THE RAILROAD WEEK IN REVIEW
July 19, 2013

"Another waste of carfare and a clean shirt." -- Art Cashin, UBS Director of NYSE Floor Operations, July18, on the sideways market

CSX kicked off Earnings Week holding its own in revenue and carloads but also with consistently improving operating metrics. I think CSX is breaking the mold of "revenue will always come back" in number of ways, and that's a very good thing for its customers, employees and shareholders alike. More on that anon.

The second quarter revenue-unit count was unexciting at best. Total revenue increased two percent to $3 billion on one percent more revenue units to 1.6 million and a one percent gain in system RPU to $1853. Operating expense went up two percent for a two percent gain in operating income to $963 million while the OR came down seven-tenths of a point to 68.6. Net earnings increased four percent to $535 million while EPS gained seven percent to $0.52 thanks to the two percent decrease in the number of diluted shares.

Here's how expense control is making a difference. Gross ton-miles increased two percent yet fuel burn was down one percent and GTMs per gallon increased three percent. CSX provides a separate slide deck for performance metrics (I wish other would do the same) and shows not only year-over-year comps but also successive quarter-to quarter trends. Six of seven measures show improvement: FRA train accident rate, OT originations and departures, terminal dwell, cars on line and train speed. Unfortunately, the PI rate spiked to 0.93 *vs*. 0.65 a year ago and a low of 0.57 in the 2012 fourth quarter.

Drilling down to carload sectors, ag products continue in the doldrums, down six percent, as lower crop yields last year depress grain shipments this year; the up-side is phos and ferts up nine percent as growers anticipate a wetter, more productive season this year. Forest prods (CSX declines to split the STCCs) gained four percent and minerals were up seven percent on housing starts. Coal tonnage dropped six percent and export as a percent of total dropped to 33 percent from 40 percent a year ago. Utility coal may have turned the corner, up nine percent, though it's still off four percent year-to-date.

Chems vols increased 11 percent on crude oil, LPG and frack sand, though CSX isn't saying what's where. We can get close by looking at the waybill samples for the first quarter. The CSX waybill sample shows just under 10,000 units of crude oil STCC 13111 in 2013 Q1 on 130,000 chems carloads in the Q1 financial report. Call it 120,000 carloads of STCC 28 chems. Assume CSX moves as many crude oil cars in the 2013 Q2 as it did in Q1. CSX reports 133,000 units of chems; if 10,000 are crude oil, then we have 123,000 units of non-crude for a year-over year delta of 123,000/120,000 - less than three percent.

Chief Commercial Officer Clarence Gooden says the third quarter outlook is "neutral to slightly favorable." The 72 percent "favorable" commodities include intermodal, all the merch groups ex-boxcar STCC 20s, both forest STCCs, and minerals, these last three having a "neutral outlook" and account for 11 percent of vols. The remaining 17%, "unfavorable" is all coal, both domestic and export.

As to "revenue will always come back," the sideways market and listless "recovery" may well be saying we'll never again see the revenue and volume levels of of six or so years ago. If this is the case, the best defense is aggressively taking costs out today in order to improve margins and shareholder value tomorrow. Kudos to CSX for getting a handle on reality.

BNSF doesn't report quarterly results as such, but it does report weekly carloads at bnsf.com. The folks at BNSF graciously provided me with their "commodity map," enabling me to slice and dice the carload report into their four aggregated categories: industrial, ag, coal and consumer. These may or not be the numbers you see in the Berkshire Quarterly, but in the several quarters I've done this so far they've been within a point or two.

Total Q2 revenue units were 2.453 million, up four percent. Merch carloads -- where I group BNSF's ag and industrial -- increased 11 percent; ex-petroleum products up one percent. Gainers of three percent or better include box car food, aggregates, STCC 24 lumber and wood, non-met minerals, coke, and "other," all of which are shortline staples.

Automotive increased 11 percent and coal was up six percent. Intermodal was up less than two percent, probably a reflection of the decrease in consumer durables spending. As the number of un- and under-employed population grows, there is less and less money to spend on furniture and fripperies, consumer durables ex-the auto you need to get to your job, assuming you have one.

