# THE RAILROAD WEEK IN REVIEW

## March 18, 2011

*“Today’s profits are tomorrow’s investments and jobs the day after,” former German Chancellor Helmut Schmidt*

**Wisconsin has announced** a $28 million freight infrastructure program, of which $21 million will be outright grants. The balance is $5 million in loans through the Freight Railroad Infrastructure Improvement Program (FRIIP) plus matches that the receiving railroads will put up. Three active rail users on state-owned lines, the Wisconsin & Southern Railroad, the Escanaba & Lake Superior Railroad and the City of Milwaukee all benefit.

Here’s the deal. The three rail customers are all active grain customers looking to use more rail, so not one nickel of the $3 million to be spread among them goes for business on the come. The money will go for track extensions, increased grain storage, the conveyors to move the product and a rail dump pit. All three are active in ethanol and bio-fuels, have previously participated in the loan program, and are looking to reduce truck traffic in and out of their facilities.

Wisconsin & Southern was awarded $14 million in grants for track and bridge improvements to which it must add $1.4 million in matching funds and take out another $million in WisDOT loans. The Escanaba gets $4.4 million to cover 80 percent of a track rehab project, a half-million dollar loan for ten percent with the railroad putting up the balance.

By way of background, Wisconsin’s Freight Rail Preservation Program has over the past 20 years awarded $98 million to carriers and communities to keep the tracks in town while loaning out another $100 million -- at interest. Not a bad deal for keeping 12 road names in the state to handle some $2.5 million cars a year over 3,600 miles of track. Clearly Wisconsin sees today’s rail infrastructure investments as jobs the day after.

**Morgan Stanley evidently** thinks so too. “Recent volume, productivity, pricing, and valuation indicators reaffirm our Attractive view on rails. Incremental data points continue to be consistent with our bullish thesis on rails for four reasons. One, our historical seasonality-driven volume forecasts imply that mid single-digit volume growth for 2011 remains likely for most rails with upside toward the high single-digits. Two, January 2011 industry employment levels, in conjunction with volume trends, point to continued strength in incremental margins.

“Three, firmer truck pricing is supportive of rail price growth - a point reaffirmed by strength in our proprietary Truckload Freight Index, and four, our Class I valuation model continues to point to upside to current rail multiples. Thus we reiterate our Attractive view on the freight rails. The Class Is are still compelling investments due to the outlook for better incremental margins on improving volumes combined with sustained momentum on core price.”

**RailAmerica carloads** for February, 2011 drifted south by 5.5 percent to 63,347 units from what they were in Feb, 2010. Nine out of 12 commodity groups showed declines, led by coal and agriculture, the two biggest and accounting for a third of RA's volume. Chemicals, RA's third biggest commodity by car-count, posted a 6.4 percent increase while paper (!!), nine percent of carloads, increased 16.7 percent.

In its press release RA said weather was partially to blame with the big hits in the RA operating regions where you'd expect the worst weather -- central, midwest and northeast. You can see it in the sequential change in volumes. Feb was off eight percent from Jan and Jan was off three percent from December.

Year-to-date loads are off two percent; however, the changes in mix as RA seeks to boost yield are still working their way through the system. I spent some quality time with CEO John Giles and Chief Commercial Officer Charlie Patterson at the CSX conference last week and remain convinced the overall direction of the company is positive. I'm not going to fret about shedding a few basis points of volume over three lousy months in the middle of the winter.

**Genesee & Wyoming revenue units** present an interesting challenge for Week in Review. Our goal here is to put non-Class I railroad franchises in the context of their North American Class I counterparts. Until just recently GWR lumped all traffic together -- North America and Australia. So unless one knew what was strictly Australian, one had a tricky time unscrambling the omelet.

Starting in January, 2011, however, GWR provides a breakout for North American carloads by commodity and they've restated year-ago data so we can see year-over-year comps quite nicely. These are the numbers I will be using in the monthly comps from here out.

February North American revenue units increased three percent vs. Feb 2010 to 57,564 units with coal & coke, pulp & paper, metals and "other" (mainly overhead coal for NS in Ohio) accounting for 62 percent of the total. Total carloads include once again the Huron Central, announced as discontinued in June, 2009 and reorganized back into the GWR fold effective Jan, 2011, its traffic once again included in the North American count. To make the comps work, GWR has put back the Feb, 2010 units that were omitted from the car counts reported for that month at the time.

Total units drifted down 13 percent from the Jan, 2011 total, largely a function of the severe winter weather endured by its properties in Quebec, Ontario, New York, Pennsylvania and Ohio. Still, year-to-date loads managed a nine percent gain, roughly three percentage points better than the Class Is through Week 8. Among the largest commodity groups by volume, coal dipped 11 percent year-over-year while, like RailAmerica above, GWR paper posted positively, in this case up ten percent. Metals, GWR's third largest group by volume, gained five percent. In sum, nine out of 12 commodity groups were up, albeit by small numbers, but still up.

**CSX is taking export coal tariff prices up** 16-20 percent on unit trains to Baltimore and Newport News. The company had previously guided to 35-40 million tons of export coal in 2011, roughly 30 percent of CSX coal revenue, with volumes up a third or so. This comes as no surprise, as the rapidly expanding export coal options for both CSX and NS indicate high

demand and limited supply of material and the means of transport. And we know from past experience that both roads price aggressively to market and with very sharp pencils.

In a note to clients, Jeffries rail analyst Peter Nesvold writes, “The term of the tariff increase is three months vs. the 12 month norm, potentially allowing for additional price increases later in the year. (We believe CSX is following the lead of BHP and other coal constituents in the move toward quarterly, or at least semi-annual, contracts in the international markets.) We see this as a substantial positive for CSX and NS.

“Export coal demand remains strong. On January, 12 we wrote about the upside export coal opportunity presented to CSX and NS due to recent global disruptions in international coal supply across multiple regions. At the time, given current data, we estimated there was roughly 5 percent of incremental upside pressure to our earnings forecast. Since then, export coal demand has been even stronger than we expected, as supply disruptions and higher energy prices have further raised demand for U.S. exports.”

Now comes the nuclear situation in Japan. UBS rail analyst Rick Paterson writes, “Increased coal demand in Europe and Asia would be positive for the eastern Class Is. Of the two, CSX would be our first pick. With close to 40 percent of its export coal being thermal, CSX has more exposure to the thermal export market compared to NS with less than 10 percent. As the eastern railroads continue to invest in network infrastructure and intermodal capabilities, they should be able to accommodate increased levels of coal shipments at relatively low incremental cost.”

JPM’s Tom Wadewitz was on the March 15 coal conference call with CSX and reports, “In our view, the capacity at the export coal facilities that CSX serves can handle meaningful growth from 2011 levels with some additional investment. The two piers at Newport News handled 58 percent of CSX's 2010 export coal volumes, while 27 percent went through the two piers at Baltimore; Mobile got 15 percent. We believe that across the three ports served by CSX, there is capacity for modest further growth in export volumes above the 35 - 40 mm ton forecast that CSX has in place for 2011.”

And in a separate note, Jeffries analyst Michael Dudas writes, “We believe the Japanese earthquake should lead to increased demand for metallurgical and thermal coals. Peabody Energy, the largest global coal company with sizable low cost production assets across the U.S. and Australia, a global trading platform with industry leading access to import/export coal flows and increased mining opportunities throughout important Asian coal basins, appears poised to benefit from pricing and volume gains.”

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