THE RAILROAD WEEK IN REVIEW

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*"The more trains function like trucks, the worse the economics become." -- **Trains** magazine, November, 2011, photo caption, page 27*

Kansas City Southern held a combined shortline and transload workshop in KC this week. Some 130 souls were in attendance, one-third of whom represented either KCS or KCS Mexico. The commercial side took center stage with enough financial and operating detail to frame the customer and service themes.

Paul Ottensmeyer, EVP and Chief Marketing Officer, opened his remarks with a very useful tidbit of KCS history. Since we were in the Stilwell Room of the recently restored KC Union Station conference center, it was appropriate to recall that one Arthur Stilwell (1859-1928) founded the KCS with a "Great Midwest" to Mexico vision. Now, with the complete integration of the original KCS and KCS Mexico, Stilwell's vision is reality.

And what a reality. Ottensmeyer calls KCS "the best-positioned growth railroad in North America." Nearly half (47 percent) of all freight revenues (estimated to hit $2 billion this year) are Mexico-related. The 6,000-mile railroad projects double-digit year-over-growth in all commodity groups and handles 40 percent of the railroad traffic in Mexico on 20 percent of the country's railroad route milage. Concludes Ottensmeyer, the "cross-border effects" will help KCS generate second-half carloads that handily beat first-half volumes; Q3 revenues are expected to be up double-digits across all carload commodity groups.

Of particular note -- and something I wish all Class Is would do -- was the "bubble map" with the locations of some 300 new business potentials laid over a system map from southern Mexico to Kansas City. To be sure, not every one will come to fruition. But if the average probability is 50 percent, we're still talking about 150+ new business locations in the pipeline. That the consensus KCS 2011 revenue of 9.6 percent beats the Class I consensus CAGR by two full percentage points is but one measure of the pipeline potential.

Turning to Mexico in particular, autos and auto parts, "white goods," (kitchen appliances) and even consumer electronics (Samsung, e.g.) are major contributors to the growing Mexican market share of US imports. It's a matter of simple economics. Currency exchange rates, the skill sets and education level of the work force and proximity to US markets increasingly work the advantage of Mexico over the Pacific Rim countries.

Exhibit A is Whirlpool. With more than $18 billion in global sales, Benton Harbor, Mich.-based Whirlpool builds and sells a wide range of major home appliances under respected brand names such as Whirlpool, Maytag, KitchenAid, Jenn-Air, Amana and other brands. KCS transports several thousand boxcars for Whirlpool annually to destinations throughout North America. And for two years in a row KCS has won its coveted Rail Carrier of the Year award.

In naming KCS for the award, Whirlpool cited the railroad's ability to "step outside the traditional railroad paradigm with proactive behavior that establishes the model for other carriers to emulate."Adds KCS president David Starling, "besides, the Whirlpool folks can jump on a plane in Michigan, have lunch in Mexico and be home in time for dinner. Try doing that with a plant in Shanghai."

Now, you may ask, what does all this Mexico business have to do with short lines and transloads? Consider: plastic resins and pulp board are the top two carload commodities going into Mexico with grain a close third. Frac sand is growing quickly and may soon eclipse pulp board, which is chiefly used for packaging. Moreover, there is, believe it or not, high-sulfur met coal suitable for export in northern Oklahoma and which could find its way to Lazaro Cardenas for the Pacific Rim or Port Arthur for European markets.

In short, says Ottensmeyer, the KCS franchise "connects the fastest growing regions in the US -- the Southeast and Gulf Coast States -- with the fastest growing industrial market in Mexico." To tap that market, KCS is making capital invests of more than $275 million in its Houston-Lazaro cross border corridor alone. Moreover, foreign direct investment in the Mexican markets KCS serves hit $10.6 billion in the 2011 second quarter alone.

The good news for short lines everywhere is Mexico is one Class I interchange away, and with the raw materials flowing in and the finished goods coming out, there's opportunity for everyone. Mexico has been tagged "the last frontier" by some wags, and for good reason: Mexico offers access to new energy markets, has advantages in "near-shoring," currency exchange rates and a technically savvy workforce, and is in the midst of record industrial expansion.

