THE RAILROAD WEEK IN REVIEW

December 6, 2013

"Companies are evaluated based on business performance, but stock prices are driven by investor expectations"— Junheng Li, "Tiger Woman on Wall Street."

Shares of three tank car makers are taking downgrades. Says *Barron's*, Raymond James Financial is downgrading American Railcar Industries (ARII) and Trinity Industries (TRN) to Underperform from Outperform and Greenbrier (GBX) to Underperform from Market Perform. FreightCar America — RAIL — does not show tank cars among its products in its 10-K for 2012, and James suggests that "it could entirely miss out on demand resulting from oil shipments, although it can hope that increased demand for crop transportation will boost its non-coal-car offerings."

James predicts peak earnings for the three tank car players next year and into 2015, but for now the rate of upward change in crude-by-rail demand is slowing.

> The North American railcar industry has ordered 100,247 tank cars over the last three years, but over that time orders for tank cars in crude-by-rail service have crowded out replacement needs for tank cars in more traditional end markets, notably chemicals. We continue to believe the industry will overbuild tank cars for crude-by-rail service, but… it remains difficult to pinpoint exactly when the overbuild will occur and/or to what magnitude.

Tank car prices, says James, bottomed in 2010 at about $80K a copy and have come back up to $121K this year. Their call is more about earnings topping out at some point and less about whether the peak will be in 2014 or 2015. Moreover, short-term leases (one to three years) are softening while rates on leases closer to five years have fallen by ten percent from historic highs. It's just a matter of when and how far, how fast do they fall.

The AAR and the Class Is have traditionally lumped together crude oil (STCC 131) and petroleum products from asphalt to LPG and lube oil (STCC 291). At the BNSF shortline conference the chemicals team said that while crude-by-rail is growing, the other groups — where short lines have the larger petrol play — are not. I made a rough attempt to break the two apart (WIR Nov 1) and then followed up with the AAR for a finer break.

Starting in the 2011 first quarter, Class I rails moved 100,774 carloads of combined 131+291, of which 11 percent was crude oil. Fast forward to this year's third quarter and the combined car count has nearly doubled, to 192,000 units with 131 accounting for 49 percent of the total. The quarter-to-quarter change in 291 was a few points up or down; for 131 it was solid double digits. Until now.

The quarter-to-quarter STCC 131 change peaked at 56 percent in the 2011 fourth quarter. Since then, the rate of change has decreased to 12 percent in the 2013 second quarter and minus 14 percent in the most recent quarter per data provided by AAR's Policy & Economics Department. I see several reasons. One, car-cycle times. You can move the same amount of oil in half as many cars if your cycle time is cut in half. Two, the oil itself. Refiners source crude according to the WTI-Brent spread and refining costs from crude to final product. Three, new sources. Pipeline capacity and availability of ocean bottoms can make one region's oil competitive in markets where the other two factors had kept it out.

Crude-by-rail may in some ways be a repeat of the ethanol story. You've read that the EPA has relented on its blending requirements for automotive fuel (WIR Nov 22). A few years ago if you wanted tank cars for ethanol, the word was, "Get in line." I'm hearing the same story now. But if the trend to less crude oil on the rails continues and the Street keeps downgrading tank car makers, the downward drift in car-maker share prices may prove out the Tiger Woman's warning.

Tony Hatch writes, apropos of RailTrends and crude-by-rail,

> Two years ago crude-by-rail was virtually unheard of, and today rail is looking to retain a 50 percent or so share in the Bakken, mostly the east and west moves. [One speaker posits] that rail has emerged as an arbitrage tool, with inherent risks in volume and location — St James losing luster; Eagle-Ford with plenty of pipe capacity about to pass the Bakken in growth. On the other hand, spreads are widening again; present price is seen as a floor; sand used per well is about to increase rather sharply; new frack sites far from sand mines are developing); and the big Canadian oil sands opportunity is some two years behind the US.

