THE RAILROAD WEEK IN REVIEW

October 17, 2014

"Unlike the jobs picture, there has been little or no improvement when it comes to average hourly earnings." — Chris Matthews in Fortune magazine

CSX opened the third quarter railroad earnings season with a seven percent revenue-unit gain, helped by nine percent more merch carloads, seven percent more coal, and five percent intermodal. Revenue was up eight percent to a third quarter record $3.2 billion.

The numbers in the merch sector deserve closer scrutiny, however. The AAR numbers from csx.com show 146,000 chems cars to the CSX financial report's 159,000 chems cars. CSX says ag includes ferts and ethanol, both STCC 28, which makes me think phosphate rock, STCC14, must be there also rather than the AAR's non-metallic minerals group.

Crude oil counts as chems as do STCC 29 petrol prods. Add the two AAR numbers and get more than 200,000 units. I suspect adding STCC 28 chems to petrol products and backing out ethanol and ferts produces the 159,000 cars in the earnings report. I've written CSX asking for clarification.

If my assumptions are correct, and what non-Wall Street financial writers are saying about poor prospects for the world economy are correct, then the prospects for commodities other than energy and food may not be all that good. If we take just the chemicals line, we can get an inkling of economic strength.

CSX has a run rate of about 40,000 STCC 29 (NGLs, etc.) carloads a month. We know that chemical prices tend to provide a good lead on global economic conditions and the message at the moment is unambiguously negative. Falling naphtha, polymer and Brent oil prices are indicative of very weak global economic conditions, and falling prices often reflect falling demand. The question remains, then, how much is crude oil contributing to the car counts for the broad chemicals commodity group?

Back out 40,000 NGL cars from chems, and see that, everything else being equal, the 27,000 unit gain in chems must be crude oil, roughly 40 trains. Seems reasonable: another 13 trains a month or three-plus a week. But if everything else remains the same, and if chemical vols are a leading indicator, one has to ask how sustainable these vols can be if there is no growth in the NGL family or in the pure STCC 28 chems less fertilizer.

Nonetheless, CSX rang up a 16 percent ops income gain to $976 million; the ops expense gain held to a mere five percent, taking the OR down 216 basis points to a respectable 69.7. I'm encouraged to see, even with the reporting quibbles, merch carload and intermodal now represent

82 percent of vols and 77 percent of revs. Merch by itself is 62 percent of revs and 61 percent of RTMs and total RTMs increased ten percent on six percent more fuel consumed. Net income was $509 million, up 12 percent, including a $16 mm charge for early redemption of high interest notes plus $13 mm worth of enviro cleanup related to "non-operating activities."

The fourth quarter outlook sees favorable conditions for every commodity group but export coal. Liquid energy will keep the chems numbers up, metals will increase on auto and drill-pipe demand, intermodal will continue to build on highway conversions, and even domestic coal will get a breather as utilities rebuild stockpiles.

All told, that's a favorable outlook for 96 percent of the CSX franchise. Short lines can take particular comfort in the projections for petroleum products, frac sand, pipe, automotive steel, road salt, short-haul phosphate rock, and construction lumber.

During the call it was evident that CSX feels it's finally getting control of the operational irregularities, even though on-time originations and departures were at 54 percent and 43 percent respectively, about where they were last quarter. Terminal dwell worsened by half an hour to 26.3 hours. The active TY&E headcount is up 300 souls with another 1,300 getting qualified even now. The loco count is up ten percent with 300 more units on order. The incremental ops ratio is a respectable 63 percent, with the reasonable expectation in the 50-60 percent range to support the targeted mid-60s ops ratio.

Kansas City Southern reported Friday before the opening bell. Record revenues of $678 million, up nine percent, record volumes up five percent to 595,400 units, and ops expense up just six percent, yielded $448 million of operating income. The operating ratio came down 164 basis points to an admirable 66.1 as equipment costs dropped 28 percent, thanks mainly to swapping out older leased power for brand new owned units.

Before getting into the commodity particulars, I have to say KCS has the cleanest commodity reporting scheme of all. The STCC 29 petroleum products group is cleanly combined with straight STCC 28 chemicals, fertilizer and ethanol included. Frac sand and crude oil have their own reporting lines. And non-utility coal and coke are in a separate bucket.

