THE RAILROAD WEEK IN REVIEW

April 5, 2013

"In 2012 we achieved best-ever velocity performance in our merchandise commodity group."
-- Steve Bobb, BNSF Chief Marketing Officer

BNSF's commercial expectations for 2013, says Bobb, "are mixed, much like the economic outlook." In an "Executive Roundup" series of interviews published in the Winter, 2013 issue of *RAILWAY*, the BNSF employee magazine, Bobb adds that the diversity of markets served will help some commodity groups "to continue setting volume records." Highlights:

* Crude-by rail continues to be the big Industrial Products news as petroleum is in the chems group. No signs of slowing in the Bakken and Williston shale formations. Housing -- lumber and construction -- is heating up as well. [Recent analyst notes on home builders in the BNSF service area support Bobb's observations. -- rhb]
* The 2012 drought will likely cause lower ag carload numbers in 2013. Just how much is a function of weather and crop production.
* Intermodal and Automotive (the BNSF "Consumer Products Unit") will continue to add revenue units through increased supply chain collaboration and highway conversions.
* 2012 system on-time performance was 87.4 percent vs. 79.6 percent in 2011.
* Cost inflation is still a drag; looking to offset same through initiatives like increased train-length, newer technology to support the work and matching track maintenance programs to the service levels required.

On the shortline and regional railroad side, Dick Ebel, AVP for Shortline Development, says the 200 properties that have direct BNSF connections total 22,574 route-miles -- three miles short of BNSF's 22,577 owned-mile system -- and touch 20 percent of BNSF's non-intermodal revenue units. What BNSF seeks is Class II and Class III carriers that can be "agile, entrepreneurial, and extensions of our Industrial Products network." Ebel's boss Dean Wise adds there's a need for "velocity and efficiency," mirroring Bobb's comments, above.

For the first quarter of 2013 through Week 12 (Mar 24), among the commodities that touch short lines the most, stone hit its peak in early Jan and has slid since; the metals, forest and processed food groups languish essentially unchanged and grain lags yet. Among the less-shortline groups, intermodal, auto and chems (really petrol since straight chems are down) are all up; coal is still down, though Week 12 saw a bit of an uptick.

I'm calling the first five commodity groups above -- the ones short lines touch the most -- the manifest carload group. The group ran some 515,000 units through Week 12, nearly 23 percent of total BNSF revenue units. And the reason I'm excluding chems from the merch group is the fact that the petroleum STCC is more than half the chems vols, ex-petrol off 4 percent YTD.

Bobb and Wise both talk about efficiency and velocity. Drew Robertson's ASI-Transmatch charts show system average train speed up 6 percent since Jan 2011 and significant gains in train speeds across all train types -- multi-level, intermodal, coal unit, grain unit and manifest -- for FY2012 over FY 2011. With respect to this last, it's all about first-mile, last-mile performance, and -- for short lines -- the interchange-on to interchange-off interval. Keeping that interval small is a big part of what Dick Eble calls being "agile."

Canadian Pacific continues to stay in the spotlight. Last week Morgan Stanley's Bill Greene called on HH et al in Calgary and came away convinced that CP remains "a compelling investment" for investors looking out two years. Greene gives three reasons for what he sees as "solid upside potential" -- upside revenue "surprises in crude-by-rail, cost-cutting ahead of schedule, asset sales could be worth more than originally thought, and CP's guidance is "too conservative." Greene reiterates his Overweight rating, seeing CP as

> a network that is certainly not broken and arguably has strong potential as we see significant opportunity for OR improvement at CP with non-economic drivers to growth and productivity. Given the run in the stock since Harrison was hired as CEO, we would expect that the pace of stock price gains could moderate going forward, but several key investment risks (key man risk, customer complaints, etc.) have been addressed or eliminated.

Greene's revised price target is $140, up from $130, 16.5 times his new 2014 earning estimate of $8.47 per share.

The other side of the argument comes from seekingalpha.com, where contributor Felix Pinhasov said back in Feb that CP shares at $115 had reached a "euphoric zone that can no longer be justified by valuation." He observes that since Ackman won his proxy battle and tapped Hunter Harrison to run the place, "the company's shares have been propelling higher and higher as investors try to discount the potential growth in earnings that could result from a more efficient operating ratio."

As we saw with NSC in 3Q2012, a well-run railroad with tight expense control will see its OR get clobbered when revenue drops due to a shift in demand for what's being shipped -- in Norfolk's case, coal. My fears are the story could repeat itself at CP if Pacific Rim demand for Canadian wheat, ferts and met coal should drop precipitously. Pinhasov seems to say as much: "At current price levels investors are simply paying too much for a company that has shown modest revenue growth and is relying almost completely on cost reduction to satisfy an earnings multiple in excess of 40 times 2012 earnings." That's scary stuff.

Also at seekingalpha, "Infitialis," a self-described "research collective that exposes fraud and folly in an effort to identify bubbles before they implode," opined this past Monday that CP is trading as a "story" instead of an investment based on the underlying operational performance of the business at this time. The writer says CP is now a "compelling short" due to the recent share

price run based on, among other things, "an irrational market assumption regarding the timing and feasibility of the railroad operational improvement plan."

I have watched, given my CP revenue fears, in awe as the stock has literally doubled in the last 15 months, with no significant breaks in the upward trend line. And though I try to be a value investor that seeks to buy good companies cheap, I acknowledge one can't fight the tape. So I bought myself a Christmas present of CP shares, and, knowing that all good things have limits, set a 5 percent trailing stop and a $130 target. As it happened, CP hit $130 on the last day of the quarter and gapped down at the open on April Fools Day. Thankfully, I got stopped out.

The feedback from the recent WIR thread on the STB and captive shippers is quite instructive. One particularly irritating anecdote about the unscientific 180 percent comes from a shortline client who writes,

> I once had an episode with a Class I where we felt that their proposed rate was too high. We then got the detailed internal workup, which it appears a clerk mistakenly forwarded to us. It was fairly obvious the commodity market manager had just applied 180 percent to the number he got from the mother ship costing system. Once we showed the Class I guys what we'd seen, they backed off. We didn't make an issue of it, but it shows how little effort went into that manager's rate-making process.
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> It's not so much the blind application of the 180 percent that bugs me, but what appears to be the unthinking use of whatever garbage the costing system spat out. I wonder how many of these guys even understand what long term variable cost is. Some presumably smart guys design the costing system, but their assumptions are largely baked in. Things like variability percentages and whatever regression analysis (or the lack thereof) that gave rise to them.

But for the accidental forwarding of the internal worksheets, it's doubtful the short line would have ever known what was behind the seemingly inflated number. Worse, had a less-inquisitive short line or even a customer seen the inflated rate, that individual might just have walked away. Another piece of revenue lost through lack of due diligence.

Do that too much and smaller top lines find their way to Net Earnings, and Net Earnings go to the top line of the Cash Flow Statement. Diminishing net income at the top of the Statement can create negative numbers toward the bottom of the statement, indicating insufficient revenue to fund the ongoing business. Sloppy pricing thus hurts two ways. Too high and you miss out on moves you might have made albeit at a lower but still profitable margin. Too low and you don't make the margins that are on the table.

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