THE RAILROAD WEEK IN REVIEW
February 22, 2013

"What are the quantities or conditions of ultimate importance to your future? If these change, for whatever reason, what are you going to do about it? -- Patrick Marren, Futures Strategies Group, August, 2009

Marren's argument has to do with scenarios, not probabilities, and I think that's useful in dealing with diminishing year-over-year carload volumes in the traditional Class II and III railroad commodities. Here's where Marren triggers my thinking:

> The standard financial models are wrong. Either the financial phenomena in question are not accurately represented as Gaussian distributions [bell curves] at all, or the "tails" of the curves in question are "longer" or "fatter" than assumed. When there is a long or fat tail, that is, when the range of plausible outcomes is much farther from the expected value than most people appreciate, it is usually because the (necessarily historical) data set they are working from does not happen to contain outcomes that truly represent the actual variability inherent in the phenomenon in question.

The smallest roads are my biggest concern. We always assume vols will grow over the long run and short-term aberrations are too far out on the bell curve of distributions to be worrisome. Not good. These short lines are on fixed divisions that are not rising as fast as operating expenses, particularly fuel, labor and safety compliance. Moreover, as Class I carload fortunes go, so, to a large extent, go theirs as well. But where a Class I takes a hit in one commodity, it can absorb the loss elsewhere. Not so the short line depending on a single or just a few commodities.

Now to Week 6. First, a look at how the Class Is are faring; second, how the short lines are affected. What were once staples of the Class I carload mix -- coal, grain, e.g. -- have taken big hits while intermodal, crude-by-rail and frack sand are going gangbusters. The AAR reports Week 6 year-over-year loads for petroleum, non-met mins and intermodal are up 56, 4 and 6 percent respectively; coal is still off 14 percent. All in, the Class Is are down 1 percent YTD.

Class II and III roads, according to RMI's RailConnect Index, saw Week 6 total revenue units increase 5 percent -- some 42,000 units. However, the sudden intermodal surge -- at the few short lines that actually do intermodal -- pushed the box count up 50,000 units. Back that out and total carloads are down a point. Coal was up 10 percent (!!), though stone/clay/aggregates, where frack sand lives, came down 3 percent and grain 1 percent. Petroleum/coke was down 6 percent, so you can see how much of a play short lines have in crude by rail.

Among other major shortline carload commodities, STCC 20 farm and food was off 14 percent, waste came down 14 percent and metals were down 11 percent. So because Class II and III roads have limited pricing power (handling lines and switch carriers have none) the present shortline scenario is one of declining carloads and declining revenues -- yet *increasing* carloads and revenues are the very quantities and conditions that are of ultimate importance to the small railroad's future. What are they going to do about it? Look for further commentary on this matter; feedback and contrary points of view are welcome.

Morgan-Stanley's Bill Greene writes, "We now think the time has come to revisit the eastern rails." He cites "significant pressures on margins and earnings" linked to lower utility coal demand thanks to warmish winters and an abundance of cheap natural gas. However, as I have already said here and elsewhere, we're coming up on easier comps and you can only replace so much coal with nat gas. So the domestic coal earnings hit is history and "We are unlikely to see a further deterioration in export tonnage in 2014."

Ah, but there's a lot more to NS and CSX than coal. Last week I showed why NS and CSX are trading at lower multiples than any of their peers and why I think CP and KCS are over-priced. On the other hand, I'm seeing evidence in the field that some roads are getting increasingly picky about how much of what they're willing to handle at what price.

The pair of charts from Drew Robinson's ASI/Transmatch on the last page tell the tale. You can see coal generated the highest number of carloads in Feb, 2008 and the lowest in Feb, 2012 for both CSX and NS. The charts are based on Jan 1, 2011 so changes over time are keyed to that date. I find it particularly telling that the carloads of merchandise commodities -- everything that isn't coal -- in the top chart started clustering in the low numbers (top chart) and around the zero change line (bottom chart) in mid-2010.

