THE RAILROAD WEEK IN REVIEW
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"Housing's strength has been impressive, but it's nowhere near enough to cushion the blow if we go over the cliff." -- Liz Ann Sonders, Chief Investment Strategist, Charles Schwab & Co.

Liz Ann is my favorite economist and investment strategist. After the dust clears at CNBC and Bloomberg, you go back and read Liz Ann to find she's generally on a track you can agree with. In the context of the general feeling of market uncertainty, she writes:

> Growth in 2013 will increasingly come into focus and the likelihood of a recession to be avoided is not only predicated on the outcome of the fiscal cliff, but also the amount of fill there is in the growth cushion. Hurricane Sandy is obviously coming into play, both as a near-term economic drag and an eventual economic boost as rebuilding begins.
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> Housing's strength has been impressive, but it's nowhere near enough to cushion the blow if we go over the cliff. And though Federal Reserve Chairman Bernanke may have cemented his position as Fed chief thanks to President Obama's re-election, we've written *ad nauseam* about the diminishing returns of the Fed's three rounds of quantitative easing. (Nov 14)

The same day a page 1 item in the *Wall Street Journal* observes that "some big American companies are making plans to slow investments, lay off workers and pay less-generous dividends if Congress and the Obama administration don't find a way to avert the so-called fiscal cliff." The writer wraps with, "Employers worry the reduced spending will hurt them indirectly by slowing economic growth." When you're already at two percent, "slowing" can really bring the hammer down on operating margins. Not encouraging words.

Where railroads in general and short lines in particular are concerned, the prospect of continued sub-three percent volume growth -- or worse -- means cost control is critical. The Class Is can't continue raising same-store RPUs forever (see below) and volume-dependent short lines will die if the vols aren't there. Clearly, there is work to do. Starting with the Class Is.

Take 3Q2012 operating expense ex-fuel per million GTMs. UP is lowest at $11.08, NS is highest at $18.04. UP gets 888 GTMs per gallon of fuel, NS gets 763. Everybody else is someplace between these two extremes on both metrics. One reason I suspect is that NS is dealing with lengths of haul that are shorter, involve more class yards en route and perhaps thinner margins.

UP gets 55 percent of revs from carload (ex-coal and intermodal but including auto) to 53 percent at NS. RPU for that group of commodities at UP is over $3,000; NS is $2500 and change. With higher carload RPUs and lower system average ops expense ex-fuel, UP would seem to be the more efficient railroad. Perhaps that's one reason UP shares year-to-date are up 15 percent compared to Norfolk's being down 24 percent.

We also know that NS has, over the four years ending June 30, 2012 lagged its closest competitor, CSX, in car-counts for some critical commodities. Take plastics (STCC 28 211). In 2Q2008, NS did 25,300 cars and by 2Q2012 NS was doing 24,200 cars. CSX did 33,200 cars in 2Q2008 to 28,330 cars in 2Q2012. The rate of decrease at NS has been slower -- down four percent vs 14 percent at CSX, yet we can tell -- courtesy of the QCS pages at US Raildesktop -- that NS rates for that STCC have increased at a CAGR of four percent in the same time period compared with six percent at CSX.

On a national basis, Drew Robertson's ASI-Transmatch charts show how *all* chemicals traffic trend lines increased at a respectable clip in 2010 (higher lows in the chart as the year progressed), increased at a less aggressive rate last year and for 2012 YTD have been -- to use the stock-watcher's term -- trading in range with some ups and downs but as of now about where they started in Jan. Drew's companion chart to the above shows year-over-year, month-to-month deltas declining in a straight line to the point where as of now all chems traffic YTD is down some 15 percent, about where CSX is with plastics.

Now circle back to NS. Highest ops expense ex-fuel per RTM, plastics RPU higher than CSX ($4,492 *vs*. $3,611 at the end of 2Q1012) yet a slower rate of decrease in plastics vols 3Q2008-2Q2012, suggests NS is doing something that allows them to keep raising prices without degrading market share. I can only suggest it has to do with service quality in the eyes of the customer.

Unfortunately, NS doesn't provide metrics like car miles-per-day, on-time arrivals and departures, cars per yard switching hour, GTMs per available horsepower hour, etc., so we'll never know well the railroad is running *vs.* the other guy. What we do know is the Q3 operating ratio gapped up five points, operating income dropped 22 percent, and EPS would have dropped 42 percent but for the share buy-back program. That really hurt share prices.

Yes, 3Q2012 coal revenue units -- where Wall Street takes a keen interest -- dipped 14 percent. But it's all unit trains and is subject to myriad external forces from the weather to the price of natural gas. Yet the chemicals group, the third-ranking commodity group by volume, a single-car business and not subject to the weather, was up four percent, beating ag products, paper/clay/forest and metals/const which were all down. Chemicals also enjoys the highest RPU in the carload group, indicating better margins. That's one way to offset the coal drag.

