THE RAILROAD WEEK IN REVIEW

July 23, 2010

" The majority of freight transported by these shippers already moves by truck." STB Final Environmental Assessment re MMA abandonment

The AAR has put a bit of a damper on the season's upbeat earnings announcements with this somber note: "Rail traffic continues to reflect the sluggish economy with U.S. railroads originating 282,199 carloads for the week ending July 17, 2010, up six percent compared with the same week in 2009, but down 14 percent from pre-recession levels in 2008." In other words, we're still in the "90-percent economy" (WIR July 9) and it's going to be a long way back to full recovery of revenue-unit volumes.

The 2010-2009 comps are up 10.3 percent ex-intermodal for Class Is and 10.0 percent for Class II and III carriers. This by itself is good because it shows the smaller roads are closing the gap in carload gains with their larger brethren. Class I strengths were metallic ores, coke, metals and coke with chems, aggregates and waste also up double-digits. Coal is off a smidge as is the paper group. RMI RailConnect short lines likewise saw strength in ores, coke (RMI includes petroleum), and metal products. Their coal was down 15 percent, however chems rose but six percent and waste loads increased 20 percent. Not a robust recovery in top-line dollars.

Still, UP put a good face on it. Revenues increased year-over-year 27 percent to $4.2 billion on 18 percent greater volume (GTMs increased 14 percent indicating some shorter-haul lanes, and that's good for short lines). Operating expense was held to a 14 percent gain, leveraging a whopping 71 percent in ops income (I can't ever recall an increase that great) to $1.3 billion and taking eight points out of the operating ratio to a record low 69.4 percent. Net income grew 53 percent to $711 million and eps also increased by 53 percent to $1.40 per ticket.

On Thursday morning's call Chief Commercial Officer Jack Koraleski had some good news for UP's short lines. Seven-day revenue-unit counts at the end of May 2010 were 170,000 vs 140,000 in 2009 and 200,000 in 2007-8. Of particular interest to short lines, car counts in ag products grew five percent to 213,000 units with revenues split 29 percent food and refrigerated products, 39 percent grain products from soy meal to corn sweeteners to ethanol and 32 percent whole grains. Particular strengths were noted in ethanol, whole grain exports and "produce rail express." [See my Feb 2010 *Trains* feature on Railex.]

Elsewhere, in automotive we see carloads of finished vehicles up 77 percent to 93,900 units; parts (where most short lines and regionals play) up 67 percent to 65,900 units. Chemical carload volumes increased 11 percent on fertilizers and industrial chemicals where carloads increased 36 and 11 percent respectively. The Industrial Products group includes both forest products STCCs, construction materials, metals, aggregates and (you gotta love this one) "government/waste," and shows strong returns in steel, scrap, hazardous waste, and non-metallic minerals.

The second-half outlook sees low inventory/sales ratios "throughout the supply chain" (not surprising given producers' reluctance to produce more than they can sell in an uncertain economic environment), tighter truck and container capacity and stagnant housing and construction. All of which puts the rails in pretty good shape with capacity, reliability and the ability to put such goods as are ordered where they are needed when they are needed. It is this value proposition that will lead to more value-based pricing and improved margins.

And, speaking of margins, the railroad operating practices behind the dramatic drop in operating ratio include more trains running with distributed-power (DP), longer trains for the manifest group and better terminal performance. Short lines have a particular stake here as UP has achieved record high levels of compliance in service delivery, place-and-pull, car connections, and AAR train velocity. Implications for short lines? Bigger trains running DP cuts the number of units needed to run a given volume and a one-mph gain in AAR velocity saves 250 units a day. You can help.

My good friend and baseball buddy Tony Hatch sums up the call thus: "Union Pacific hits it out of the park – following on last week's terrific CSX performance, UNP reported a 52 percent YOY earnings jump in Q210, fully 17 percent above Street consensus – and one can argue that on an apples-to-apples basis it was more like a 75-80 percent increase over the trough that was the '09 second quarter.