CSX and NS 2012 fourth quarter carloads ex-coal and intermodal but including automotive were up 4 percent, based on their financial reports released last month. But the point is all the merch commodity volumes aren't changing all that much either in numbers or percents. The only commodities seeing any upticks in these charts are chems, food and lumber; all three are among the top RPU producers for both roads.

If the top RPU groups are posting carload volume gains and the lower RPU groups are not, I have to say CSX and NS are going after the high-margin cars at the expense of the low. But, what happens if the high-margin commodities don't grow and they've run off the low? The rails won't be able to make their operating margins and they'll start taking off trains. So when clients tell me class Is are pushing back on lower RPU moves, I ask them to find out why. Could it be market managers are looking at car margins, not train margins? A pity if they are.

Genesee & Wyoming North American January carloads include RailAmerica's for the first time. The Feb 13 press release compares the Jan 2013 totals with Jan 2012 carloads broken out for both roads. RA commodities are realigned to fit the GWR groups and adjusted to eliminate double-counting where RA and GWR once swapped carloads. Had the two roads been operating as one on Jan 1, 2012, they would have handled 128,438 units for the month; the Jan 2013 number is 138,433 units including 3,310 for the Wellsboro & Corning (RA), Marquette Rail (RA) and Columbus & Chattahoochee (GWR), up 5 percent.

Highlights: Petroleum products, though only 7 percent of vols, increased 52 percent on crude oil and propane in the Pacific, Southern, Mountain West and Canada Regions. Forest products (STCC 24), 8 percent of vols, were up 22 percent and paper, 11 percent of vols, grew 13 percent. The problematic "Other" line -- mainly NS Overhead coal in Ohio -- is now truly Other, with overhead coal being moved to the Coal & Coke commodity group. Still the largest commodity at 20 percent of total, vols increased 7 percent; the re-classified Other group was off 16 percent. Waste was the only remaining double-digit decliner, off 12 percent.

Railroad investors who wish to hedge their bets against the long tail of unforeseen events can take a clue from index funds and ETFs. For example, consider AAPL and the Schwab US Large Cap ETF, SCHX. The former started its long descent from $700 to $450 back in September, 2012. In the same period, SCHX climbed -- slowly -- to $36 from $34. AAPL is the ETF's largest holding at 3 percent, but, as you can see, the 97 percent of holdings elsewhere minimized the AAPL damage.

In like manner, GWR's 100+ names in North America plus its extensive Australian holdings minimized the overhead coal damage. GWR shares have over the same period increased to nearly $90 from $65, up 40 percent, to AAPL's 30 percent decline. Now imagine, if you will, the bottom falling out of the ethanol market for any number of shortlines whose futures are linked to it. The *scenario* for them is devastating and there appears to be little they can do about it.