One might make the argument that NS must increase margins in the other three groups. I don't think one can do it by raising prices. Chems enjoy a higher revenue to variable cost (RVC) multiple because of *place value*: a carload of plastics is worth a lot more to an extruder in NJ than it is to a resin-maker on the Texas Gulf Coast and the difference becomes the freight rate basis. A carload of rock, on the other hand, is much less scarce and so has much less place value, so it can't command a premium freight rate.

But the cost of handling both on the RR is about the same. You can afford multiple handlings on commodities with a decent RVC multiple; you can't where margins are thin. Ergo the need for exquisite cost control in thin margin lanes to shrink the variable cost per car, increasing the RVC multiple without touching per-unit revenue. And since most short lines live in The World of Thin Margins, cost-control is even more important, as is knowing where their connecting Class Is are making their money and how. That's why I run these comps.

BNSF has been making great strides in carload volumes and margins as evidenced by their peer-beating third quarter results: total revenue units up six percent, total merch carloads up 11 percent, more merch carloads than anybody but UP, railroad operating income up 21 percent and best operating ratio improvement, down 3.4 points to a third-lowest 68.8 -- a tenth of a point behind KCS and two-tenths behind UP.

I mention this in the context of the NENE buy-back where Know Your Margins was key, and in the context of EP 714, which may have a deadening effect on shortline transactions. Here Larry Kaufman has some valuable observations on my comments last week:

> When Staggers was negotiated and passed it was desperately needed. Many of the negotiations were aimed at making it passable with transportation economics a secondary or even tertiary consideration. Fast-forward 31 years, and we have a different railroad industry. To state the obvious, it is healthy and vigorous and making money for its owners and executives. I think a strong case can be made that some tinkering might be in order.
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> On paper barriers, for example, I am very familiar with the argument that if paper barriers are outlawed many more miles of railroad will pass from the scene because absent the barriers, Class Is will raise prices and potential short-line acquirers won't be able to afford to pay the new price. Just a bit of sophistry, I think. The price always is what a willing seller and a willing buyer agree on. I'm not sure that filing an abandonment petition because the price was too high for the short-line does anyone any good. So, if I were ruling the world, I'd probably do some tinkering with paper barriers.
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> I'd do the same with market dominance standards, only here I'd be inclined to give the railroads considerable slack. There is just so much revenue involved in any transportation movement, and what we have here is the shipper world demanding that government put its big, beefy thumb on the scale and push more of the revenue to shippers.
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> That would be bad, all rhetoric aside, and I don't think anyone, including shippers, benefits from making it more difficult for railroads to raise money for capital spending programs. On the contrary, I think the case can be made that shippers have benefited from the existing

market dominance criteria. That said, I suspect that some tinkering could be done that would not do positive harm to the railroads.

Larry concludes by saying a new look at access rules is probably in order, perhaps extending terminal switching boundaries out a greater distance than at present, giving some shippers some competitive access but not putting us all back to the days of rigid ICC regulation. All points well taken, Larry, and thanks for weighing in.

Providence & Worcester has finally released its third quarter results. Total railroad operating revenues dipped five percent to $8 million on 8,090 conventional carloads, down 19 percent. A respectable six percent jump in RPU generated quarterly carload revenue of $7 million, down 14 percent. Intermodal revenue, representing a mere four percent of total revenue units, was up 67 percent to a whopping $299,000 on 4,100 units at $73 each, up $4 year-over-year. (Frankly, I don't know why they even bother dedicating the locomotives and crews to this tiny franchise).

Three other revenue items, only two of which showed in the tables and the third had to be inferred from the small print in the filing, make up the other $million in revenue. Operating expense, after capitalizing certain items, increased nine percent to a bit over $8 million -- comp and benefits is now up to 53 percent of sales -- for a $295,000 operating loss *vs.*a positive $639,000 a year ago. The operating ratio worsened to 103.7, a gain of 11 points.

Happily, P&W now puts Other Income like property rentals and sales below the line, letting an operating loss show as such. Before, a $million property sale above the line could shave ten points off the operating ratio, giving an inaccurate impression of how the railroad was actually performing. All in, P&W delivered a net quarterly loss of $381,000 against a net profit of $1.6 million a year ago. Ebitda was $3.9 million which makes the total market cap at the closing share price of $13.36 nearly 17 times operating cash flow. Looks a bit rich to me. A ten-multiple would indicate a share price closer to $8 and change.

Reader Claussen scores. "Concerning your ethanol article (WIR 11/9), your math is incorrect. One tank car holds 30,000 gallons of ethanol, so 800,000,000 gallons would fill 26,667 tank cars or 267 unit trains." Bingo. I've been working the crude-by-train numbers that are in barrels per car, nominally 600-700, depending on the writer. My brain simply didn't make the switch to gallons from barrels. Thanks for the sharp eye, Pete. And I have changed WIR 11/9 accordingly in the PDF version in the rblanchard.com archives.