds and regulatory challenges." I'm hearing more and more about truckload-RR conversions, and not just to intermodal. At the recent NS shortline confab in Roanoke I heard a number of encouraging words about truck-carload conversions. And the amount of merch carload traffic I saw on the Shenandoah line while driving between Phila and Roanoke provided some nice anecdotal evidence.

The RailAmerica and Genesee & Wyoming July carload stories were hardly howling successes. RailAmerica saw total carloads down 7% as coal -- 17% of total vols -- dropped 26%; absent coal the rest of the portfolio was off only a point. The chemicals group was the star performer, up 6% at 11% of total vols. Year-to date vols were off 3%.

GWR posted a 7% increase for North American July carloads, with particular strength in overhead NS coal on its Ohio lines. (GWR reports consolidated carloads including Australia, but I omit them for our purposes.) Ex-coal, units were up 5% on double-digit gains in "minerals & stone" and "farm & food." STCC 24 lumber and related goods (7% of vols) dipped 11%. Year-to-date carloads increased 6% but the July total was off 2% from June.

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Shortline Revenue Units

RMI RailConnect Index

Commodity Groups YTD Week 26 2006				**297 names**	
Commodity	**Cons**	**Ind**	**Ag**	**Coal**	
IM	461,148				
Coal				381,260	
grain			348,782		
Farm ex gr			121,306		
Ores		76,093			
SCA		290,326			
Lumber FP		200,564			
Paper Prd		228,706			
Waste/scrap		159,928			
Chems		397,511			
Pet/coke		151,113			
Metals		316,034			
Motor Veh	61,099				
Other		88,391			
Totals	522,247	1,908,666	470,088	381,260	3,282,261

Commodity Groups YTD Week 26 2011				**337 names**		**% Change**
Commodity	**Cons**	**Ind**	**Ag**	**Coal**		
IM	203,680					**-55.8%**
Coal				300,746		**-21.1%**
grain			365,094			**4.7%**
Farm ex gr			127,961			**5.5%**
Ores		76,135				**0.1%**
SCA		306,031				**5.4%**
Lumber FP		100,323				**-50.0%**
Paper Prd		167,441				**-26.8%**
Waste/scrap		145,029				**-9.3%**
Chems		454,237				**14.3%**
Pet/coke		132,777				**-12.1%**
Metals		229,716				**-27.3%**
Motor Veh	38,752					**-36.6%**
Other		59,827				**-32.3%**
Totals	242,432	1,671,516	493,055	300,746	2,707,749	**-17.5%**
% change	**-53.6%**	**-12.4%**	**4.9%**	**-21.1%**		