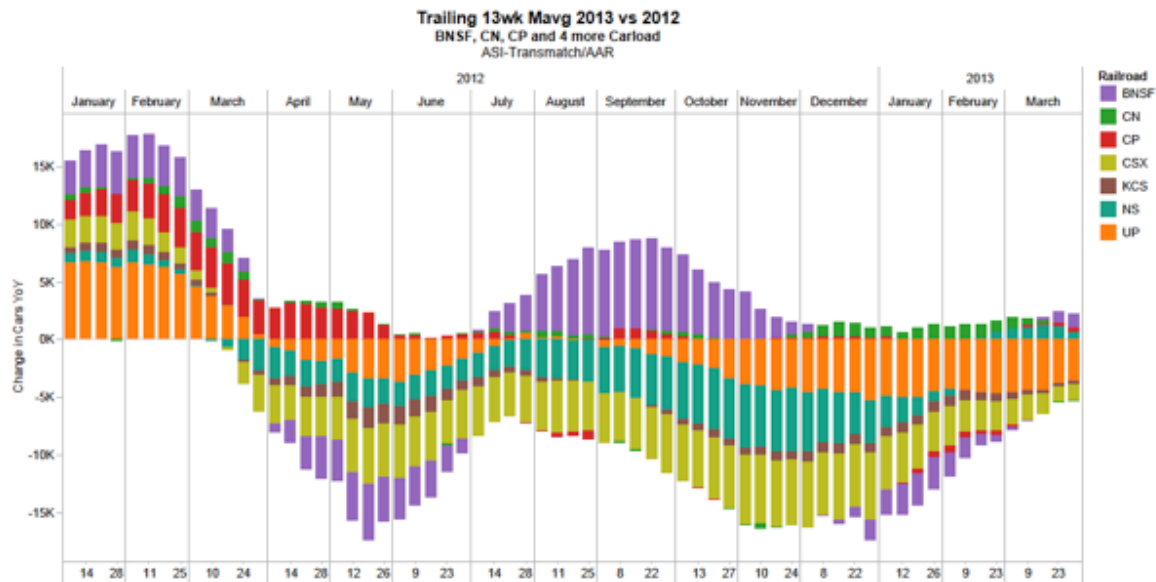


THE RAILROAD WEEK IN REVIEW

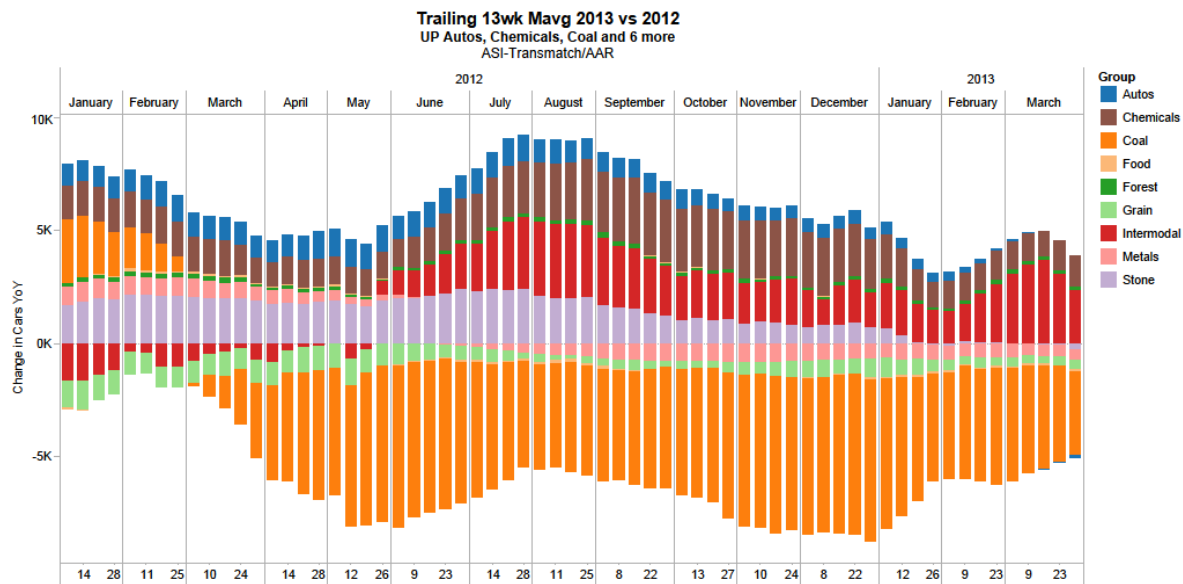
April 12, 2013

Union Pacific first quarter total revenue units are coming in on the downside by about one percent and the weekly comps show why. Compared to its peers, UP's rate of weekly improvement in Q1 has lagged. You can see how BNSF went to negative from positive in Q4 then turned positive again in late March and how CSX has improved the year-over-year spreads since Jan. NS did OK into Mar, then fell back a bit.



The root cause is coal. You can see in the lower chart year-over-year deltas showing how coal (down 17 percent) offset the intermodal and chems gains. Within chems, up 12 percent *in toto*, petroleum (read crude-by-rail) is up 49 percent and straight chems up 2 percent. Agriculture was down 8 percent on a 16,000 unit drop; gains in non-met minerals and forest products made up 12,000 cars of that. Within forest products, STCC 26 commodities account for nearly half the vols and the car-counts are unchanged year-over-year. Lumber was up 5,000 cars, however.

Wolfe Trahan's April 2 note on UP says coal comps will "ease materially" in the next quarter, grain comps will get better starting in July and explains why "pricing matters" -- UP leads the crowd with the "strongest pricing/yield trends" among US rails. Longer term, Wolfe Trahan "continues to favor" UP's balanced commodity mix and posits that UP "can maintain the best margins among the Class I rails longer term."



