THE RAILROAD WEEK IN REVIEW
October 4, 2013

"I'm pleased to say that the parties were able to come together to assemble the right business and labour conditions to justify the resumption of rail traffic on the major portion of the KPR." -- Jim Vena, COO, Canadian National

Canadian National buys back another short line, the Kelowna Pacific (KPR) in southern British Columbia. CN had originally leased the 120-mile property to KPR in 1999 in a bidding process (I had represented another interested party). KPR went into receivership last July and quit running. Now comes CN to resume service.

Tolko Industries (a lumber producer and major customer), the T&E and MOW labor unions, and the Trustee have reached mutually satisfactory agreements to take the railroad out of bankruptcy. The rail segment runs between Campbell Creek, B.C., some 10 miles east of Kamloops, to Kelowna, B.C. The southernmost 30 miles from Lumby Jct. to Kamloops will get the axe for lack of business; the seven-mile branch to Lumby (where Tolko is) stays.

The terms of the parties' agreements justify the "sizable capital investment" required to start operations. CN says it will do so "as soon as we can ensure the track is brought back to a standard to ensure safe train operations."

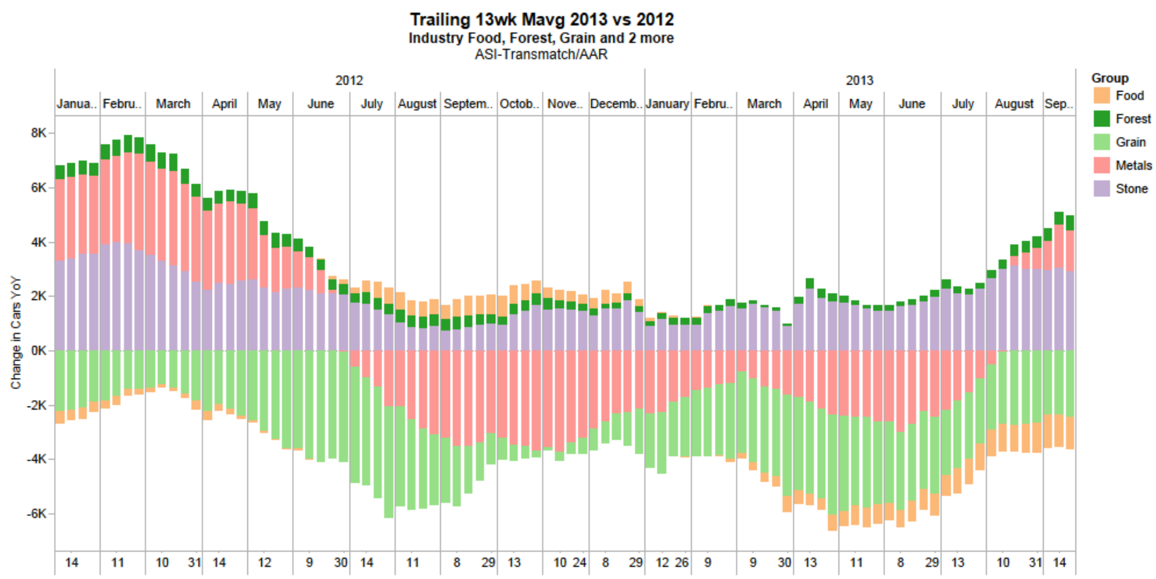
Like the man says, "Use it or lose it." I get so tired of hearing short lines wringing their collective hands about "partnership" and the need to keep cars running where there is little economic justification to do so. Here's a case where the short line couldn't make ends meet and forced CN to take back the line segment to protect a major customer's supply chain.

If the service offering doesn't meet shipper supply chain requirements, there's no need to perpetuate a failing business proposition. Happily, in this case, CN saw a viable business that justified the infrastructure investment the short line didn't -- or couldn't -- make.

A Stifel report from NEARS, while written mainly for investors, offers up some clues as to what it will take to build back merch volumes outside the "heat and eat" sphere: "The belief is that railroads can still close the gap and provide solutions to the challenges, mainly from continuing to improve service levels, i.e., faster transit times and increased velocity that will increase capacity."