And the dependence on government stipends increases. Dennis Gartman, he of The Gartman Letter out of Suffolk, Va., notes how the percentage of the population receiving "meaningful support from the government" has grown from fewer than one in three to a potential two in three just five years from now. He concludes,

> We are indeed swiftly becoming a nation of "takers" from the government rather than "makers" of goods and services, and holders of jobs. Tax revenues are being drawn upon from an increasingly smaller percentage of the population, with the top 1% paying ever higher taxes and an increasing large portion of the nation's revenues, and we can only wonder when and how this shall end other than badly. Who is John Galt?

Union Pacific unleashed a swirl or superlatives on Thursday's earnings call. In his opening remarks CEO Jack Koraleski says this is the best-ever quarter for operating revenues, operating income, operating ratio and net earnings, giving large credit to the railroad's "agility and diverse franchise.” Total revenue increased five percent to $5.5 billion; even though revenue units slipped half a percent, RPU rose five percent.

Operating income was $1.9 billion, up nine percent, as ops expense held at a three percent gain. Carload revs ex-coal rose five percent with gains in auto, chems (crude oil included) and industrial products offset the eight percent decline in ag revs. Below the line, net income was up ten percent to $1.1 billion; eps rose 13 percent to $2.37 on a two percent decrease in share count.

Six-month capex is $1.7 billion, with 62 percent of planned YTD track replacement complete plus 15 out of 30 miles of planned double-track on the Sunset done. The Southern Region is getting siding additions, terminal enhancements, particularly in Fort Worth for Mex and Permian Basin volume increases, and signal upgrades. Free cash flow after dividends stands at $833 million, double what it was a year ago. Net debt is 39 percent of equity.

Decreased grain and grain products loads dragged ag vols down ten percent though Chief Commercial Officer Eric Butler says 2014 looks better. Potash is up seven percent as farmers try to get some nourishment into the fields for the next crop. Intermodal vols slipped three percent mainly on slower imports; highway conversions are still good but not enough to offset. Coal and industrial products vols were little changed.

Chems vols gained ten percent, six percent ex-crude oil. Second-quarter crude oil moves were 16 percent of chemical moves, up from 13 percent last year. Within the IP group, non-met mins and lumber increased on shale-drilling and housing starts; declines in scrap steel, rock and military shipments offset.

The second-half outlook calls for sustained volume growth and RPU gains in corn, finished vehicles, crude and chems in general, drilling and construction, and intermodal. Industry spot-and-pull now meets 96 percent of commitments, slow-order miles are the lowest ever and manifest train size is up with room to grow.

Kansas City Southern rounded out Earnings Week on Friday. Total revenue increased six percent to $579 million. Revenue units increased three percent with half the drop in grain alone. System RPU was up three percent; all but three commodity groups posted mid single-digit gains or better. Even utility coal was up a thousand carloads or two percent.

GAAP ops expense jumped 17 percent, though absent a profit-sharing credit taken last year the delta would be only four percent. As a result, the reported 69.0 operating ratio for the present quarter compares favorably with last year’s 70.5, adjusted for the credit. The drama continues below the line where reported net income gets adjusted upward to $106.3 million from the GAAP $15.4 million. Last year gets adjusted down to $96.9 million giving us a plus ten percent delta. The 96-cent adjusted eps is up nine percent over the adjusted 2Q2012 number.

Setting aside the non-GAAP noise, I still maintain KCS is a solid property and I see the poor corn harvest more a one-off event than life-threatening. Merchandise carloads -- everything but intermodal and coal/coke -- were off four percent though if grain were just flat year-over-year, the merch group would have been up three percent. Crude oil and frack sand show nice ups, but combined these two account for 11,000 loads out of 233,100 merch units; 534,900 total units. Grain's run rate is closer to 15 percent of merch loads.

