# THE RAILROAD WEEK IN REVIEW

## September 12, 2014

*"The historical cost advantage of coal versus natural gas has been greatly narrowed, at least in the short term." — Rail Solutions Investors' Guide 2014-2015*

**Genesee & Wyoming North American carloads** for August are up 13 percent to 159,634 units, and seven percent year-to-date to 1.2 million units. For the month, three of the top seven commodity groups that comprise 80 percent of the North American franchise are up double-digits: coal/coke, minerals/stone, and ag products. Coal for the midwest utilities replenishing stockpiles, minerals on frack sand and ag products on the strong 2013 harvest and start of a 2014 repeat. Same store carloads, absent the RCP&E, were up nine percent.

CFO T. J. Gallagher said at last week's Cowan conference that the RCP&E is running 15 percent ahead of expectations, helped by the current crops plus working off backlogs. He said their focus is on the smooth flow of equipment on-off the property and are up to 13 train starts per week from ten. In response to a question from the audience, T. J. said he does not think the Canadian government mandates concerning grain moves will affect what they're doing in South Dakota and in fact hopes to double GWR's interchange volumes with CP (now less than 6,000 cars).

**Scott Group at Wolfe Research** writes that August coal exports out of Norfolk (NS) and Newport News (CSX), Virginia were down 11 percent from a year ago. He notes, "This was the 6th straight month of year-over-year export coal declines." Scott maintains an exhaustive history of coal loadings here going back several years. I added an extra column to show the total change over the 15-month period May, 2013 through August, 2014. NS is down 21 percent, CSX is down 40 percent.

NS was up year-over-year in six of the 15 months; CSX was up in five. Year-to-date NS was up four percent in Feb, flat in May, and down the rest; CSX was up six percent in Feb and down the rest. Concludes Group, "We remain cautious on export coal volumes," though Dennis Gartman (who lives in Suffolk, Va. and can see all this stuff more readily than I can), writes in The Gartman Letter,

> We Americans have heard the term "Taking coal to Newcastle" from our British friends as an example of doing something utterly useless and or redundant. Newcastle was and probably still is the centre of waning British coal mining operations. We bring this up this morning because US exports of coal to the UK have been rising… sharply and steadily… since earlier this century. We are in fact carrying coal to Newcastle.
>
> But it is not just the UK where US coal exports are rising; it is happening all across Europe. Again, turning to coal exports at the turn of the century they were approximately 12 million

tons; rising to 33 million in ’09 and rising to 47 million last year, making export coal a growth industry. We make no explanation as to why US exports of coal have risen so sharply; we merely note that they have and that the trend is clearly well established and years in the making. Coal… a growth industry? Who knew?

All the above notwithstanding, my message to short lines, especially those NOT in the coal business: coal has been so big for so long for both roads that they are going to have to scramble to replace the lost revenue. The most logical place to get it is in the merch carload sector.

Moreover, coal margins are much higher than in merch because (a) it’s point to point in unit trains and (b) the steam coal moves mostly in leased equipment. Ergo watch very closely for merchandise-lane rate hikes, especially in tariff-based rates that can be changed quickly and without much notice. I’ll be sanity-checking merch carload revenue-cost ratio changes here and there. Please drop me a note if you have some specifics.

**I’m feeling a little better** about the lumber loading outlook. The AAR’s *Rail Time Indicators* for September describes the situation thus: “If slow and steady win the race, then rail carloads of lumber and wood are headed to victory lane. Combined U.S. and Canadian carloads were up seven percent in August 2014 over August 2013, but they remain far from where they were before the housing bubble burst.”

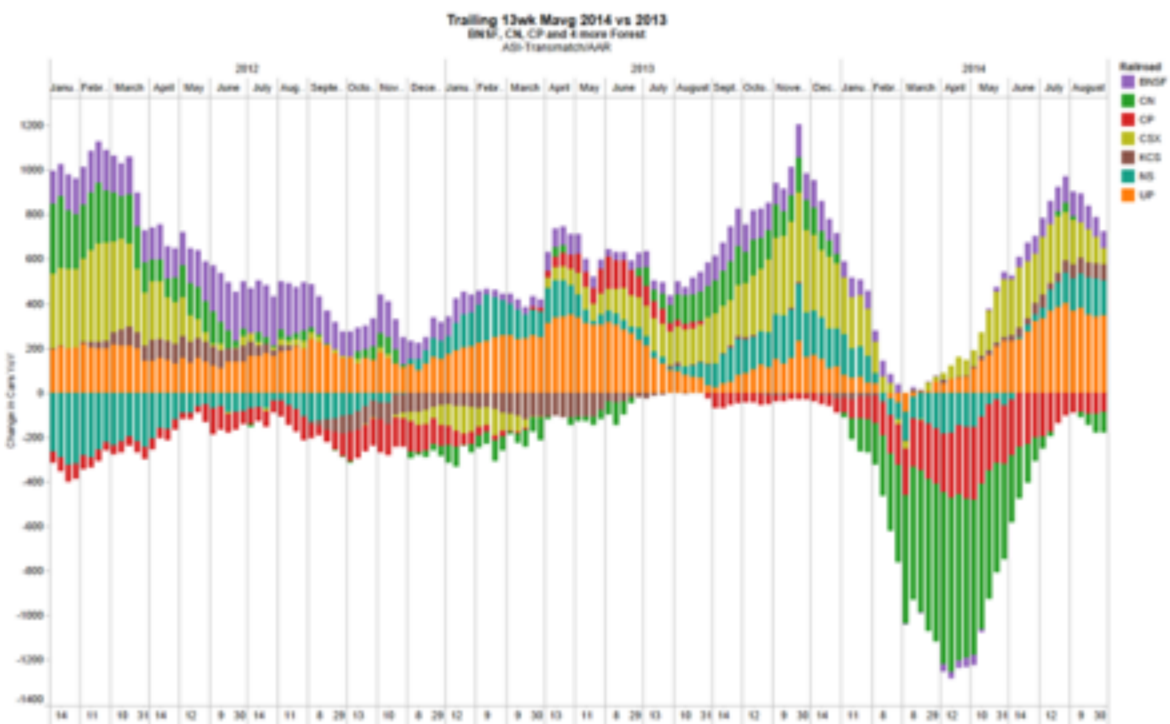
A note from JPM on home builders says, “They are well positioned to rally through year-end” propelled by “order growth acceleration and stable gross margins in 2H14. More broadly, we expect the housing recovery to resume at a moderate pace over at least the next 2-3 years (assuming rates increase at a modest and measured pace), driven by continued job growth and a further modest easing of credit standards.” So if orders are coming in for new houses to be occupied by spring, lumber has to start coming in now. Is it?

