THE RAILROAD WEEK IN REVIEW

March 21, 2014

"Companies must always be on the alert for the next Big Thing; One-Hit Wonders might as well enjoy it while it lasts."- James Suroweicki, The New Yorker, March 17, 2014

Over lunch last week, a client reminded me of my statement a year or so ago that of the present universe of 500+ short lines and regionals, perhaps 30 percent would be gone in ten years. He wondered aloud as to whether I still hold to that, and what changes have I seen thus far. Yes, I still hold to that and I have seen changes pointing in that direction.

Take the 40+ RailAmerica names GWR has absorbed. They still operate under their original names, some of which go back to RailTex days, but their locos now bear the ubiquitous orange and black GWR colors, and they all in fact operate as part of a largely contiguous GWR network. Gary Marino's Patriot Rail holding company is gone, though some names linger. CN absorbed the Wisconsin Central, Bessemer, the Jay, the DM&IR, the Chicago Central, and the Quebec Central holding company, among others. And just recently short lines Waccamaw Central, Stourbridge and Grenada filed for abandonments over lack of traffic.

The common thread among all these non-Class I names is they outlived their usefulness as stand-alone common carriers, tied as they were to one or two low-margin, high-cost commodities (paper, aggregates, e.g.) or lived on somebody else's overhead business. They were, in effect, one-trick ponies and they managed to enjoy it while it lasted. A rule of thumb for any business, regardless of industry, is that you'll lose ten percent of your customers every year, and if you don't replace them you'll be out of business in ten years.

The other part of the equation is knowing which customers pay their own way and which the railroad is subsidizing. I've written before about the Money Ball-RTM parallel, where the player who hits few homers but gets on base the most by any means is worth more than the .400 hitter. On a short line, the customer with few cars but who generates the most RTMs is worth more than the high-volume customer generating the fewest RTMs.

Knowing which is which requires following the money: revenues come in, expenses go out, and how much is in the bank at the end of the day. To this end, I've updated my shortline benchmark spreadsheet, which you can download from the resources page at www.rblanchard.com. I also have it in Numbers for Mac if you wish to use it on your iPad.

I start with the standard expense lines - comp & benefits, equipment rents, fuel, etc. - and provide a shortline ballpark percentage guideline for each item as percentage of revenue. Thus, if you're running an OR in the 90s and see you're spending 40 percent of revenue on comp & benefits, you'll know where to start cutting. And be sure to put demurrage above the line as

"other income." Don't try to offset car hire or you'll never know what you're paying out as per diem and whether that number is in line with the benchmark. And please drop me an email, text me or pick up the phone if you care to discuss how to benchmark *your* property.

Florida East Coast Railway closed out the year with freight revenues of $262 million, up 14 percent, on six percent more revenue units. Carload sector revenues increased 20 percent on 14 percent higher volume with double-digit revenue gains in stone, auto and chems; food products were up nine percent. A new ethanol terminal, a new auto contract, and expanded construction projects played a major role. Intermodal sales grew 11 percent on three percent more units thanks in part to highway conversions; intermodal RPU was up eight percent on value pricing.

Operating expense was held to a seven percent increase, leveraging a 36 percent operating income gain and taking the OR to a respectable 74.4, down 477 basis points. No surprises here, with volume-driven increases in all the usual places, however FEC took its $4.7 million in two years' worth of 45G credits as an offset to other expenses. Net income turned positive after a $13 million loss in 2012. Progress on the three big Strategic Initiatives — Miami Port expansion, Port Everglades intermodal terminal, Miami Logistics Center — continues apace.

Union Pacific earned praises from Barclay's in a note Monday, citing all-time high share prices and a market cap approaching $85 billion. They suggest shares have further to run:

> Solid end-market demand, above-inflation pricing and a track record of consistent efficiency gains point to continued valuation expansion. Further, within a broader industrial universe, Union Pacific shares have higher growth expectations with lower volatility compared to many 'quality' large cap companies.
>
> Union Pacific is quietly becoming a major industrial benchmark. Solid *operational performance* [*italics added— rhb]* supports continued gains and, despite the large appreciation in UP shares [*up 20 percent to the DJI's five percent over the last six months — rhb*], we still see meaningful upside from a strong outlook for top-line expansion and margin gains driven by both pricing discipline and efficiency gains.
>
> UP's strong outlook, relatively inexpensive multiple, and low volatility create compelling case for its shares. With earnings expectations above most industrial companies along with lower price volatility, we view UP's current 15x forward multiple as relatively inexpensive to other similarly sized industrial companies.

Note carefully the reference to "solid operational performance." The AAR's 2013 train-speed performance measure comps put Union Pacific in the Number One spot among the Big Four US Class Is. This metric compares average train speed for all line-haul trains between major terminals; it does not include way freights or switching jobs.

Thus UP is the consistent leader in getting trains over the road in a timely fashion (my friends at UP tell me a one-mph variation is system train speed is worth 250 road units). Moreover, UP creates trip plans for loads *and* empties between OD pairs including short line stations, so shortline trip plan compliance is measured. So even though average speeds for short lines and their serving locals are not captured in AAR train speeds, shortline interchange-on to interchange-off performance in car-miles per day is factored into trip plan compliance. With speeds like these for core trains, prompt car cycles on short lines will be rewarded with more carloads.

Crude oil may dominate the headlines, but it's not a ready source of new business for short lines. My sense is the STCC 29 petroleum products group offers non-Class Is the better revenue opportunity. Telling how much takes some number-crunching.

Since both the AAR and the Class Is bundle crude-oil carloads either in chems or petroleum products, the fastest way to break them apart is with the STB's Quarterly Commodity Statistics. I went to USrailDesktop.com and downloaded the 4Q2013 and 4Q2012 QCS data for the seven Class Is and dug out numbers for crude oil, STCC 131, and petroleum products, STCC 29.

Crude oil is clearly the fast grower, up by nearly half again year-over-year. But it's still less than half the 131 plus 29 total if you combine both, which tells me short lines still have a good shot at the straight 29s from propane to asphalt. Here, Norfolk, CSX and KCS are up double-digits; UP's up five percent; BNSF and the Canadians are unchanged or down a crumb.

As to CSX and NS, both say they are aggressively going after decent-margin carload business to offset coal losses. STCC 29 is one place it's working. And at BNSF, presenters at last year's BNSF shoreline meeting petroleum products breakout session were urging short lines to help build back this business.

My take: Crude may be grabbing the headlines, yet there's still a solid petroleum products business to pursue out there.

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