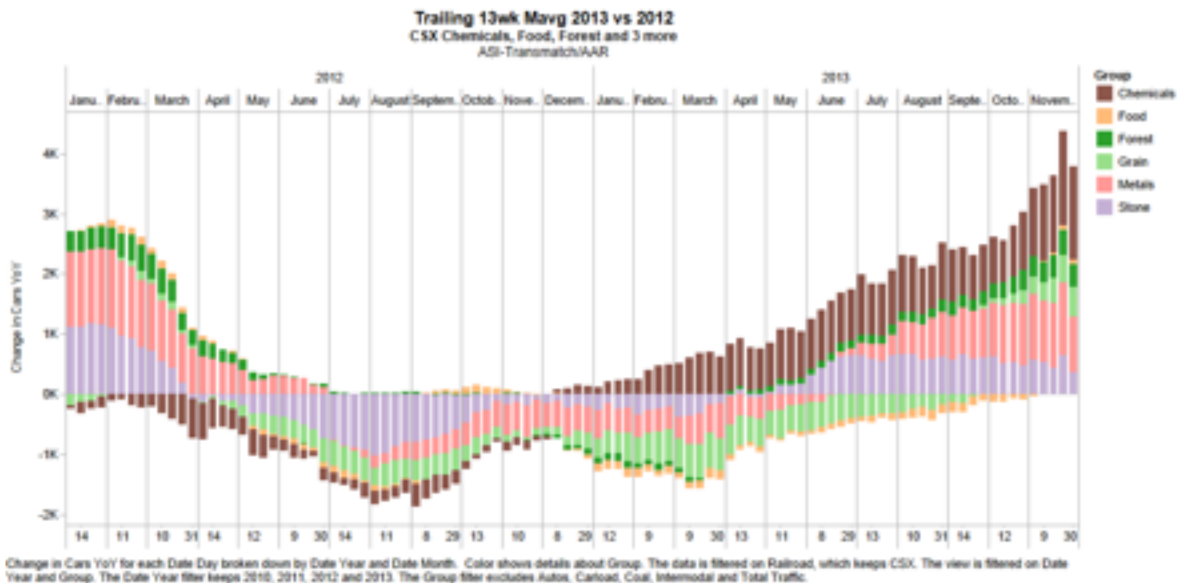
Also at RailTrends, CSX Chief Transportation Office Cindy Sanborn talked about how CSX is "adjusting away from a coal focus and and re-emphasizing service-sensitive growth areas." I've written before about the operating turn-around at CSX, generating more than $150 million a year in better operating efficiency. Important to merch carload customers, Cindy also talked about CSX first/last mile improvements and the resultant gains in customer satisfaction. (For proof of this pudding, see chart on page 3.)

In sum, Tony writes that RailTrends 2013 "proved all over again that the railway industry is anything but staid, boring, change- or technology-adverse. Innovations in operations, power, rolling stock, marketing and industrial & market development were the *stories du jour.*" What I expect to see as a result is further growth in share, efficiency and opportunity and Tony promises to have that on tap for RailTrends 2014, yet once again at the W in NYC Nov 20-21.

Week 48 (Nov 30) year-to-date car-counts from the AAR increased two percent year-over-year to 33 million units. Intermodal was up four percent to nearly 15 million boxes, 45 percent of total units. Back out auto, coal and crude (I estimate crude is half the 'petroleum products" total, per AAR above) and you're left with what I call "shortline commodities," i.e., those short lines see the most of, 5.3 million cars, down six percent.

Flipping to RMI's RailConnect Index, total non-Class I loads increased six percent to 6.8 million; back out intermodal, coal and auto and you're left with 4.9 million units, up one percent. In other words, the Class Is are losing merch carload business while the short lines are increasing the merchandise franchise. It has to do with customer focus, I am convinced. Out on the road I see short lines everywhere bringing customers back to the railroad — those that were lost when the class Is had the line segment.

But a turnaround may be at hand. Take CSX. We heard Cindy Sanborn tell the RailTrends crowd that the merch carload sector is growing again, thanks largely to their Total Service Initiative for the Carload sector. Here's the Transmatch weekly carload trend for CSX — no auto, no intermodal, no coal.



Everything has turned positive, and, even without the crude-skewed chems sector, one must conclude the carload sector has turned around nicely for CSX.

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