THE RAILROAD WEEK IN REVIEW

June 28, 2013

"Short lines can help keep the railroad fluid with consistency: meeting the ISAs, root cause failure analysis, communicating with NS field managers and prompt problem resolution." Bob Bartle, General Manager, NS Northern Region

Norfolk Southern hosted its 12th Annual Shortline Meeting at the iconic Hotel Roanoke June 17-19 with the theme, "Partners on the Fast Track to Growth." Tuesday morning's formal presentations covered a wide spectrum of interests: corporate and shortline marketing, regional operations, equipment management and mechanical. And the record-setting number of 345 individual breakout sessions provided ample opportunity to drill down to specifics.

The presenters were successful in explaining the hows and whys of where NS wants to go; however, feedback from some of the 150+ shortline representatives in the room was they wanted more granular shortline-specific information. That's unfortunate, and it's what the breakouts are for. Understanding the corporate direction -- in this case, Fast Track to Growth-- is an essential element in creating the seamless transportation product customers want to buy.

NS Class II and III railroads operate nearly 20,000 route-miles, effectively doubling the railroad reach of NS. Over the past five quarters these roads handled 1.3 million revenue units, some 15 percent of the 8.9 million units over the NS system in the same period.

Quarter	SL	NS*	SL%NS	SL Seq	NS Seq
1Q2012	256	1,731	14.8%		
2Q2012	270	1,799	15.0%	5.5%	3.9%
3Q2012	265	1,785	14.8%	-1.9%	-0.8%
4Q2012	262	1,792	14.6%	-1.1%	0.4%
1Q2013	257	1,784	14.4%	-1.9%	-0.4%
Total Units	1,310	8,891	14.7%		
*** NS Total rev units incl intermodal**					
Source: NS Shortline newsletter, May 2012; NS financials for respective quarters					

I'm reluctant to try to strip out coal, intermodal or automotive because NS has a number of small-railroad connections that make significant contributions in each: CIND for finished vehicles, INRD for coal and a number of GWR roads with intermodal. Moreover, the sequential quarter-to-quarter volume changes for short lines was less than NS in three out of four quarters. In other words, the shortline carload sector held up better than the core system, even with the latter's intermodal strength. (NS does not distinguish between same-store and total unit deltas.)

Chief Commercial Officer Don Seale's state-of-the-economy briefing set the table well for the meal that followed. "This is," he says, "not a robust recovery, and is spotty at best," citing gains in housing starts and automotive and from bringing consumer durables manufacturing back to North America , offset by losses in coal and steel. The sweet spot for NS, says Seale, is that 50 percent of the US population is in the NS service area, that congestion and crumbling highways enhance the NS competitive position and that carload short lines can benefit.

Now come newly-tapped VP Transportation Terry Evans and his three Regional GMs to talk about how they're providing seamless service. It was like listening to a broken record: turn the equipment, do it consistently and fix what breaks in such a way it doesn't break again. Ingrid Crawford, Director of Car Management, provided a helpful overview of the fleet and what they're doing to get more turns per car. [Personally, I'd like to see NS get rid of car-hire relief. Forgiving car hire only encourages short lines to sit on empties rather than returning them to revenue-generating activities.]