The best slide in every KCS presentation is the Strategic Growth Areas bubble chart. For the first half of this year these five groups are up 28 percent and represent 19 percent of total KCS freight revenue for the quarter. Automotive, nine percent of KCS sales, is up 20 percent; cross-border intermodal is up 78 percent after a dip mid-year last year, lagging only slightly the record high hit in the 2012 first quarter.

Crude oil is up an eye-popping 193 percent, though it represents only one percent of sales. Frack sand is up 12 percent and represents less than three percent of sales; loads originating and terminating at Lazaro-Cardenas are up four percent and account for nearly four percent of vols. Pull it all together and even the most casual observer can see how the powerful Mexican and energy franchises can help KCS overcome short-term shortfalls in one place or another.

The second half, says Ottensmeyer, will likely bring more of the same, except that energy-related vols will likely tick up on crude, coal and frack sand. Though the Port Arthur crude-oil terminal discussions appear to be proceeding more slowly than anticipated, Pat sounds optimistic. Corn has hit its nadir as crop conditions have improved and KCS just opened a new Mexico-oriented grain elevator in Illinois. In all, a solid report, notwithstanding the financial statement drama.

More fallout from Lac-Megantic. This derailment-cum-explosion incident may likely turn out to be one of the worst North American rail disasters in more than 20 years. The accident had undone in a heartbeat all that Ed Burkhardt has done over the years for the short line and regional railroad industry -- almost. That he took the grown-up role, stepping up before the microphones and taking the hits by his lonesome, without a gang of PR flacks and lawyers, tells you what kind of stuff he's made of.

Without Ed and his RailWorld investors, it's doubtful there would even be an MMA today. CP originally built this line to reach New Brunswick as part of its trans-continental network (see David Plowden's *Requiem for Steam* for superb black-and-white photographs of Lac-Megantic 50 years ago), then sold it to a group that combined it with the Bangor & Aroostook, a northern-Maine potato road that highway competition eventually killed off. That business foundered and Burkhardt's MMA came along on 2002 to save the line and keep it running to serve the paper mills and others.

The chattering classes are full of advice for Ed as to what to say, to whom and when. I shudder to think what the average shortline guy in this situation is going to say, so a few suggestions are in order. Thus I turned to fellow pundit Fred Frailey, a chap who's been reporting on this business long enough to know what works and what's a waste of time. Quoth he:

> To the CEO: Get out of the bunker and make yourself seen and heard; you may get more accomplished in your office far away from the havoc, but it leaves the wrong impression on employees and the public. Don't be flip; now is the time to hide your ironic sense of humor. When you open your mouth in public, say only what you are absolutely sure about - no conjecture.
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> Never, ever lose your cool, your composure around others, even if you're exploding inside from frustration or anger or irritation. Be patient when asked stupid questions by authorities or the press. Not to be corny, but ask yourself: What would my mother say to do in these circumstances?

Canadian Pacific has hired veteran railroader Tony Marquis as its new VP for its Eastern Region operations covering eastern Canada and the US northeast. He's another ex-CN guy and has 25 years of operating experience, bringing what COO Keith Creel calls "a strong service focus." That will be a real plus. The folk running the D&H are first-rate, but I always feel Calgary has too much of an arm's-length relationship with them.

More than a few short lines and regionals in New England, New York and Pennsylvania have direct CP interchanges and many more extending into northern NJ reach CP over haulage agreements with NS. Even as Hunter is chopping away at the excesses, CP needs to bring in new revenue streams. The energy-related and feed businesses are ripe for wider development.

Rich Timmons will stay on as ASLRRA President for another 18 months, even though he had previously announced his intention to retire (and gotten a great send-off dinner at the Annual Meeting in April). The decision to retain Rich comes from the ASLRRA Board of Directors, extending his term in office through December 2014.

Personally, I'm very pleased. Rich is a tireless supporter of the Class II and III railroad industry, has an encyclopedic memory that keeps tabs on all the issues from 45G tax credits to truckload size and weight and threatened legislation. He knows the levers to pull and when, a skill he no doubt burnished in his Army career, retiring as a three-star general staring down the North Koreans across the DMZ. Thanks, Rich.