THE RAILROAD WEEK IN REVIEW

January 18, 2013

"Canadian National is the best run railroad in the world, in our view. Fourth quarter RTMs grew twice as fast as vols on a percentage basis." -- John Larkin, Stifel Nicolaus

John Larken is the only rail analyst I know of who actually worked at a railroad. He spoke at a BNSF shortline meeting a couple of years ago on trucking trends that will affect short lines and had them eating out of his hand. His Fourth Quarter Review contains what he calls "Railroad Capsule Summaries." Excerpts herewith:

> *Canadian National*, Hold, is the best run railroad in the world, in our view. We believe the company's operating margins, free cash flow generation, and business development strategy are the industry's best. In 4Q12, revenue ton-miles increased 8.4% y/y, while unit volume growth was 3.4% y/y. CN continues to see stronger increases in intermodal volumes vs. CP and is benefitting from volume growth in petroleum/chemicals carloads and declines in metals, ores and coal carload traffic. Management guides to a 63 OR, roughly, which appears conservative to us as we believe incremental volumes and further productivity improvements will help to drive the operating ratio lower over time.
>
> *Canadian Pacific*, Buy, has less comprehensive geographic coverage in North America than CN, yet is is a big exporter of coal, fertilizer, and grain to the Pacific Rim. CEO Hunter Harrison has revealed a detailed plan to achieve a mid-60s operating ratio. For 4Q12, unit volume is up 0.9% y/y driven by increases in grain, coal, auto, and petroleum carloads as well as intermodal units.
>
> *CSX*, Buy. Long the laggard of the two eastern U.S. railroads, the company has improved its operations and increased prices faster than most observers believed possible. The company's National Gateway initiative could change the way freight is distributed in the Midwest as its Northwest Ohio intermodal facility is the efficient hub terminal needed to re-classify freight destined for secondary markets. Export coal volumes could continue to grow; utility coal is particularly soft and is being largely offset by growth in chemical, automotive, and intermodal shipments. Pricing continues to move up at low- to mid- single digit rates year-over-year. CSX continues to offset a portion of its cost inflation with increased productivity.
>
> *Kansas City Southern*, Hold, has the most organic growth potential in the coming years among the North American railroads given the enormous opportunity to move incremental trans-border freight. Mexico is quickly becoming the location of choice for outsourced U.S. manufacturing of high-value/high volume goods. The Port of Lazaro Cardenas, should grow much faster than U.S. ports due to the proximity to numerous consumption centers, available real estate for expansion, and relative lack of environmental constraints. Volume growth

> slightly outpaced the industry in 4Q12 -- up 1.9% y/y, led by intermodal, up 6.9% y/y; there were y/y declines in coal, agriculture, and forest products carloads.

> *Norfolk Southern*, Buy, has the better operations of the two big U.S. eastern railroads, in our view. NS is in the process of implementing strategic technology-driven cost reduction initiatives and has an impressive series of corridor-specific strategic marketing initiatives. The Juniata locomotive shop (Altoona, PA) gives the company a locomotive life-cycle cost advantage vis-à-vis its competitors. We consider NS management team to be top notch and believe that the company should respond well to a gradual economic recovery, increased global trade, and continued shift of highway traffic to rail. 4Q12 volumes were down just slightly y/y as softness in coal volumes offset strength in intermodal and automotive traffic.

> *Union Pacific*, Hold, is the only publicly-traded Western U.S. railroad, has significant exposure to an economic recovery as it hauls more chemicals, automobiles, and industrial products than BNSF. The combination of operational improvements, pricing power, and economies of network density should be powerful earnings growth drivers the coming few years. UP (alone among Class Is) still has roughly 5% of its revenue ($1 billion) remaining under legacy contracts that have yet to be re-priced to market prices over the next few years. UP, like the other U.S. railroads, has suffered from declines in coal traffic during 2012; however, other carload and intermodal traffic has largely offset the 4Q 17.2% y/y drop in coal volumes.

GWR is now the only exchange-listed operator of AAR Class II and III railroads. I'm excerpting the portions of Larkin's note that deal with North American carload volumes.

> GWR, Hold, has just acquired RailAmerica and is now working to integrate the two operations, while eliminating duplicate overhead functions. Combined, we estimate the two will make up a $1.6 billion revenue business that hauls just under 2 million carloads annually. [However], it may ultimately become difficult to find sufficient organic and/or acquisition-driven growth given the dramatic jump in revenue base driven by the RailAmerica deal.

Finally, BNSF. Because the railroad is now under the Berkshire Hathaway aegis, the rail analyst community no longer covers it. So here's my attempt at a Larkin-like Capsule Summary:

> BNSF is faring very well not having to play in the Sarbox as a public company. They can invest as required without incurring the wrath of Wall Street for spending a larger percentage of revenue than the other roads on capex or taking a hit in certain commodity lanes to increase contribution per carload. Revenue units for 4Q slipped 1.2% y/y in spite of a near double in crude-by-rail and auto up 20%. Industrial products units ex-petrol (nominally in the chems group) were off 12% y/y. The railroad contributes roughly a third of Berkshire net earnings.

Railsync *Command* from ShipXpress is another entry in the paperless event reporting sweepstakes, with one critical difference: it works on an iPad or Galaxy tab, and it is free (no additional charges per device or per month). Designed for 8-inch screen size, Command supports both the iPad and the Samsung Galaxy, though other generic android devices have been used successfully as well.

To me, the big selling point is that there is no proprietary hardware requirement and no software is loaded on the device. Moreover, the ShipXpress technology platform allows operating without a live internet or cell phone connection; events are recorded, stored and in real time and updated to the cloud when a connection is available. It allows you to minimize field data entry by setting up work orders that the field can execute with one click and manage the exceptions.

ShipXpress president Charith Perera tells there are no add-on charges for running *Command* on a hand-held. Thus you can buy your preferred device off the shelf because the platform is truly webcentric and device independent. You do not have to load up any software on any device and you can print to any printer that you have access to. It also means if you are traveling and happen to not have your own computer with you, you can access through any other computer using your secure login credentials - the same way you would access your bank account. Perera has promised me a demo run on my very own iDevices and you will read my reactions here.

Indiana Rail Road and Canadian National are to build a new downtown Indianapolis intermodal terminal that will allow the two roads to offer Indiana importers and exporters an all-rail option for containerized products moving to/from Asia. CN serves the Port of Vancouver, B.C., and the Port of Prince Rupert, B.C., both called on by a number of container shipping lines offering scheduled service from all major Asian ports. CN estimates total transit times between Pacific Rim ports and Indy will be 18-20 days. Operations will start in June, 2013.

I asked INRD President Tom Hoback how the containers will flow between his railroad and CN. He writes, “CN will handle blocks for us Homewood - Effingham - Newton where we pick up the intermodal blocks along with general merchandise. We then bring the blocks directly into Indianapolis where containers will be available for pick up the next morning.

“Once the service is established and we get a certain base volume, there could be incremental tweaks to our through service. Because Central Indiana exporters and importers have had significant issues draying containers between Chicago intermodal facilities and central Indiana, and it has become very expensive, we believe this service will gain a lot of acceptance.” Thanks, Tom.