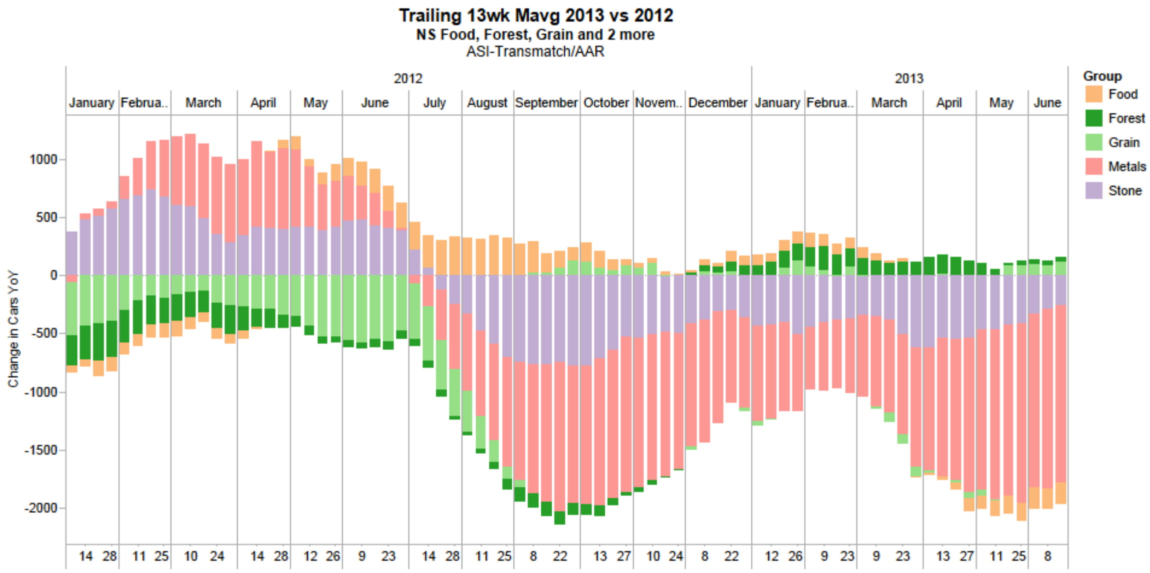
Over lunch, CEO Wick Moorman said, "Short lines are critical to our success and we we want to support your first-mile, last-mile skills wherever we can." What he calls "seismic shifts in the railroad business" are coming more quickly than anticipated. Thermal coal is way down with no likelihood of it ever regaining its former position and met coal is "equally depressing." Steel world-wide faces excess capacity. Out west, Wick thought BNSF was going to take a hit from coal, but "Warren Buffett bought a railroad and they discovered oil underneath it."

Now the shortline message: "Over the next couple of years we've got to think about how to grow carload volumes and improve profits. NS has the premier intermodal franchise in the east, but it's limited to the reach of our corridors. We've got crude oil to east coast refineries -- good business but finite. And we have all the gas-drilling commodities. However, put them all together and they're nowhere close to offsetting coal losses.

"That's why all of you are so important to us. What we have to do as a company is focus on growing the general merchandise business.We can handle those volumes with the margins we need to continue to make the investments. So as we look around we're going be more focused on how do we grow the carload biz. That's going to have to be a key part of our strategy."

Thus I was reassured to hear from senior management about the commitment to sustaining and growing the 15 percent of volumes that the short lines handle. And I'm hopeful shortline managers will cite these Encouraging Words next time their views are at odds with their NS counterparts.

The stakes are incredibly high. The graph shows how Week 25 carload commodity loads compare vs last year's Week 25 vols. I've taken out intermodal, auto and coal precisely to show how the very NS commodities that are the lifeblood of the Class II and III roads are in deep doo-doo. (I've also taken out chems because crude oil dominates the group. AAR chems ex-petrol are flat year-over-year.) In short, the NS 2013 Week 25 lags the 2012 number and Wick is right: the only way to right this ship is to turn the carload business around.



Change in Cars YoY for each Date Day broken down by Date Year and Date Month. Color shows details about Group. The data is filtered on Railroad, which keeps NS. The view is filtered on Date Year and Group. The Date Year filter keeps 2010, 2011, 2012 and 2013. The Group filter keeps Food, Forest, Grain, Metals and Stone.

The margin creep downward is worrying. As vols go down, so do revenues. And if ops expense is not contracting at an equal or better pace, operating margins narrow. NS this year has a $2 billion capex program; for that to be at the historical average of 15 percent of revs requires 2013 revs in the neighborhood of $13 billion.

Clearly, that's not going to happen. The consensus revenue estimate is $11.2 billion; the $2.0 billion capex plan is 18 percent of that. So as revs come down and ops expense does not come down as fast, net income shrinks as does cash from operations. Keeping the same capex level shrinks free cash flow leaving less for dividends, share re-purchases and paying down debt.

Thus Wick's admonishment to the short lines, "Tell us how we can help you grow your business," is serious business. I do hope somebody's listening.