THE RAILROAD WEEK IN REVIEW

September 9, 2011

"Our 'sales blitzes' seek to identify who's out there in terms of potential new carloads and how do we convert them into actual freight on the rails." -- Clyde Preslar, CFO, RailAmerica

The Dahlman Rose & Co. Fourth Annual Global Transportation Conference in NYC on Wednesday was a real treat. It's not that often one can sit in a room and have the players come to you. We heard presentations from six of the seven Class Is (BNSF excepted) plus short lines (RailAmerica, Pinsley, Watco, Anacostia), JB Hunt, and a shipper panel (Wal-Mart, Formosa Plastics, Owens Corning, First Energy).

The Class Is were pretty much agreed that even though volumes are nowhere near what they were, say, four years ago, volumes are still growing in selected lanes and they're doing much better at keeping costs down, growing incremental margins, and making better use of assets from cars to crews to locomotives to available track space. In all, a worthwhile day.

Canadian National VP for Investor Relations Bob Noorigian led off the the Class I comparing weekly carload and RTM performance 2008-2011 to date with the latter slightly ahead of 2010 and even with August, 2008. Nearer term, carloads are up 3.8% for 2011 YTD and 3.7% for the current quarter to date; RTMs grew 4.8% and 4.9% respectively for these periods. After reviewing some 2Q2011 highlights (constant-currency sales up 11%, operating ratio 61.3), Bob took us through a number of commodity-specific trends that could work to the advantage of CN short lines: forest product up due to increased lumber and paper shipments to China, frack sand (40-60 cars per drill site) from Wisconsin origins, finished steel and an earlier grain crop.

Oscar Munoz, CFO at CSX, was up next. He allowed as how the current environment is "moderating, though the long-term outlook remains intact." YTD vols are up one percent with merch carloads up 3%, coal off one percent and intermodal up one percent with domestic running ahead of international. Domestic utility and industrial coal lanes are flat to down though export coal -- particularly to Asia -- is growing rapidly. Quarter-to-date ag is down a point on corn and fertilizer lanes, industrial products are up 5% on autos, scrap and steel. Liner board is up along with cement, aggregates and waste -- all positives for short lines.

Brian Grassby, SVP in Finance at Canadian Pacific, called August CP's "recovery month" with "metrics now back at historic levels" and citing car velocity in miles-per-day and terminal dwell in particular. Bulk (grain, coal, fertilizers) dominates with 43% of revs, merchandise (industrial and forest products, automotive) is second at 29% and intermodal a close third at 28%. The grain origin split is 60-40 Canada-US. The Asia trade in coal, potash and fertilizer continues to grow; carloads in support of new energy sources -- oil sands, shale gas -- are increasing at a GDP+ rate.

I asked about how serving many small grain elevators supports CP's Long Train Strategy. Said Grassby, "Elevator operators know the faster they can turn the cars, the more grain they can

move in a season. We gather them up, put them in long trains to turn quickly at the port, and get back to the elevators for another round." Short lines please take note.

Union Pacific CFO Rob Knight reviewed UP's Q2 and first half results and quickly segued into UP's Q3 to date performance: weekly carloadings at 187,000 and within striking distance of the 190K achieved in 2006 (I seem to recall CEO Jim Young saying they can do 200K without any major capacity additions); YTD loads up 3% with chems, industrial products and ag in the lead, again a positive for short lines. UP dominates the Mexican rail business with its part ownership of Ferromex and that road's coverage of Mexico's industrial heartland east and south of Mexico City plus six crossing points to and from the US. Near-sourcing and coal two big growth areas. Lastly, non-coal energy is expanding thanks to UP touching five shale areas plus the Wisconsin frack sand origins -- "a rail pipeline."

Kansas City Southern CFO Mike Upchurch dove right into the "superior revenue growth" KCS is seeing thanks to August carloads above pre-recession levels, consistent with seasonal patterns, and leading the Big Six class Is in getting back to 2007 peak levels. Upchurch expects the trend to continue, estimating a 9.6% CAGR for revenues through 2013 vs. 7.6% CAGR consensus for the other Class Is. Like UP, KCS has a major role in Mexico, and since it's a larger piece of the total traffic base for KCS than for UP, the effect on total vols and revs is magnified. Here again, truckload conversions are the big growth drivers. The Bakken and Niobrara oil fields represent potential new traffic to the petroleum processing facility on KCS at Port Arthur, Texas.

