THE RAILROAD WEEK IN REVIEW

November 7, 2014

"The world is awash in workers and the growth will be in countries with cheap labor. We have a market-share theft game going on in the world" - Laura Geritz, Wasatch Emerging Markets Small-Cap fund, quoted in Barron's Nov 3

Genesee & Wyoming's third quarter NA revenue units increased 9.4 percent year-over-year to 462,342 while merchandise carloads including auto and overhead, excluding coal, were up 11.6 percent to 374,115 carloads. Of this, the newly-minted Rapid City Pierre & Eastern contributed 15,664 carloads of ag and minerals, mainly. Same-store merchandise vols gained 6.9 percent. Same-store revs all-in were $12.9 million, up 3.2 percent; new ops added $19 million.

Commodity-wise, the Minerals & Stone group was the big winner, up 28 percent on frac sand, salt, cement, and is now the number three revenue producer behind metals and chems (coal is fifth). Overhead vols, mainly empty NS hopper cars back to the Mon coal fields, were up 18 percent on 25,000 units. Back out RCPE and overhead cars (for both Qs) and total volume delta drops to five percent.

North American revenues including "non-freight" (switching, Atlas, etc) came to $351 million, up 10.0 percent. Operating expense was up a mere three percent, leveraging a commendable operating income jump of 30.5 percent to $101 million and an operating ratio of 71.4, down 449 basis points year-over-year. Diluted EPS gained ten percent.

With 100+ names, GWR is a good proxy for the shortline community as a whole with a few caveats. Few are, at the same time, (Sep 2014 numbers) 18 percent coal, 31 percent minerals and stone, 11 percent paper and 4 percent overhead. And few can boast double-digit gains in commodity groups with 3Q vols north of 10,000 cars: minerals & stone, ag prods, food/kindred, and other/haulage.

That leaves these commodity groups with more modest gains, and where most short lines live: forest prods (both STCCs), metals, chems including ferts but excluding STCC 29 petrol prods, waste, coal/coke. Eighty percent of GWR non-intermodal units in NA are in (most>least) coal/coke, mins/stone, metals, ag prods, forest prods, chems.

Two of these - metals, mins/stone - are related to oil & gas drilling, and school is still out as to the sustainability of this market segment. The "Other" category is scary as it can go away in a heart beat. Australia, as a reminder, is 80 percent of revs and it's facing some rough seas. Good thing GWR added RCP&E to help next year's NA same-store comps.

Continuing the theme of the Class disconnect between the walk and the talk, here is another recent and rather egregious example. A good friend of many years, who recently retired as a shortline manager but who continues to watch the trends, writes,

> Our short line was losing business to truck lines on a move of aluminum coils. We worked with an excellent superintendent on our Class I connection so we could put the coil cars on the head end of our outbound consist. On arrival at the Class I yard, the coils were pulled off and put directly on an outbound run-through train to the destination carrier. This saved 24-36 hours and we regained the lost business share plus gained additional market share.
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> Then our excellent superintendent was promoted and left the area. Market share slipped. I ran traces and found the cars were spending an additional 24-36 hours in the origin yard. The new superintendent said he was sending the cars over the hump to keep his hump numbers up so the hump wouldn't be shut down. He said that in the future all cars would continue to go over the hump.

Looks to me like the first guy was being measured on through-put and dwell-time; the latter guy was being rewarded for cars classified per day. Shows why one needs to be mindful of what one asks for. Of course, what may be going on here is that, as the railroad was being reconfigured for shifting traffic lanes, the number of train-starts between my friend's OD pairs increased to the point where the coil moves no longer earned their car-replacement cost. And with the grain guys being up in arms about short-notice car availability, and the STB fussing about "captive shippers," the Class Is have no choice but to rein in local train starts to put the fungible resources against present and probable demands. Sorry.

Union Pacific's Investor Day presentations from last Wednesday provide excellent guidance for short lines looking to expand their interchange volumes with UP. By way of background, UP total year-to-date revenue units through November 1 were up 7 percent, carloads ex-intermodal grew 6 percent, and merch carloads ex-coal gained 5 percent. Big merch gainers include grain, up 32 percent; crushed stone, sand and gravel (where frac sand lives), up 20 percent; and lumber/panel up 11 percent. Petroleum products, alas, drifted south by 7 percent, with volumes roughly split between crude oil and the STCC 29 group including NGLs, LPG, and asphalt, etc.

UP anticipates increased ag products loads in export grain, ethanol, DDGs, and packaged foods from frozen meat to imported beer. Healthy demand for energy E&P pipes, housing lumber, and construction aggregates present added vols for Industrial Products, while the new US competitive advantage in nat gas feed stocks will add more plastics production capacity and create additional opportunities in nitrogen-based fertilizers. It's all good for the UP feeder lines.

A whistle-blower lawsuit going back several years has taken the shares of car-builder Trinity Inds (NYSE-TRN) down 40 percent in the last month. At issue is a supposedly defective highway guard rail that had previously been accepted by the FHWA for federal-aid reimbursement authority. The whistle-blower, one Joshua Harman, alleges TRN " knowingly presented or caused to be presented a false or fraudulent claim" about the design of the product.

I've done a little digging and found that the manufacturer is TRN's Construction Products segment, with 3Q2014 sales of $170 million or 9.3 percent of TRN's total sales of $1.8 billion. Putting that in perspective, the railcar manufacturing segment had sales of $1 billion or 54.2 percent of the total. The guard rail itself contributed less than one percent of 3Q sales.

A Bloomberg news item from last June says litigant Harman and his brother "own two small companies in Virginia that once made and installed generic end terminals based on Trinity's ET-Plus design. In 2011, Trinity sued for patent infringement." Bloomberg suggests that in this case it isn't about safety at all — it's payback time. From the 10-Q again: " The Company maintains that Mr. Harman's allegations are without merit and intends to challenge the damages award on the ground of insufficient evidence. The Company will vigorously defend its positions."

CSX whacked the plaintiff's bar soundly with a $7.3 million award relating to a fraudulent asbestos lawsuit. The railroad had brought "civil and RICO fraud claims" against two asbestos attorneys and a radiologist back in 2007, alleging the three "conspired to manufacture and litigate fraudulent asbestos claims against the company."

A jury agreed and awarded CSX nearly half a $million in damages, tripling the base award as required by the federal racketeering statute. Those damages and legal fees totaled the $7.3 million. Funds are to be donated to the CSX Foundation to support philanthropic efforts serving CSX communities. CSX is to be applauded for persevering and for helping the rail industry.

BNSF hail and Farewell Dept. Merril Lieb assumes the duties of VP, Interline/Shortline Development this month. He began his railroad career with a BNSF predecessor as an intermodal trainee, earnings his operating stripes in that sector before moving to marketing the carload side in 1994. He comes to us from BNSF field sales out of Denver and is succeeding Dick Ebel, who is retiring.

In an e-mail exchange, Merril writes that he intends to focus on customer service and market development — hardly surprising given his background. He sees a great opportunity to help the BNSF shortline community improve its safety record, decrease car cycle times interchange/on to interchange/off, and make infrastructure investments that will maximize ROI.

So thanks, Dick, for all your good works in cementing the BNSF-shortline relationship. And welcome to the fray, Merril.