KCS further breaks out the its "strategic growth" commodity groups. These are, in order of percentage of revenue, highest to lowest: automotive, Lazaro-Cardenas, cross-border intermodal, frac sand and crude oil. For the quarter these groups combined contributed $140 million in revenue, one dollar out of every five KCS took in — an all-time high for the group.

Automotive generated 28 percent of revenue on 22 percent of carloads, chiefly from the auto builders in Mexico and their numbers seem to increase daily. Petroleum products ex-crude increased 16 percent, though frac sand slipped five percent on a producer-shift to unit-train destinations. That is expected to reverse near term. Cross-border grain grew 25 percent, cross-

border intermodal was up 16 percent and crude oil leapt 27 percent as the Beaumont oil terminal expanded deliveries.

For the fourth quarter revenue outlook, KCS sees outperformance in ag/minerals, intermodal, and automotive, as one might expect. The legislative situation in Mexico appears to be settling down as the importance of the railroad to the economy and the rule of law to the railroads are serious considered. The 85 new locos due in the fourth quarter will be assigned as needed irrespective of the border between Mexico or the US. That's a good thing, too, as a five percent fuel burn increase became a six percent GTM gain, and a one percent gain in GTMs/gallon, though gallons per thousand GTM held steady at 1.4. Still, KCS proves once again that owned power runs better than leased power.

Regarding the supposed offer of CP to merge with CSX, the less said the better. As near as I can figure out, the *Wall Street Journal* broke the story last weekend after an October 2 Reuters item quoted CP CEO Hunter Harrison as saying he'd be interested in buying or operating either the Indiana Harbor Belt, the Belt Railway of Chicago, or both.

I have to say I think the quality of WSJ reporting on rail matters has fallen markedly since Dan Machalaba's retirement, and it could be the new WSJ transport writers discovered both CP and CSX share partial ownership of the BRC and IHB and made some unwarranted assumptions. As of 11:30 on Thursday, Reuters says Ackman will neither "confirm nor deny takeover rumors about CP and CSX." Cagey.

The rail analyst community was having none of it. Tony Hatch writes, "What I am hearing from my railroad 'kitchen cabinet' is best expressed as: what unbelievably poor timing given the excited political reality focused on issues of rail safety and service, plus what regulatory changes might ensue including access. Most old railroad hands I spoke with are either flat against it or don't think it could ever happen."

Allison Landry at Credit Suisse says in her note, "Beyond what we view as impenetrable regulatory rules at this juncture, we would also add that CP proposing a merger at this point in time would distract the management team from hitting the long term targets that it laid out last week. In our view, regulatory concerns regarding competition and market dominance will likely impede any further consolidation amongst the N.A. Class I rails."

Genesee & Wyoming September carloads for North America increased 5.5 percent to 145,447 units; of that, the four-month old Rapid City Pierre & Eastern brought on 5,101 cars — more than half ag, a quarter "minerals and stone," which I will assume is mostly bentonite, and 17 percent chemicals traffic. GWR same-store carloads increased 1.8 percent.

Leading same-store commodity carload additions include 4,700 carloads in the Coal & Coke commodity group, up 16 percent, in the Midwest and Central regions; 3,000 Minerals & Stone

carloads in the Ohio Valley and Central regions, up 16 percent; 1,300 Metals loads, up eight percent in the Southern and Ohio Valley regions.

North American carloads are up 7.2 percent year-to-date but down 8.9 percent from the August total. For the quarter, GWR did 462,342 North American carloads, up 9.4 percent . The RCP&E did 15,664 carloads at about the same commodity split. Adding the Dakota line's 4,708-car first month haul in June yields a four-month total of 20,372, or more than 61,000 carloads on an annualized basis. Recall that early on, GWR's Jack Hellmann said they were planning on 52,000 carloads in Year One. More than 20,000 carloads in the first four months has them 40 percent there with two-thirds of a year to go. Well done.

This is your third and final warning to get your ducks in a row for RailTrends 2014, November 20-21 in New York. As you read above, CSX seems to be coming out of the woods on congestion with double-digit volume gains in a number of commodity groups and KCS is turning its own corner. To that add what ought to be a spirited earnings season, seasoned with CP-CSX merger speculation. Will they or won't they? Will the STB ever allow it? And with the cast of top railroad names on the bill, it ought to be an SRO crowd. There are a few tickets left, so get 'em while they're hot. See you at the W Hotel, 48th and Lexington.

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe, click on the Week in Review tab at www.rblanchard.com. © 2014 The Blanchard Company.