Don Seale, Norfolk Southern's Chief Commercial Officer and the only non-finance Class I speaker, brought up the markers for the Class Is. NS revenue units are up 4% quarter-to-date 2011 vs what they were a year ago. Coal, auto, intermodal and metals/construction lead while ag, chems and paper trail, though some one-time mix changes in ferts (counts as ag at NS) and fly ash (counts as chems) were the culprits here.

As of this month T&E are levels back to where they were in 2008. Speeds are up, dwells are down and the PI ratio is down. GTMs per employee and gallon of fuel slipped a bit due mainly to schedule disruptions from bad weather and other anomalies. The "Franchise Growth" chart has a number of shortline opportunities: metals/construction, agriculture and forest products, all of which lead to myriad new shortline business opportunities -- Marcellus Shale is but one example.

RailAmerica CFO Clyde Preslar was the day's only stand-alone shortline and regional railroad presenter. Right out of the box Clyde showed how RailAmerica's commodity and geographical diversification favor the carload rail franchise they enjoy -- 27 states and three Canadian Provinces with ag products Number One in revenues at 16% of total and everything else ten percent or less with 90% of all loads being interchanged with Class I carriers. Even though carload vols have declined by 30% since 2006, average RPU is up 42% due to shedding large numbers of low-rated commodity-OD pairs and substituting traffic with higher yields. RA's unique "sales blitzes" have proven particularly effective in bringing in new revenue streams.

Carloads through July 2011 are up one percent excluding coal (took double hits from weather and supply-chain changes) and ex-FSC RPUs are up 4% over the last 12 months. Non-freight

revenue, mainly from the Atlas acquisition, has increased 20% YTD. Project Horizon is now fully rolled out across the RA system, capturing lost revenues and improving billing accuracy.

The shortline panel was particularly instructive given its focus on the carload sector and first-mile, last mile advantages. Whereas the Class Is all spoke in terms of gross numbers, trends, obstacles and outlook, little was said about actual customer interface. The short lines fixed that. Anacostia's Peter Gilbertson, asked about volume trends, spoke for all when he said, "sideways" with qualifications. Supporting that, Pinsley's John Levine cited growth in ethanol and coal and Terry Towner of Watco saw hints of expansion in construction materials ex-housing-related.

The shortline panel drilled down into shortline service concerns. The long and short of it is short lines get caught in the middle between shipper supply chain needs and the cascading effects of Class I car, loco and crew shortages, compounded of late by extreme weather. However, all three stressed the need for shortline ops and local Class I ops to keep the communications lines open to nip any service lapses in the bud, before anything gets too far out of whack for the customer, the short line or the Class I.

Rounding out the program was the shipper panel with representatives from Wal-Mart, Formosa Plastics, Owens Corning, and First Energy -- an electric power company formed in 1997 through the merger of Ohio Edison and Centerior Energy, using coal for 62% of its fuel requirements. Class I crew shortages, locos out of place and weather disruptions affected all the shipper companies to one degree or another and in some instances cascading down to their serving short lines.

The shipper panel members all mentioned trucker hours-of-service, fuel prices, and CSA (Commercial Safety Appliance) 2010 as having an effect on truck capacity. In addition, truck shortages by type vary from place to place: reefers in the west, flatbeds in the south and midwest, and bulk wherever frack sand is moving. Truck pricing is "stagnant" or increasing by small amounts, once again depending on lanes, truck types, capacity and geography. All of which says to me that a thorough understanding of the shipper's supply chain and the role of transportation therein will help any railroad build the business base.

The Dahlman Rose crew, especially lead rail analyst Jason Seidl, deserve a round of applause for bringing together an engaging group of industry leaders with a smallish group of professional rail industry watchers. I thought the presenters gave a generally positive outlook -- no double-dip recession, markets are changing to the advantage of the rails, and capex is growing to meet the transportation needs of those new markets. That can only be good for the Class II and III railroad community.

No Week in Review Sep 17; I'm out looking at coal short lines in Central Penna.

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