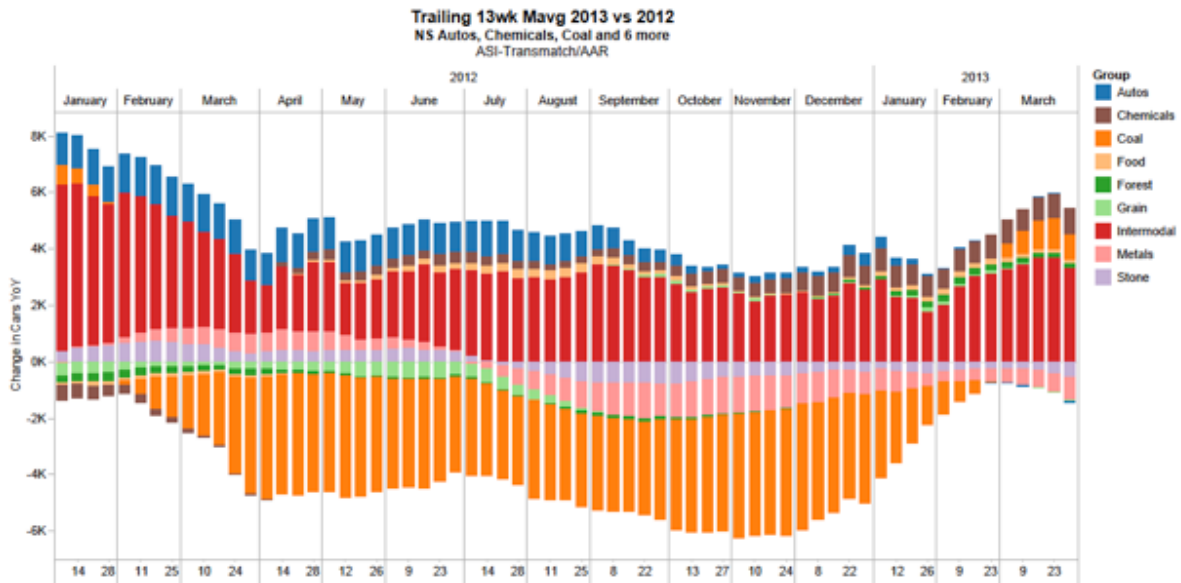
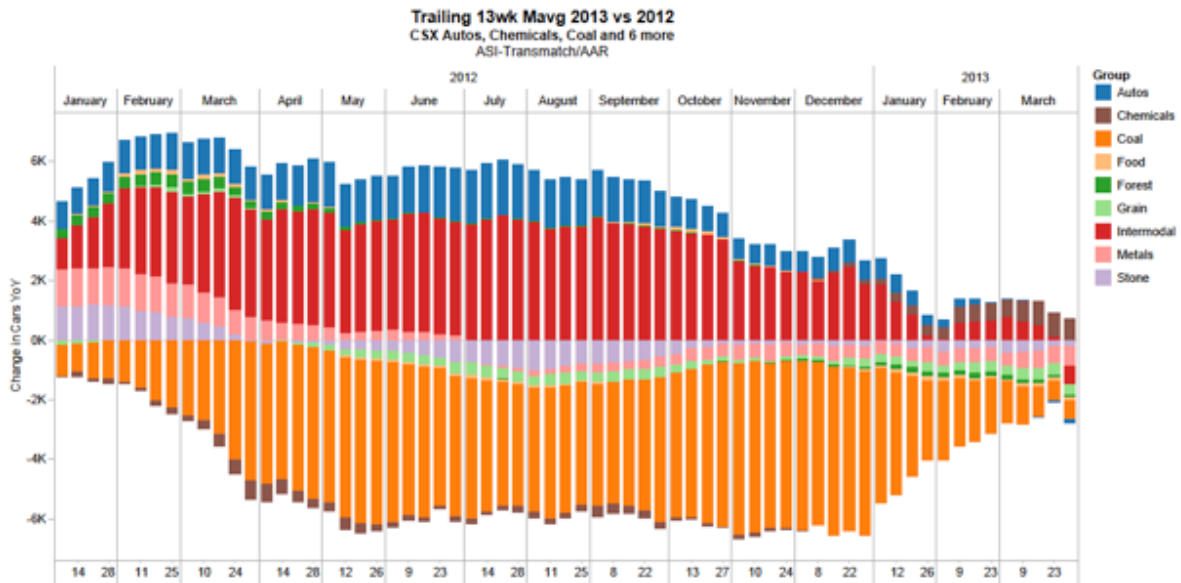
Jason Seidl's *Trackwork Weekly* charts break out petroleum and chems so you can readily see how crude-by-rail inflates the chemicals commodity count. I was reading another sell-side analyst report touting the competitive advantages CSX has over NS and how it's playing out in coal and intermodal.

Frankly, I don't see it, at least as far as benefits to non-Class I carriers are concerned. These numbers are extracted from Jason's note and they in turn come from the AAR.

What I see is NS with the stronger intermodal franchise, the corner turned in coal, a slight edge in petroleum and both roads ending the quarter in about the same place percentage delta wise in merch carload vols.

More to the point, from a Class II or III railroad perspective, is where the deltas lie. Keep in mind that each bar represents one week of a trailing 13-week moving average. Draw a line from the first week of Jan above the line to the last week of Mar and see the trend. The color code tells you how each commodity group has changed in the 13-week MA.

CSX	2013	2012	%chg
Total Units	1,574,976	1,601,350	-1.6%
IM	612,372	598,961	2.2%
Coal	275,045	308,016	-10.7%
Auto	106,027	105,863	0.2%
Petroleum	29,830	19,028	56.8%
Carload	551,702	569,482	-3.1%
NS	2013	2012	%chg
Total Units	1,797,423	1,730,741	3.9%
IM	860,524	785,164	9.6%
Coal	336,138	342,364	-1.8%
Auto	98,148	96,250	2.0%
Petroleum	32,567	19,831	64.2%
Carload	470,046	487,132	-3.5%



The CSX trend is clearly down. What's up is chems and we know what's behind that. We can see coal approaching what Wall Street calls "an inflection point," that is, when the trend changes direction. But across the quarter the volume trend is unmistakably down.

