THE RAILROAD WEEK IN REVIEW

April 6, 2012

"Kansas City Southern is one of the best-positioned names in the rail sector, given its compelling structural and secular growth story." Credit Suisse research note, April 5

First quarter carloads for the short lines and regionals in the Week 13 RMI RailConnect Index increased by 1.25 percent. But if one drills down to the merchandise carloads that make up most short lines' bread and butter, the gain is 0.98 percent. Intermodal, 9.2 percent of the RMI reported volume, increased 20.8 percent, though the number of non-Class I names with any significant intermodal business is minuscule. Without intermodal the non-Class Is are off 0.4 percent.

Auto, another commodity that touches a relatively small number of names in the RMI universe, is 2.4 percent of the total RMI unit count and increased 14.8 percent. Back that out and loads are off 0.7 percent. Lastly, coal. My Class I sources tell me most short line coal is either overhead or terminating steam coal and that the export play for short lines is minor. Coal vols for non-Class Is dropped 12.4 percent in the quarter, leaving the net change for Non-Class I roads at zero-point-nine-eight percent.

The Class Is (US, Canada, Mexico) didn't do much better. Total units including coal, auto and intermodal increased 0.9 percent; ex-intermodal they slipped 1.1 percent. Auto was up 15.4 percent, though at less than ten percent of the whole it wasn't enough to offset the other weak numbers, down 2.1 percent ex-auto. Class I coal sank 8.6 percent yet the double-digit gains in aggregates (no frack sand) and petroleum products gave the merch carload sector a 2.1 percent gain -- about the rate of GDP growth at this point.

Nor is it likely to get much better. David Ross at Stifel, Nicolaus may be writing about LTL in this note, but the shoe fits for rails, too:

> "Our outlook for LTL industry tonnage growth through 2013 is for a slow, potentially choppy, recovery (1.0%-2.5% annual freight growth) with no expectation of a housing recovery. Our newly issued 2014 LTL tonnage growth forecast increases to 2%-3%, as we believe housing activity should begin to pick up by then, although not in a robust manner."

As for the coal story, it's mainly a US story as the Canadian roads are mostly into export met coal and is less than 15 percent of both vols and revs at CP and even less than that at CP for 2011. CSX and NS were both 31 percent of 2011 revs and 23 percent of total vols for coal while coal was 27 of revs at BNSF and 21 percent at UP; coal was 25 percent of vols for both.

The eastern roads, while somewhat more insulated with export met coal, are more exposed to gas-switching due to their proximity to gas and the "dirtier" Appalachian coal. A note from Wolfe Trahan kind of supports this thesis, saying,

> Because coal is so far out of the money in many areas... lowering transportation costs would not be enough to increase volumes.... Natural gas consumption [may] increase about 30 percent in five years as new facilities are constructed. Coal consumption [could] drop 5-10 percent in 5 years and 15-20 percent in 10 years from current levels. In addition to increased use of natural gas, several older power plants will ultimately be put out of service to satisfy upcoming emissions regulations from the EPA.

Kansas City Southern is the topic of a favorable April 5 note from Credit-Suisse. They conclude that better-than-anticipated Bakken crude oil shipments, strength in long-haul frac sand, cross-border intermodal and export grain volumes should help offset coal losses. Moreover, coal isn't really doing all that badly thanks to "unit train economics" and the ability to move assets once reserved for coal to better use elsewhere. KCS's 2012 full-year goals remain as stated on the Q4 call -- mid-single digit volume and pricing growth with an operating ratio in the neighborhood of 71. Credit-Suisse reiterates its Outperform rating with a target price of $84.

Last week's comments re the upcoming ASLRRA Annual Convention drew some encouraging responses. One was from the ASLRRA's Dave Mears, drawing attention to this offering:

> Sunday's Car Hire Training is a never-before-offered and long-needed training in a matter that impacts the rail industry by hundreds of millions of dollars annually and yet remains one of its most complex and elusive business processes. One of the most remarkable things about this training is that so many of the industry's experts – from Class I, II and III railroads, as well as from car hire systems providers and car management services providers – are converging at this one time and place to instruct it.
>
> The session is what may well be a once-in-a-career chance to learn from the masters of this profession and to have any and all possible questions about it answered by this collective. I attended the run-through of this all-day training last week and I can personally say that it will be an extraordinary learning experience.

Dave's right on target here. It's an all day session from 8 AM to 5 PM with particular attention to the mechanics of car hire from basic rules to car hire rate negotiation, from the liability continuity system (LCS) to the processing of car hire claims. The fee is $229 per person (members), $329 (non-members) or $109 as add-on to full registration.

John Larkin at Stifel Nicolaus has just published his first quarter preview outlining the themes that defined the quarter, provides financial comps and outlooks with a summary for each sector: rails, truckload, LTL and so forth. Specific points that will most affect non-Class I rails: rates will continue to go up in the three-to-five percent per range net of fuel surcharges; increased Class I

productivity (longer trains, distributed power, better asset turns) will partially offset cost creep; current manifest train start schedules can absorb ten percent more volume at little incremental cost.

The steam coal business will remain an EPA target and cheap nat gas will exacerbate the situation. However, nat gas fracking is creating new markets and commodity lanes (frac sand, crude oil, pipe, a newly competitive chemical industry in global markets) that may offset some coal losses. He concludes that ethanol remains a growing opportunity. If you want to see the report, ask me.

What will your short line look like in five years, given the above and other trends? Consider: higher prices at the pump discourage pleasure driving and encourage smaller cars. Less driving means less ethanol to meet the ten percent blend mandate. (Bloomberg says waning demand for gasoline is putting the U.S. on course to miss the 13.2 billion gallon target for ethanol use for the first time. However, the EPA is pushing E-15 for cars made since 2001.) Smaller cars mean more finished vehicles per auto rack and fewer railroad carloads to move the same number of vehicles.

Consider: improved car cycle times mean fewer cars to move the same number of revenue ton-miles, more cars blocked for the distant node and less classification at intermediate yards, creating more opportunities for short lines to become customer supply chain partners by streamlining the transportation process. Consider: consistent, reliable and dependable transport services mean less inventory on the floor as goods can go right from the car to the production line -- no waiting in a warehouse or stock pile.

The Class Is are even now deliberating on what they want their infrastructure to be in 2016. Short lines and regional railroads can be part of the planning process by helping their customers institute supply chain practices that can move the same amount or more goods in the same or smaller number of freight cars.

Just the other day I called on a short line that is adding passing sidings and new industrial leads to handle more business per crew start. Best of all, they're including the connecting Class I train masters in their deliberations so they can plan for the increased throughput. No question about what this short line will look like in five years; one can almost see it now.

No WIR next week. I'm in Arizona for Part Four of a *Trains* magazine story on single-commodity shuttle trains.

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe click on the Week in Review tab at www.rblanchard.com. © 2012 The Blanchard Company.