THE RAILROAD WEEK IN REVIEW

March 27, 2015

"North American rail volume for the first 10 weeks of 2015 was 6,872,966 carloads and intermodal units, up 1.9 percent compared with 2014." — AAR

On the eve of the ASLRRA Annual Meeting in Orlando, I thought it appropriate to see How We're Doing. The GE Trans (ex-RMI) RailConnect Index for the week ending March 14 says short line (Class II and III rails plus switch-settlement names) carloads finished the week down 1.5 percent year-over-year vs. the same period in 2014.

However, the total is 12 percent intermodal, coming from a handful of short lines that do a land-office business in boxes, and that doesn't reflect what most of the 432 names in the Index are doing. Likewise, the Index includes coal and automotive, where a small number of carriers have PRB unit trains off the Class Is or handle auto racks in export/import service. Excluding coal, intermodal, and auto, the merch carload business, where most short lines live, is up 2.1 percent.

The North American Class Is, on the other hand — ex-auto, intermodal, and coal — aren't doing that well. In the merch carload sector (total vols less intermodal, coal, and auto), year-to-date units were up a piddly six-tenths of one percent — 14,000 units — over the 2014 number. And as I scan down the commodity list, the only gains north of 5 percent are in petroleum products (just barely, up 5.2 percent, and that's mostly gains in crude oil), met ores/metals (taconite to scrap steel, 7.6 percent), and grain, 7.9 percent.

Meanwhile, the short lines are doing very well in aggregates — including frac sand, up 14 percent; grain, farm and food, up 6 percent; and straight STCC 28 chems including ferts, up 7 percent. The common thread is — what else? — heat and eat, which tells me if you're not a short line in the heat-and-eat business you may want to be looking for another line of work.

Consider this. The supply of everything from iron ore to corn to copper to crude seems to be running ahead of demand. Just this week, Morgan Stanley sent out a note showing how stocks of corn, beans, and wheat exceed use volumes. The Philadelphia Fed March 2015 report says "The demand for manufactured goods, as measured by the current new orders index, remained at a very low, albeit positive, reading." China-watchers say that country is dumping hard goods like copper and steel on world markets to raise liquidity. And everybody knows the crude oil story.

In my humble opinion, falling commodity prices are a harbinger of an economic slowdown. The global political picture is unsettled, to say the least, making it difficult for companies to plan ahead. As a result, manufacturers will look for simple stasis: just keeping the doors open and doing what you can with minimal headcount, capex and inventory. Small volume deltas in nonheat-and-eat commodities is one result and the non-class I feeder railroad network feels it first. Let's see what The Narrative is in Orlando.

Reuters reports that US refiners are looking increasingly for crude straight from the individual well, not as a blend from several wells dumped into tank cars and forwarded. The article cites Marathon and Phillips 66 as "getting into the first-mile game" in order to secure a "more predictable, consistent stream" of crude oil. Moreover, by doing their own first mile, they get to control the last mile, too, and become less reliant on Cushing blends in the bargain.

Says Reuters, "Shipping crude by truck, though costly, has become a fast-growing necessity in places like the Eagle Ford in Texas and Permian Basin, where newly-productive shale oil patches are ill-served by small local pipeline gathering systems." What the article doesn't say is these sources are also served by short lines that *can* load cars by well and send them out over UP or BNSF in manifest service — never mind the unit train — to refiners seeking a certain spec that they can't get from Cushing.

> While the blends of the Cushing crudes may technically meet the API gravity ceiling of 42, industry players say the mixes can be inconsistent in makeup and generate less income because the most desirable stuff is often missing. The blends tend to produce a higher proportion of fuel at two ends of the spectrum: light ends like gasoline, demand for which has fallen in recent years; and lower-value heavy products like fuel oil and asphalt. What's missing are middle distillates like diesel, where growing demand and profitability lie.

The result is what one long-time driller calls a "dumbbell-like material rich in front and back ends, neither of which refineries find most profitable." Happily, here is a niche market where short lines can do their first-mile thing and pass cars on to the Class Is for the last mile.

Frac sand is one heat-and-eat commodity that continues to favor short lines, even with drill-counts coming down. A March 25 note from Wunderlich Securities tells us they see exploration and production companies ("E&P's") trading down from ceramics/resin-coated propellants to raw frac sand (particularly Northern White), and doubling the amount of sand per well they were using last year. In fact, a few drillers have used as much as 10,000 tons of sand per well.

This is one reason why a decline in rigs doesn't necessarily equal a decline in oil field production. Cost is the big driver, and lowering transport cost from sand pit to well is essential. As one Class I friend puts it, "Location, location, location wins every time," and it's why short lines who can get within an hour's truck ride of the well-head will do just fine.

Kansas City Southern has lowered its 2015 revenue growth targets to reflect a softening in demand for energy transport, deterioration of the Mexican peso against the US dollar, and lower fuel surcharge revenue as a result of lower WTI prices. Additionally,

> The Company expects the impacts of foreign exchange and fuel surcharges to be largely offset with lower expenses; however, the impact of lower carload volumes is expected to reduce operating income. The Company is changing its guidance for line-haul revenue growth in the energy commodity group (includes frac sand, oil and coal) from double-digit growth to single-digit growth for 2015. Line-haul revenue growth for all other commodity groups, overall carload growth, and capital expenditures are all expected to be in line with previous guidance.

And for this, the world was suddenly awash with Wall Street KCS downgrades, taking the rest of the rails down along with KCS. To me, it appears that all crude oil is Bakken crude as far as the Street is concerned, yet KCS sees very little Bakken crude. The chatter on stocktwits.com is all about "we saw the Bakken slowdown coming and so we are not surprised."

As for KCS proper, we knew Port Arthur was going to be slower coming to fruition than originally thought because now-President Pat Ottensmeyer has said so several times. Still, it's better to pre-announce a short fall in March than surprise on the April call. And it's not like the decline in crude prices is anything new, it's just the latest in a series of commodity downgrades.

Want proof? See the chart for USCI: High of $61 July 1, on a downtrend since, now $46. (The ETF holds futures in copper, cocoa, beans, zinc, nickel, cattle etc.) May lumber has dropped to $286 from $340 per thousand board-feet in Dec. Corn is now $3.93 vs. $4.25 per bushel at Christmas. The world is long commodities and short demand. Ergo prices are coming down.

The KCS downgrade may be the canary in the coal mine where rails in general are headed. They do best in bulk: heat and eat. Crude oil is heat; corn and beans are eat. If there's less demand, there's less to move, creating smaller volume and revenue deltas for rails — precisely what KCS is talking about.

As if to confirm that theme, GWR on Wednesday said it's reducing first quarter 2015 revenue guidance to $375 million from $400 million due to North American commodity weakness — utility coal and metals in particular. Last year GWR Q1 revenues amounted to $376 million, of which $300 million, 80 percent, was North American ops. Steam coal and metals were roughly a third of total units.

GWR adds that this quarter saw higher higher expenses due to winer conditions. Last year NA ops expense was $244 million, unchanged year-over-year, for an 81.4 OR. GWR expects total ops expense, US and AUS, to rise $5 million. Given GWR's 80-20 US-AUS ratio, if US ops expense goes up $4 million and revs are unchanged, it looks like a Q1 OR of 83.