THE RAILROAD WEEK IN REVIEW

July18, 2014

"Canadian Pacific in the second quarter achieved record after record after record." — CP CEO Hunter Harrison.

Florida East Coast Railway President Jim Hertwig and about 200 dignitaries celebrated the opening of the new 43-acre Port Everglades Intermodal Container Transfer Facility (ICTF) in Fort Lauderdale Monday. It's an impressive sight. It's a great example of what a public-private partnership can bring to a community.

Broward County contributed the land, valued at $19 million. Grants and loans from various Florida DOT agencies covered the $48 million in construction costs and the railroad chipped in a $5 million chunk of its capital plan. There are six 3,000-foot working tracks with GPS-steered overhead Mi-Jack cranes than can work independently. The contractor — the same one who rebuilt Amtrak's Chicago Union Station track structure, by the way — used steel ties and a deep ballast roadbed to support the 136-pound welded rail.

There are no public highway crossings between the ICTF lead and the FEC main, roughly two miles away, and yard jockey tractors can bring containers from dock side to train side without touching any public roads. What really impressed me about this facility that they started with an empty piece of land and purpose-built what they wanted. It wasn't a matter of bending a previously-built older site to a new use. I can hardly wait to go back in a few months and see the new ICTF in full swing.

The facility replaces the 12-acre vest-pocket intermodal ramp at Andrews Avenue and 24th street, where loading tracks were so short FEC crews were forced to block a four-lane state highway to build their usual 6-8,000 foot trains; the yard was so cramped two lift cranes couldn't pass each other on adjacent tracks. Worse, the several miles of city streets between the ship piers and the ramp further compounded the congestion problem.

Fertilizer buyers are seeing some price relief, which in turn could be good for short lines serving agricultural communities. *DTN Fertilizer News* says seven of eight key fertilizer groups have posted lower month-over-month prices. Moreover, says DTN, falling commodity prices (corn, e.g.) are helping the ferts price slippage.

The smart money's educated guesses have ferts prices about 20 percent lower by the time the fall fertilizer season begins, as fertilizer will follow commodity prices lower. Fertilizer now in the $500-per-ton range could be closer to $350 to $400 per ton after the drop. "The late-summer/fall fill will be weaker as far as price goes," Royce Bialas, location manager for Central Farmers

Cooperative in Dimock, S.D.,says. "You can't have corn prices fall this much and not have fertilizer prices drop right along with it."

Bialas says the wild card in lower retail fertilizer prices could be natural gas prices, which have been stronger earlier this year. Higher natural gas prices could work against lower fertilizer prices, but ultimately, the fall of the commodity market will most likely push retail fertilizer lower, he said.

CSX results for the second quarter show a marked improvement in merch moves even without the expected growth in crude-oil moves. Carloads ex-coal increased eight percent to 760,000 units with gains in seven of nine commodity groups, flat in two and declines in none. Merch revenues increased 11 percent and average RPU gained two percent. Coal has stemmed the tide for the nonce with quarterly carloads actually up seven percent and three percent year-to-date; intermodal continues its upward trend — seven percent over last year's period.

All-in, CSX posted $3.2 billion in total sales, up seven percent year-over-year, on eight percent more revenue units [*feeder rails gained 5.2 percent ex-auto, coal - rhb*], though RPU dipped a point on mix. Operating expense inched up seven percent, creating ops income just shy of a billion dollars, up six percent, leaving the OR essentially unchanged at 69.3, up 13 basis points from last year.

On the call Chief Commercial Officer Clarence Gooden said the strong 2013 harvest is behind the 11 percent jump in ag products vols and higher ethanol production levels. Moreover, "The construction sector grew eight percent overall, reflecting a rebound in shipments after the winter weather subsided and the ongoing recovery of housing and construction activity. Finally the industrial sector grew 11 percent led by strength in the energy-related commodities including crude oil, liquefied petroleum gas and frac sand."

He concludes his remarks saying the Q3 volume outlook (his slide 11, if you're singing along) is favorable for markets comprising 84 percent of revenue nuts, including intermodal and domestic coal. He's neutral on forest products, four percent of vols, and sees declines in export coal, waste and minerals, 12 percent of vols.

Chief Operating Office Oscar Munoz says network performance remains below expectations. On-time arrivals and departures, system average train speeds and yard dwells all took year-over-year hits, due in part to the double-whammy of the winter dig out and a rapid surge in volume, particularly in the northeast and upper midwest. Oscar's slide 15 shows this graphically and presents a terrific feeder line opportunity: CSX is the dominant Class I east of Buffalo. And to underline this, CSX is making capacity enhancements along its Hudson River West Shore line and down into Philadelphia over the ex-Reading in New Jersey.

Oscar says CSX is shifting resources — including crews and locomotives — accordingly, and "We've been in regular contact with our customers to provide them visibility and sincerely thank them for their patience as we work to increase their increased demand." The feeder line family is a big part of the story, and I know Len Kellermann is eager to have his new staffers get educated on shortline capabilities. Give them a call, get them out, show them what you can do, and even take them on customer calls.

Fellow scribe Fred Frailey is noodling around with some CSX volume trend numbers going back to the 2006 second quarter. In an email and subsequent conversation (wonders of technology: he was speaking from a southbound Amtrak train to Florida and I was speaking from a northbound Amtrak train from Florida), Fred correctly notes total 2014 vols are off five percent from the 2006 number, coal down 30 percent and intermodal up 26 percent. He has 2006 merch vols up four percent excluding automotive. If you include auto in the merch group (as CSX does) then the delta is down 11 percent.

