THE RAILROAD WEEK IN REVIEW
January 20, 2012

"Global Insight economic projections reflect the continuation of a relatively slow-growing economy in 2012." -- Jack Koraleski, Chief Commercial Officer, Union Pacific

Wednesday morning's Union Pacific earnings conference call was one of the most energetic and up-beat I have ever heard. And for good reason. Total sales jumped 16 percent to a quarterly record $5.1 billion, ops income grew 23 percent to $1.6 billion, net income went up to $964 million and diluted eps increased 27 percent to an all-time high buck-ninety-nine thanks in part to the two percent reduction in shares.

Fuel burn increased six percent against a five percent gain in GTMs. Operating expense ex-fuel was up six percent. Free cash flow (operating cash flow less capex) was a resectable 14 percent of sales. And the operating ratio dropped 188 basis points to 68.3 percent. The incremental margin was 59 percent after fuel-price adjustment.

Fourth quarter revenues were up in every commodity group -- by double-digits for all but ag products. Merchandise carloads increased five percent, though within the group ag was the only downer -- export grain dropped 43 percent while domestic grain and "biofuels" offset. Auto and chemicals sales both grew by ten percent; auto parts vols (where short lines have a small play) grew seven percent. In the chemicals group, petroleum products were up 43 percent on crude oil out of the Bakken and Eagle Ford Shale plays; plastics increased seven percent.

Carloads in the industrial products group increased seven percent with strength in frac sand and pipe plus steel for autos and iron ore exports to China. Intermodal was a bit of a disappointment with units off three percent. During the call Koraleski showed how weak imports and a contract loss cost the international side 35,000 units or a seven percent hit. Record domestic vols, up three percent or just 11,000 units made up some of it. Later in the call EVP-Operations Lance Fritz said the Southern Region accounted for about half the manifest carload growth -- good news for short lines in that region.

So the question is what's for dessert? Can UP do it again in what looks to be a so-so year, volume-wise? The list of commodities with "solid" growth potential (call it five percent-plus) includes such shortline stalwarts as frac sand and pipe, auto parts, petroleum, lumber, ferts and other metals. Moderate growth (GDP, more or less) commodity groups are domestic grain, grain meals, industrial chems, plastics, soda ash and construction materials. The slow-to-no-growth groups include (get this!) biofuels, paper, STCC 20 foods and export grain.

Genesee & Wyoming December North American carloads increased just two percent year-over-year to 64,549 units. The "other" commodity group (mainly NS overhead coal in Ohio) up to now has been running about ten percent of total vols, was itself down 20 percent; the coal and coke group (28 percent of total units) car-count declined five percent. The minerals & stone and metals groups offset these losses.

Year-to-date, GWR handled 785,277 units, up 4.5 percent; December units were 2.6 percent ahead of November. It's not been a good year for the company, with month-to-month carload deltas down as often as they were up. With 70 percent of units in coal, paper, metals and aggregates, one can see how a luke-warm economy can affect total carloads. The tea leaves say 2012 isn't going to be much better.

RailAmerica December carloads were off one percent year-over-year counting the recent Alabama acquisitions; same-store RA was off only zero-point-four percent. Like GRW's North American franchise, RA is skewed toward coal, paper and aggregates and for the year was running in the 70,000 cars a month range. A particular RA strength, however, is in chemicals at 9.6 percent of the total to GWR's 7.8 percent. But when the chemicals group is the second biggest decliner (down 11.9 percent to coal's down 12.9 percent), the dollar hit is that much greater.

RA's year-to-date carloads dipped three percent to 840,014 units with December loads up two percent over November; month-to-month carloads declined in seven out of 12 months. Picking up on the UP outlook thread of what's likely to be up or down or sideways, aggregates (nine percent of total) look best; domestic grain (16 percent) and chems are so-so, and coal (19 percent) lags. Happily, the number of ISS-based short lines in the RA portfolio gives them some pricing power and can mitigate the financial effects of slow to moderate volume growth.

Frac sand is moving in unit trains to Marcellus Shale customers in eastern Pennsylvania from central Nebraska. Frack sand is moving in unit trains to Marcellus Shale customers in western Pennsylvania from central Nebraska. The Nebraska Central (a Rio Grande Pacific property) originates the train at the Preferred Sands mine in Genoa, Nebraska, about a two-hour drive west of Omaha and some 55 miles east of Grand Island.

This facility has the capacity to process 1.2 million tons of silica sand per year, is in the largest sand reserve of its kind in the country, and has an annual replenishment rate of approximately 1.5 million tons. And Preferred has similar plants in Minnesota and Arizona, so we can expect them to be around a long time. (BNSF has been running a Texas train out of Minnesota since last August. Minnesota Commercial originates and Fort Worth & Western terminates.)