NS is the study in contrasts. The intermodal corridor strategy of specific lanes with shorter distances between ramps is paying off in highway conversions. (See also the intermodal percent changes in the spreadsheet above. The percent change in chems is about the same as CSX but notice how coal has moved above the line -- it's past the inflection point. NS reports April 23.

Art Cashin, NYSE Floor Ops Director for UBS Financial Services, on good earnings in a less-than-robust economy:

There is one last incongruity we should consider. How could such good earnings be achieved in a struggling and sluggish economy? The somewhat oxymoronic answer, simply, is good management.

At company after company, hard-pressed but creative managers were forced to do more with less. More product with fewer people and less resources. That is, to some degree, why the macro economy looks sluggish while earnings grow. Good for Wall Street, not yet so good for Main Street. The proof of that thesis can be seen in corporate profit margins. They are at all time record levels. Never before have managers been able to wring one more drop from a stone.

That brings us to this earnings season (which really starts in earnest next week). Company managers are lowering estimates at a frantic pace. Wall Street skeptics, thinking the managers are playing possum, are holding to higher estimates. The real question is: can managers expand margins that are already at record levels? Is there more blood in that stone? We've seen earnings are key to stock prices. That's why this earnings season may be critical.

The big concern for the rails will be how they can increase earnings on minuscule volume growth. I think the winners will be the names that can get their 4-6 percent rate increases and hold ops expense expansion to three percent or less. CSX is up first with numbers after the bell Tuesday. Their system RPU is up at a 5.6 percent CAGR since 2009; can it continue?

Yesterday I wrote in a note to clients that now's not the best of times to be in the shortline business unless you have a franchise that is strong in heat and eat. Now comes the GWR Mar carload report to bear me out. Revenue units on their North American properties (now including what was RailAmerica a year ago) were essentially unchanged year-over-year for the month and quarter, a pattern that mirrors very closely what we see in the Week 13 RailConnect Index.

Put their NA carloads list down beside the week 13 RailConnect Index and see single low digit deltas up or down in aggregates, chemicals ex-petrol, paper and ores with larger negatives in waste and metals. Now if the GWR guys and gals, some of the best in the business, can only eke out small gains while owning one-fifth of all NA shortline names, what does that say about the remaining 80 percent of Class II and II names, many with fewer resources than GWR?

Of late I am seeing what appears to be an uptick of interest in short lines among lenders. The reason is an uptick in borrowing among SL owners. Not good. I suspect some borrowers are already leveraged to the hilt, where EBIT barely covers interest payments on existing debt. And since these names are switch carriers and handling lines, a fall off in vols is a fall off in revs. Lather, rinse, repeat.

What goes around, comes around. Back in Sep-Oct 2008, when financial markets were imploding in the wake of the sub-prime mortgage fiasco, I wrote,

An investor friend of mine has two rules for stock pickers that ought to apply to short lines as well. Rule Number One: if the company needs to borrow money to stay in business, set it aside. Rule Two: if the company makes something you can't live without - like food and fuel -- then hang onto it.

Into the first group we put short lines that are on the government dole with rehab grants, 45Gs and other goodies. Into the second group we put those lines that move grain and coal and pay their own way. I call it heat-and-eat. Coal and natural gas drilling supplies fall into the first group; grain for everything from Cheerios to chicken feed goes into the latter. Both are good for short lines.

And you'll note it's heat-and-eat that are the strong commodity groups among all AAR classes of railroad. These are the commodities that keep volumes up and the keep down need to seek the kindness of strangers for support.

Do yourself a favor and take your railroad's financial temperature: How many dollars of revenue to you get from each dollar of asset and how many dollars of loan do you have for each dollar of owner equity? Then divide your annual interest payments into your EBIT and see what you get. Do let know how you score -- confidentially, of course, and not for attribution.

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