THE RAILROAD WEEK IN REVIEW
March 20, 2015

“Diversification is a protection against ignorance. It makes very little sense for those who know what they're doing.” — Warren Buffett

Kansas City Southern has performed a useful service by providing specific lead times for empty placement. In Tuesday’s Open Letter to customers, KCS provides lead times by car type for requests starting March 22. Three types of boxcars plus bulkhead and center-beam flats will require 7-day notice before desired placement for loading. Gons, hoppers (open-top and covered) and technical reefers take a 15-day lead; general service flats are special order only. (This last is a bit of a surprise as I didn’t realize they are in such demand or short supply.)

The fact that KCS sees fit to put out lead times for general merchandise equipment bodes well for the merch franchise. Moreover, the just announced backlog from Greenbrier (GBX) is another positive Leading Indictor for the merch biz. For the three months ending Feb 28, buyers stepped up with orders for 10,100 units worth more than a $billion and cutting across all commodity lines: double-stack intermodal wells, grain covered hoppers, mechanical reefers, insulated box cars, gons (specs not provided), and both general-service and crude-oil tank cars.

The PLG Conversation with Tony Hatch (WIR March 13) triggered some useful afterthoughts with several correspondents. Chief among them has to do with transportation options. Pipelines head south out of Bakken but run up against northbound product from south central and western Texas. Trains want to go to Calif but there’s no place to go — except toVancouver BC and then south by barge. There are no pipes to the east, so rail is the only option.

Of course, Philadelphia area and other east coast refineries can and do use crude oil from everywhere, so the Bakken share depends on the Brent/WTI spread plus the cost of transportation. At the moment, rail is the only option for Bakken crude to get east. Which brings up an interesting geopolitical problem. Putin’s Ukraine exercise has interrupted the usual flow of westbound Russian oil, so he’s giving himself options by building pipes to China. Us?

Like Russian oil, Bakken can only get so far by pipe and if that’s shut off — Cushing is full, e.g. — what options do the Bakken producers have? Oil with no place to go has zero value. The logical endgame then is for Bakken producers to shut down, leaving the US population centers hostage once again to non-US sources. Putin at least will have options for Russian oil. What will we have? Miles of unused tank cars stored on idle branch lines that once served coal mines.

The Wall Street analyst community does a great job covering the railroad industry — as long as the rail carriers in their reports have shares that can be bought and sold on the exchanges. I’m looking at one note, for example, that compares Week 10 revenue-unit volumes for 6 North

American Class I railroads: all but BNSF, which, as you know, is part of Berkshire Hathaway, and you can't buy shares of BNSF other than as a part of Berkshire. Yet BNSF and Union Pacific are arch-competitors in the west, just as CP and CN compete in Canada, and the US East is divvied up by CSX and Norfolk.

So if you want to look at the UP in the context of its competition, you have to put the former's comps against what BNSF reports in its weekly service update, found at bnsf.com under the Customers Tab and clicking Notifications on the menu to the right. That'll take you to a list of PDF reports arranged by commodity group: consumer (auto and intermodal), coal, agricultural and industrial.

Under industrial for the week ending March 13, you get not only the usual AAR metrics (dwell, cars-on-line in terms of cars moved, train velocity), but also loco velocity, car velocity, and — get this — trains held plus the number of trains on the system. Moreover, we get updates on how the railroad is actually running. For example,

> The mainline track that was temporarily closed due to the train derailment outside Galena, Illinois last week was reopened on Monday and traffic is moving through that corridor. Fully normal traffic flows through the area will resume by the beginning of next week… Mild temperatures and dry conditions are expected across much of the network during the next several days…In California we lifted intermodal traffic restrictions in advance and resources were already pre-positioned to support greater westbound inventory and equipment flows."

I have just finished squaring the BNSF 10-K numbers with the Berkshire Annual and the Week-52 AAR numbers. (My March 6 note was based on estimates from Buffett's Letter.) Freight sales were $22.4 billion, up 5.3 percent; 10.3 million rev units, up 1.8 percent; system RPU $2,180, up 3.5 percent. Merch carload revs including auto and petrol prods came to $10.4 billion, up 11.8 percent, on 3.0 mm rev units, up 4.8 percent; RPU was $3,498 up 6.7 percent. Fuel Surcharge revs were unchanged, $2.9 bn per year; net revs ex-FSC were $19.8 billion, up 6.2 percent.

Within merch carloads, petroleum prods posted 568,000 units, up 12.7 percent. Based on QCS data, BNSF petrol prods appear be a third NGLs (STCC 29 including pet coke, LPG and so forth) and two-thirds crude oil. LPG, roughly half the total STCC 29 vols, has a run rate of 20,000-25,000 units a quarter whereas crude has increased every quarter to more than 100,000 units as of 3Q2014, the latest available from QCS. For what it's worth, ZTP data suggests nearly all the 3Q2014 BNSF crude out of Minot/Bismarck went to the Phila region with maybe 10 percent to Houston and a tiny fraction of that to LA.

Frac sand, STCC 14413, is in the BNSF Sand & Gravel group, 292,000 loads, up 17.7 percent en toto. Of this, frac sand vols at the end of 3Q2014 were 40 percent ahead of where they had been a year ago. There were no other significant changes beyond plus or minus a few points in any

other Industrial Products commodity group with more than 100,000 annual units. Grain carloads gained 3 percent to nearly half a million units; grain mill prods were flat at half the volume.

Operating income was $7 billion, up 5 percent, with a 69.2 OR, unchanged. Net income was $4.4 billion, up 3.0 percent. Interestingly, if BNSF had the same share count and multiple as UNP, it would sell for $119 a share. Berkshire B shares go for $144, suggesting you can buy BNSF for the $119 and get the rest of BRK/B for 25 bucks!

The balance sheet and cash flow statement are rock solid. Net debt of $741 million against total capital of $51.7 billion. Retained earnings up 32.2 percent year-over-year. Current ratio 1.05, gross margin 30.8 percent, net margin 19.4 percent, interest coverage 159x. Operating cash flow 159 percent of net income, capex 23.1 percent revs, free cash flow after capex including equipment $1.8 billion.

Noel Perry, one of the more insightful commentators on the railroad scene, writes regularly for FTR Transportation Intelligence. His latest epistle, "Growth — Recession: The Tale with Two Halves," posits that every economic expansion eventually hits the brakes and we are due "sometime over the next three years." He notes that "mature recoveries tend to feature consumer spending and small business expansion, especially in the service sector." Which means more haircuts and meals out but not necessarily more merchandise carloads of shortline freight.

From this Noel concludes even though times may seem OK now, bad times are sure to follow. He warns, however, that "conventional economic commentary seldom deals with the chance of recession. It is apparently too risky for the tastes of my economists – or their primary clients. That view, however, does not reflect reality."

Regular WIR readers will recall I've been beating the drum for firming up one's business relationships today against less happy times tomorrow. Noel joins the chorus, suggesting three defensive steps. Adapted for the shortline environment, they are: first, to build on sustainable relationships with customers, Class is, suppliers, communities and co-workers ; second, to increase cash reserves and lessen reliance on the Kindness of Strangers: 45G subsidies, TIGER grants, and any reliance on other people's money.

And third, to take advantage of low interests and favorable bank terms to run quick-return projects, while avoiding projects with long-tail payouts. "Those kinds of projects are better started in the downturn when asset costs are at their minimum. Moreover, they mature just as the market is expanding and when competitors are still digging out from recession." Hear, hear.

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