To get a handle on exactly where the growth might be, I compared STCC 242 (“sawmill products,” of which STCC 24 211 2x4x8 studs are the biggest part) QCS carloads for 4Q2013 and 2Q2014. See table for results. Everybody but NS is up double digits with UP the biggest player (Drew's chart shows this graphically), handling a third of total (originated, terminated, and overhead) moves. NS and CSX numbers are about the same, which is to be expected as they both serve the same geography.

What I can't explain is why NS was ten percent ahead of CSX in 4Q2013 and lost the big lead in 2Q2014. I suspect pricing. NSC took paper/clay/forest rates up 2.1 percent in 2Q2014; CSX took forest rates up 0.9 percent in the same period. Now see how CSX closed the volume gap in 2Q2014 to a mere 100 cars or so. Their forest carloads increased 6.8 percent in 2Q2014 to NS p/c/f down 0.5%.

Shortline take-away: If you connect with both CSX and NS, compare STCC 242 vols of both for 4Q2013 and 2Q2014. See if there's any share shift and whether pricing could be a factor. If you connect with NS alone, check year-to-date volume comps and the levels of business at your lumber receivers. If they're up and you're down, see if there's a CSX transload in the area that might be replacing your carload-direct service. I've seen it happen in pet food -- why not here?

| STCC 242 | 4Q2013 | 2Q2014 | Seq Ch | |
|---|---|---|---|---|
| BNSF | 11,749 | 13,041 | 11.0% | |
| CN | 12,034 | 14,076 | 17.0% | |
| CP | 2,827 | 3,231 | 14.3% | |
| CSX | 9,028 | 10,518 | 16.5% | |
| KCS | 999 | 1,315 | 31.6% | |
| NS | 9,945 | 10,633 | 6.9% | |
| UP | 18,576 | 23,576 | 26.9% | |
| Total | 65,158 | 76,390 | 17.2% | |
| STCC 242 Sawmill products | | | | |
| Source: QCS for both periods | | | | |




*Forest Products total vols by Railroad, courtesy ASI-Transmatch*

**CSX volume strength has continued** into the third quarter, says CFO Fredrik Eliasson. Speaking at the UBS "Best of Americas Conference" this week, he noted the company's impressive volume growth in the first half and acknowledged that service levels aren't where they need to be thus far in the back half of the year. Power and crews seem to be the largest contributing factors.

Fredrik's slide 10 provides excellent detail for short lines in the merchandise carload sectors. These three — ag products (and here I'm including ferts and food), construction and industrial products — are big consumers of crews and locos. Coal is a little less so, with its spider-web gathering network (see system map in WV, Ky) but with fewer destinations -- Newport News or power plants, mainly. Sharply increased demand for first-mile, last-mile resources eats up power and crews; slow down the railroad and the shortage gets worse due to hold-outs, re-crews, and missed connections at core yards.

Like NS and BNSF, CSX held back on adding non-fungible resources (track, crews) lest management be accused of over-capacity (older heads will recall how the Street beat up BNSF's Rob Krebs for adding capacity during a down-turn). True, you can't build a church for Easter Sunday, but if you're in the church business you need that capacity. It takes times to build track and get crews qualified, but that's what strategic planning is for. They didn't plan, service quality declined, and customers have been unhappy.

Combined ag prods, ferts and food/consumer were 12 percent of vols in 1H2014. I've already written that record corn crops are depressing prices and farmers' equipment purchases, but they sure help loaded car-counts and revenue. I'm not privy to their unit train/single car split in ag, but of the 400,000 carloads in these three groups for the front half of 2014, I have a dollar that says at least half was in high variable-cost single-car service.

CSX links housing starts to merchandise volumes in lumber, aggregates/waste, metals and other building products like cement. Through week 36 (September 6) CSX did about 43,000 carloads of lumber and plywood, up six percent. The portion of the other commodities cited on slide 16 that go to housing is small, so lumber is the leading indicator; see commentary above.

CSX is targeting a mid-60s OR, which is great for Wall Street but doesn't do much for customers who are out of feed corn or lumber. In the church business? Better build a bigger church and build it in time for Easter. From what Fredrik says, we'll have a real cathedral to railroading by Easter, 2015. And customers will smile once again.