The Pennsylvania train runs weekly with three grades of sand in 90 cars, making the trip in an astounding four days -- half what it would take in manifest carload service. A typical train can leave Genoa on late on a Friday, is handed off to the UP for movement to the NS and beyond to GWR's Pittsburgh & Ohio Central with scheduled placement at the McKees Rock Industrial Enterprises Port of Pittsburgh facility the following Tuesday morning. The train is unloaded immediately into storage bins -- one for each grade -- and is on its way back to Nebraska for a refill in less than 24 hours. Thus sand that's on the ground Day One in Nebraska can be on a Pennsylvania well site Day Five.

It's all about asset turns. UP is using a pair of SD70MACs on the train and Preferred Sands is leasing a fleet of 4,000 covered hoppers that is still growing to meet the anticipated 2012 market of 55,000 loads to well sites in the US and Canada. And you can see as well where BNSF was coming from in its sand unit train discussion at last fall's short line meeting near Dallas. To be sure, a $million in demurrage fees may be only a rounding error to a Halliburton or Schlumberger or EOG, but cars are getting scarce and are expensive. Cutting transit times in half halves the number of cars the supplier needs to keep the supply chain full and doubles the number of trains.

The Reading & Northern is hardly wringing its collective hands about the sorry economy. The road saw double-digit carload growth last year hitting nearly 24,000 units, the highest ever in the road's 20-year history, and expects to do even better in 2012. CEO Andy Muller credits "wise business choices and investments" in additional product lines, particularly those serving Marcellus Shale and anthracite coal interests.

As for the former, the railroad partnered with D&I Silica to develop the old Lehigh Valley Pittston Yard into a regional frac sand terminal, handling well over 1,000 carloads of sand and other gas-drilling related commodities. And the R&N added value for its anthracite customers by investing in port facilities along the Delaware River near Philadelphia, where it could export anthracite coal to international customers. Reading & Northern partnered with Kinder Morgan to invest in setting up a facility and transport hundreds of carloads of anthracite to the new port.

By the end of the year, the railroad had secured a long-term contract with Rio Tinto, the company's largest coal consumer. As part of its commitment to this facility, R&N purchased 180 aluminum rapid discharge railcars at a cost of approximately $4 million in the fourth quarter of 2011. The port project just goes to show how one can turn adversity into customer value. Export anthracite had been moving out of Baltimore but when the loss of that route became imminent, R&N went looking for a better, closer site and the Kinder Morgan Fairless Hills facility won.

Tidbits from the Street Department
Updates and Outlook. End-of-year notes can be useful guides for short lines to use interviewing their customers and keeping their Class I partners up-to-date as to volume prospects. From Jason Seidl at Dahlman & Rose:

> Shippers expect their respective businesses to grow at an average rate of 5.8% over the next twelve months. This is a notable improvement from the 4.5% recorded in our 3Q11 survey. Additionally, 42% of shippers said they were more confident in the direction of the economy now than they were three months ago.To complete the brighter picture, 40% of shippers now say their headcount should increase in the next 12 months vs 31% in 3Q11, and only 5% expect lower headcount vs 14% in 3Q11.

Chris Ceraso at Credit Suisse sees positives in the upcoming fourth-quarter earnings calls:

> Freight volumes held surprisingly well during the fourth quarter and we continue to expect mid-single digit pricing gains for the railroads for the quarter. Our composite score is based on combined volume and service data, giving us a better sense of the impact of both sets of data points on operating income. [*UP scored the highest; KCS fared least well. Best of all, CP was hot on the heels of UP. I'd like to think the Pershing Square action is helping. -- rhb*]

Also from Ceraso comes the Credit Suisse Transport Outlook 2012:

> Our Freight Forecaster model is calling for a modest, 2% increase in freight growth for FY12. This is a notable slowdown from tonnage growth of about 5% in 2011, but is largely consistent with the volume estimates baked into our earnings models and generally in line with consensus expectations. The U.S. rails' combination of modest volume and pricing growth along with modest operational enhancements and share buyback programs translates into mid-to-upper teen EPS growth.

Railroad Facts: The 2012 Edition is now available from the AAR. Short lines would be well-served by incorporating a number of the key Class I metrics in their own planning, pricing and budgeting. In particular: Revenue ton miles (divide by route miles; locos and emps to get RTMs per each); freight revenue per ton-mile (and loco and employee); freight car miles (by short line and customer); average length of haul; average tons per carload; net ton-miles per train-hour (for short lines, I'd make it per crew-start hour); RTMs per carload (and customer); and RTMs per gallon of fuel.

You can get most of the raw data on your line from RMI. I'd love to hear from anybody who uses these measures and what you've learned about your properties in the process. Copies of the publication can be purchased online at www.aar.org in the Statistics & Publications Online catalog for $5 for AAR members, and $20.00 for non-AAR members. To get your copy call or e-mail Holly Arthur, harthur@aar.org, 202-639-2100, my usual contact for all things AAR.