With that background being laid, now comes Darin Selby, AVP for ShortlineRelations, to put the shortline contribution in perspective. Like his counterpart Chris Spiceland at NS, Selby talks about the "multiplier effect" of short lines on the KCS network. The reach is broader than one might think: 47 class II and class III railroads and switch carriers in ten US states and Mexico, with some 5,320 route-miles of track, extending the KCS/KCSM/shortline reach to more than 11,000 route-miles.

Short lines generated 26 percent of total KCS domestic revenues and 25 percent of domestic volumes (ex-intermodal and auto) year-to-date 2011. Paper and forest products, ag and minerals dominate the terminating side of the business while short lines are strongest in originating paper and forest commodities. To put these in context, second-quarter 2011 ag and mins accounted for 31 percent of KCS system carloads; paper and forest was 15 percent. Transloads in the US and Mexico generated more than $100 million in sales, nearly ten percent of system revenues, and obviously a growth area going forward.

At the end of the day, perhaps Jason Seidl, lead rail analyst for Dahlman Rose & Co. and guest speaker, sums it up best: "No signs of a recession are seen by Kansas City Southern or most of the attendees at the company's annual shortline conference. Indeed, the company's 15 percent volume growth QTD is not indicative of a downturn. In the longer term, the company is the best-positioned railroad to benefit from the fast growth of the Port of Lazaro Cardenas and the Mexico near-sourcing phenomenon. We came away from the conference with a reaffirmation of our view that a recession remains unlikely and we continue to believe that KSU offers good value for long-term investors." I agree.

Schwab's Chief Investment Strategist Liz Ann Sonders has a slightly different take, especially regarding the small businesses that dominate shortline franchises.

> We've received a lot of questions about the likelihood of a double-dip recession and what the stock market's saying about the economy. As we've often noted, the risk of another recession is certainly elevated, but it's not yet conclusive. Part of why we think another official recession might be avoided is actually not great news: Many segments of the economy, including small business and housing, never came out of the 2007-2009 recession to begin with, so they may not drop from recent levels sufficiently enough to hurl the economy into another official contraction.

Wednesday's WSJ op ed piece from Maine Senator Susan Collins makes an even finer point, citing a pending EPA rule on boiler fuel at paper plants:

> That EPA rule on boilers is a good example of why we need a regulatory time-out. According to a recent study by the American Forest & Paper Association, if the rule went into effect as written it could, along with other pending regulations, cause 36 American pulp and paper mills to close. That would put more than 20,000 Americans out of work—18 percent of that industry's work force. Once those mills close, the businesses that supply them also would be forced to lay off workers. Estimates are that nearly 90,000 Americans would lose their jobs, and wages would drop by $4 billion—just because of over-regulation.

The recession effects have another three years to run, according to William & Mary's John Merrick, associate professor of business, in his remarks at the College's Economic Forum this week. Deborah Hewitt, Clinical Associate Professor of Economics and assistant dean for MBA programs, adds, "The real problem remains unemployment, though a few sectors have fared well: computer science, architecture, biomedical engineering, petroleum engineering and anything math-related." That leads right in to comments by Professor John Boschen; "You have seven million fewer people producing the same GDP so productivity growth starts generating more growth as we come out of the recession." In other words, technology is the light and the way, giving us newer, better ways to do what's needed. Davis-Bacon, step aside.

The 2011 Edition of the annual RailTrends conference kicks off in New York November 1, later in the year than usual, but on the far cusp of the meetings and earnings seasons and that's a good thing. Congressmen John Mica, Chairman of the House Transportation & Infrastructure Committee, will be among the speakers, joining such notables as the AAR's Ed Hamberger, BNSF Chief Commercial Officer John Lanigan and winner of Progressive Railroading magazine's latest *Rail Innovator* Award, KCS Chairman Mike Haverty.