"The Operating Ratio (OR) dropped eight points to a UP-record low 69.4. UP did this by hitting on all cylinders – volume growth of 18 percent, pricing gains of ~5 percent, increased service levels despite the volume recovery (Customer Satisfaction and Service Delivery Indices both up; system velocity also up) and operating leverage (crew starts up 7 percent, only roughly a third of the volume increase). UP still doesn't provide guidance, which we understand, but therefore spent most of the conference call fending off analyst questions on how low could the OR go, etc etc., a good problem to have."

Canadian National continued the theme Thursday afternoon. Quarterly revenues increased 18 percent to C$2.1 billion against a seven percent gain in ops expense, powering a 40 percent jump in operating income to C$813 million and a remarkable operating ratio of 62.1, a six-point improvement over last year's second quarter. Net income was C$534 million, up 38 percent. I have often said CN is a financial company that happens to run a railroad and the cash flow statement bears that out. Free cash flow -- cash from operations less capex less dividends came in at C$895 million, ten percent greater than operating income. You don't see numbers like that very often.

What else jumps out is that CN posted these gains on a 27 percent hike in revenue units (usually we see the percentage of revenue increase greater than the percentage change in revenue units). Not surprising, then, is the negative delta in revenue-per-unit in all the carload commodity groups but coal. Operating highlights include single-digit percentage improvements in GTMs per train-mile, cars per yard-switching hour, and mainline GTMs per available horsepower.

Terminal dwell came down to 16.5 hours from 17.8 hours in the 2009 fourth quarter, including the EJ&E, train velocity improved by 0.6 mph to 28.3 vs. two quarters ago, and car-miles per day was essentially unchanged compared with second quarter 2009 at 211 miles. For the year to date, carloads per week are up seven percent over 2009 to roughly 88,000 units and equal to 2008 at this point in the year. Taken together, these metrics -- even unchanged or with small deltas -- show absolute numbers any other Class I would kill to achieve.

Key Themes on Housing "To Focus On Through EPS Season" from UBS: "We continue to believe fundamentals in housing are approaching a trough. That said, underlying conditions have weakened recently, reflecting the pull forward in demand experienced from the tax credit and declining consumer confidence. Further, we anticipate continued uncertainty over the near term. This should ease, however, toward this year's end as signs of stabilization—and a gradual recovery—become evident.

"We expect the home-building stocks to pull back through EPS season, driven by the continued weakness in the broader housing market. We'd view this as an opportunity to get more constructive on the group." In other words, UBS sees no more light at the end of the tunnel than do folks like Jack Koraleski (above) or Wick Moorman (WIR July 16).

How the Montreal Maine & Atlantic (MMA) saga is playing out comes to us in this update from *Railway Track & Structures*: "The state has offered $18 million to purchase the 233 miles of rail line that MMA is seeking to abandon in Aroostook and Penobscot counties. Maine Department of Transportation Rail Program Director Nathan Moulton says the offer is conditional on federal approval of MMA's request to abandon the tracks. The STB is still considering whether to allow MMA to abandon the railway, and Moulton says the offer will protect the right of the state to purchase the line if the STB grants that request.

Meanwhile, *Railway Age* reports in sum: The STB'S Final Environmental Assessment finds "The majority of freight (more than 90 percent) transported by these shippers already moves by truck. Although some shippers have questioned that conclusion, statewide data shows that freight rail in Maine carries approximately 10 percent of total tonnage in the state." Moreover, for the one in ten using rail, truck transportation would be "available to transport the vast majority of shipments at issue in this case." And "the increased truck traffic for the worst case scenario would have minimal impact on overall highway safety in the region."

The lesson to all rail users, would-be rail users and rail service providers is not new: Use it or lose it. I recall a shortline rail service provider on a light density line in the north-central wheat fields who faced the same dilemma as the MMA: we can't afford to keep running trains but the town "needs" us. But the country elevator in question continued to shun the railroad. Finally the operator decided his need to preserve capital trumped the town's "need" for rail service and applied for abandonment. In this case, the application was granted, the railroad went away and eventually so did the town. Use or lose it.