In other words, turn the cars. I expect we'll hear a lot from Dave Garin & Co. on this topic at the upcoming BNSF shortline meeting. Over the the years BNSF has beaten this drum the loudest on this topic (the AIM Program to sort out customer drilling priorities, the Velocity Program to manage and control demurrage, e.g.). And I think Dave Garin personally Gets It more than his peers when it comes to matching service to demand, though Cindy Sanborn at CSX appears to be hot on his heels.

The quarter now is over and let the games begin. This ASI-Transmatch chart shows a 13-week rolling average in the AAR rate of change in manifest-service carloads, chems omitted as crude-by-rail so dominates that line. Low-rated aggregates on the upside are offset by ag products on the downside. Metals are flat; food -- grain mill products ex-ethanol (the AAR puts this in chems) and STCC 20 items -- continues to slip. And because so much of this is high-cost, labor-intensive local business, it's hard to see where the incentives are for the Class Is to go after more.



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 Industry. 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.

We have here a picture of stagnant carload vols, a sobering trend for short lines because carload volumes are stuck in a no-growth mode, leaving little room for mistakes (see MMA and crude oil) or property improvement (see the flurry of TIGER grants. e.g.) What's more, the only growth I see in the shortline sector comes from acquisitions (see GWR+RA). With acquisitions, however, comes added debt, further limiting the operator's options for running the faster, smarter railroad shippers demand.

I don't see it getting any better any time soon, either. The most recent Morgan-Stanley Shipper Survey (out this week) cuts to the truck vs rail dynamic quite handily. Author Bill Greene starts out saying that shippers' economic outlook is "relatively unchanged" and that inventories continue to shrink. And with less stuff to move, carrier capacity constraints will loosen, meaning more vehicles chasing fewer goods -- and more vendors to choose from.

Greene expects rail volume deltas to remain in the plus 2-3 percent range as shippers perceive service reliability as so-so, making rail rate increases a greater challenge than when capacity was tight. Shippers also expect truckload and intermodal capacity to loosen up, creating yet more competition for the manifest-freight carload sector.

As if further proof is needed, refer to the AAR's Week 38 (September 21) manifest-service carloads, ex-coal, crude, auto and intermodal. What's left -- the shortline stuff -- slipped another hundred thousand units (1.3 percent) to 30.4 percent of total moves from 31.3 percent. By themselves, the short lines did a little better, up 2.1 percent in the manifest group, absent the usual suspects.

If there's any good news in here at all, it comes from Ned Davis Research on Day One of the government shutdown. "The ISM Manufacturing Index rose 0.5 points to 56.2 in September, the highest level since April 2011, indicating above-trend growth in manufacturing output... The survey was conducted during the month, well before the government shutdown. This suggests respondents either did not expect a shutdown, or thought that one would not have a big impact on manufacturing." Small comfort, perhaps, but better than nothing. As Cashin says, "Stay nimble."

The just-released Top Picks report from Credit-Suisse is a useful document not only for sorting out the rails from the C-S perspective, but also for their views on energy and other industry leaders, many of which you may have as customers. KCS moves to Number One with a "compelling structural, secular and cyclical growth story, driven by cross-border U.S./Mexico business. Near-sourcing opportunities, truckload conversions at the border, and share gains in finished vehicles market are poised to drive industry-leading revenue growth."

CP steps up to Number Two. "Although CP is largely a 'cost story', we believe that the company is also well-positioned to generate solid revenue gains. Specifically, CP stands to benefit from [more pro-rail] customer supply chain adjustments as well as more favorable core pricing gains. From this CP will reap an improved earnings stream from a lower cost business model."

UP slips to Number Three from Number One. C-S expects "legacy re-pricing to generate superior incremental margins in 2013 and beyond. Following renewals on some $750 million of its book in 2012, UP still has close to $1 billion in re-pricing opportunities 2013-15. Growth in relatively high-yielding and profitable drilling and shale-related activities help offset weak utility coal."