Picking up on Fred's theme, I drilled down into the commodity groups to see where the damage was worst and where there might be offsets. Food & consumer, metals, forest products, minerals, waste & equipment (these last two in "Emerging Markets" in 2006) are off double digits; phosphates & ferts and auto are down between five and ten percent. The chems group is up 17 percent largely (based on my research elsewhere) on STCC 29 plus crude oil. Ag products is the only other gainer, up nine percent.

As noted above, the present quarter presented no double-digit merch carload gainers save ag products, chems, metals, and waste & equipment. Leaving out coal, combined merch (including auto) and intermodal are up a mere 51,000 units — less than four percent — to 1,451,000 in this quarter. That's a CAGR of half a percent year, less than a fifth of the US GDP delta over the same period. Looks to me like the rails may be losing share.

Hunter Harrison continues to work his magic at CP. He and President/COO Keith Kreel are making good on promises to increase train-length (up 7 percent to nearly 7,000 feet), train weight (up 9 percent to more than 8,000 tons), and fuel efficiency (gallons per thousand GTM down 5 percent to one gallon even). Train accident frequency is half what it was a year ago.

Second quarter ops income jumped 40 percent to C$587 million on revenue C$1.6 billion, up 13 percent, while ops expense was held to a gain of less than two percent for an operating ratio of 65.1, down a whopping 686 basis points year-over-year. Fuel burn in gallons was up less than a point against GTMs up six percent. I've often said CP wasn't charging enough, but I think that's turning the corner. System RPU is up nine percent on three percent more revenue units; Merch RPU including auto is up ten percent. It was interesting to hear Creel do the revenue portion of the call, and that may continue for a while.

During the Q&A, RBC's Walter Spracklin brought up "changes on the executive team on the sales side" and asked (rather obliquely) if Creel would keep the double load. Said HH, "I don't see any short-term change or long term. If we're to identify the appropriate candidate be it internal, external, of course we are in the business of developing people. We will hire someone and we will do that, but right now it's nothing that I am seized with or concerned with. I think it's working extremely well."

Revenue was another key theme during the Q&A. Much of the HH story has been about the cost side, so it was refreshing to hear about where the money's coming from. HH again: "This is a year of transition where we are close to the end of the line wringing cost out where it's smart. We will be able to improve the the quality of our revenue on the individual components.

"You will start seeing this really ramp up in the back half of '16… If we can improve the physical plant and have a safer physical plant, we can move faster on it. We can lower our cost as a result. We can have greater asset turns and provide better service to the customer, all of which comes full circle, adding to the bottom line."

CP is clearly shifting the focus to growing the top line from shrinking the expense line. And for once somebody's talking specifically about carload: "It's that whole book of merchandise business that people tend not to focus on both internally and externally that I'm trying to be a champion of." Amen to that.

Kansas City Southern wrapped the week with revenues up 12 percent to $650 million on seven percent more revenue units and a five percent gain in revenue per unit. Like CP, KCS breaks out crude oil from chems (crude down 22 percent, chems up three percent; others ought to do the same, led by the AAR — hint, hint) and double-digit volume growth in metals/scrap, grain, ores/minerals, frac sand, and automotive. Total merch loads gained 11 percent.

Operating expense increased 11 percent, operating income was up 15 percent and the operating ratio was 67.0 after adjusting for lease termination expense (more on that below). Fuel efficiency could be better as they burned 13 percent more gallons to generate 13 percent more GTMs. The cost of a gallon of diesel fuel was up three percent yet the fuel burn of 1.4 gallons per thousand GTMs is unchanged year-over-year.

Readers know I'm a strong supporter of owning one's own power. CFO Mike Upchurch says they're now at 50 percent owned, against a target in the mid-60s. "We said when we started this effort a few years ago it would likely take us five to eight years to really execute that strategy. We're roughly three years into it. I think as we look out over the next two to three years, we'll be somewhere in the mid-60s, which would be a target. And that's about where the ownership has progressed through the industry."

Then there are the Tier-4 fuel considerations. Upchurch again: "We're ordering 85 new locomotives this year; they are all incremental because we see traffic growing faster starting in 2015 and because the Tier-4 requirements kick in on January 1. These units are actually about 15 percent cheaper to run." To which Dave Starling adds, "We're taking delivery of 45 of these units in the third and fourth quarter, so they are really being purchased going in to 2015."

"I don't know if you heard or not but we're being told that EMD will not build a Tier-4 locomotive in 2016. So, you're going to have one supplier that's going to build locomotives in 2016, and all of us are very concerned whether the order book is going to be filled and the volume is going to be there. The last thing we need is to be short of locomotives and turning down revenues. We're going to be aggressive on locomotives for this year and you will see us into '16 as well." [*This is the second mention I've heard this week of EMD/Progress stepping back. — rhb*]

Continuing the theme, what this all boils down to is managing increased volumes and getting one's own plant (locos, main lines, yards, crew) up to snuff to handle the growth. However, not everything moving on KSC originates on KCS, so congestion problems elsewhere invariably cascade over to KCS. Take grain, for example. Lumpy deliveries from beyond wreaked havoc with car supply and consistent train service. Getting rid of the inbound irregularities will automatically smooth out the lumpiness and get grain back to an unexciting slow-growth business.

The overall impression one gets from the three rails reporting thus far is an industry where gains in ag products, crude oil and intermodal mask so-so progress in chems, forest products, aggregates ex-frac sand, and metals. Operating ratios have broken thru the 70 barrier to the down side, revenue-ton-miles are on the increase and the rate of negative change in coal seems to be slowing.

Still, for all the talk of trucks off the highways, it seems to me more and more single carload business is finding its way into trucks and from trucks-on-own-wheels to trucks (containers) on flat cars. Heat-and-eat remains the dominant carload theme and those not in this game will be soon be in a going-out-of-business sale mode.

Week in Review takes its annual July vacation next week. I'll cover second quarter earnings for NS, CN and UP in the August 1 issue.

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