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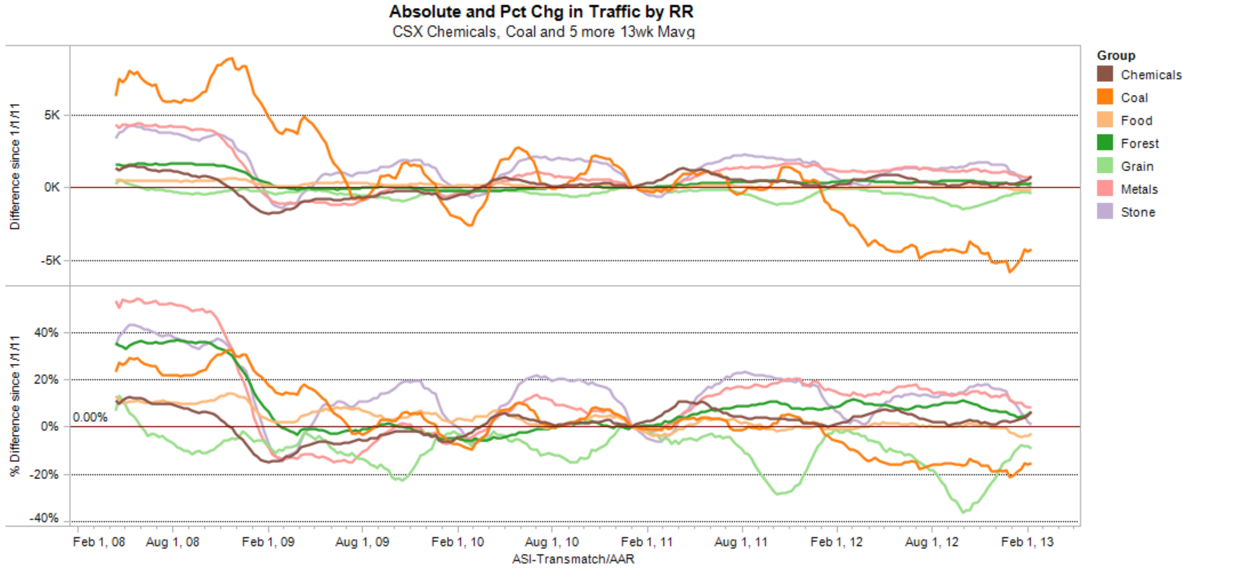
Absolute and Pct Chg in Traffic by RR
CSX Chemicals, Coal and 5 more 13wk Mavg
Difference since 1/1/11
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40%
20%
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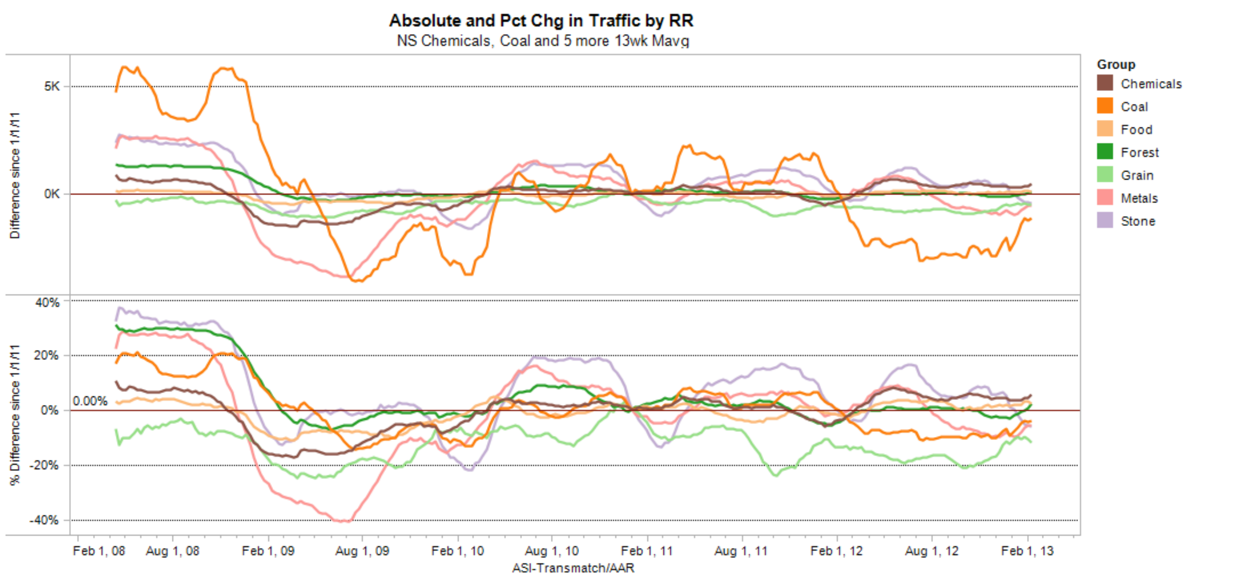
ASI-Transmatch/AAR
Group
Chemicals
Coal
Food
Forest
Grain
Metals
Stone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