THE RAILROAD WEEK IN REVIEW

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Energy-related operations at Watco are now 15 percent of sales, up from three percent when we first started our energy businesses in 2008." -- Rick Webb, Watco

I've kinda given Class II and III rails short shrift in the crude-by-rail sphere. However, there are in fact three major players readily at hand: Iowa Pacific Holdings, Pan American Railways and Watco.

Rick Webb, Watco, CEO was the guest speaker for the *Morgan Stanley Crude By Rail* webcast on Monday, giving his views on the subject from the perspective of a rail service provider. Rick's unique position is that Watco is not only in the business of moving cars but is also the largest car repair shop service provider in the US.

His thesis is that railroads are morphing from being the only way out for crude oil in places like the Bakken to being a service provider with a "compelling business proposition" in support of and in competition with pipeline networks. He says rail advantages include simultaneous access to multiple markets beyond the ends of the pipes, speed to market, and protecting product identity. Moreover, one can put up a crude-oil rail load-out in five months once land and permits are in place.

Watco is a pioneer in crude oil terminals, having worked with BNSF in Montana and Oklahoma, has already put $50 million in the ground and sees an opportunity to quadruple that investment. Moreover, says Rick, their partnership with Kinder-Morgan is opening doors in Canada and US western plains and Gulf Coast. In car repair, nine of Watco's 16 car-repair facilities are now tank-car certified with a tenth coming on line later this year; bookings are solid. Terminal service revenues now account for 15 percent of Watco total sales, up from three percent in 2008.

Bakken production, says Rick, is likely to reach 1.2-3 million barrels per day from the present 800,000 bpd and as it grows -- and pipeline capacity grows -- the rail share will probably diminish to 40-50 percent of total barrels from the present 60 percent. But it's up to the rails "to preserve the value proposition." I can't argue about that. Crude-oil shippers are keenly aware of car-lease costs per day, so much that better turn times can command a higher per-unit rate.

Iowa Pacific Holdings has two railroads in West Texas that are active in the Permian Basin crude-oil fields. In the first quarter IAPH moved 2,033 carloads of crude oil and natural gas liquids, up from 170 cars a year ago. Most of the crude oil traffic is on the Texas-New Mexico Railroad (TMNR) and forwarded to UP over a new interchange facility at Monahans, Tex.

Further north, the West Texas & Lubbock (WTL) terminates frack sand from UP origins in Wisconsin. IAPH President Ed Ellis says he has nine crude oil and NGL customers on his lines with three of them running unit trains; the TMNR-UP trains typically have UP run-through power. More terminals are under construction even now, with an ultimate capacity of 100,000 barrels a day (one and a half trains worth), up from the 21,000 BPD run rate last month.

My local BNSF contact confirms that BNSF crude moving to the northeast goes CSX to the Buckeye Terminal in Albany and to Pan Am Rail for beyond to Canada. So, in essence, CSX is a line-haul carrier to Buckeye and a bridge carrier for Pan Am because they don't directly serve the ultimate destination.

NS, on the other hand, forwards Bakken crude from BNSF to the the PBF Energy refinery in Delaware City, Delaware, and to the Sunoco refinery in Westville, NJ, where the Conrail Shared Asset operation physically handles the cars. So all of it is NS line haul. It's important to make the distinction because of reporting vagaries between and among agencies.

CSX kicked off the first quarter earnings season with revenues of $2.98 billion, unchanged year-over-year. First quarter operating income was a record $875 million, the operating ratio a record low 70.4. Earnings and EPS also set quarterly records, $459 million and 45 cents respectively. First quarter total revenue units decreased 1.5 percent mainly on coal, metals and ag products.

Chems were flat ex-crude-by-rail, putting the chems commodity group vols up 11.1 percent. Phos & Ferts was best vol delta, up 5.0 percent; intermodal second at 2.5 percent. System average RPU increased 1.3 percent to $1,875. All merch groups save ag products posted positive RPU deltas, albeit small in the low single digits. Intermodal RPU increased 1.3 percent; coal decreased 2.8 percent per car.

Operating expense came down 1.3 percent with decreases or no change in every line item save depreciation. Loco fuel expense (CSX is the only road to break out loco and non-loco diesel fuel expense) was unchanged even though price per gallon increased 3.5 percent because CSX used 3.6 percent fewer gallons to move 1.0 percent fewer GTMs; RTMs were off 2.3 percent. GTM/gallon increased 2.8 percent. Free cash flow after dividends was $97 million, down 35 percent.

Merchandise remains the dominant CSX commodity group with 60 percent of RTMs and revenue. Coal is second with 29 percent of RTMs and 26 percent of revs; intermodal brings in 11 percent of RTMs and 14 percent of revs. Two tidbits on relative profitability: CFO Frederik Eliasson says intermodal is approaching merch carload in yield per unit, Gooden says crude-by-rail margins very good but still lag coal. And in no way is CSX using pricing leverage to win new coal business from the competition.

Chief Operating Officer Oscar Munoz drilled down into the ways improved operating practices are saving CSX $150 mm a year: better crew-customer collaboration, moving more merch carloads on fewer crew-starts, and taking T&E employee-count down 4 percent on 2 percent

fewer units moved. Yard dwell, system velocity and overtime hours are all moving in the right direction; the active loco count is down 8 percent vs the 2012 first quarter.

On-time departures hit 91 percent and arrivals were 85 percent on time (Ward told me when I interviewed him for the Feb RA Capex story *on time* is to the minute, not something else). As a result of all this, the OR came down another 72 basis points year-over-year to 70.4, another record. Best of all, the PI rate decreased to 0.66 from 0.80 since 4Q2012. Operating income rose 2.2 percent to $875 million, net income increased 2.2 percent to $459 million and EPS gained 4.8 percent thanks to the 2.5 percent reduction in diluted share count. The share buy-back continues with another $billion authorized; dividends will see a 7.0 percent increase.

Looking ahead, Gooden says same-store moves (same commodity, same customer origin, same destination, same car type) are 76 percent of their franchise and the 2013 outlook is favorable or neutral for 86 percent of commodity lanes, the only unfavorable affecting the majority of short lines and regionals will be ag products due to continuing drought effects on animal feed.

What I see from this quarter's results is an expanding role for the CSX feeder-road network, assuming they can get first-mile last-mile right. The incentive is there as CSX is the only Class I paying Class II and III lines (not switch fee or ISS) a percentage of revenues including fuel surcharges. The direct Class II and III railroad benefit is in revenue. Even where vols may slip, carriers participate in rate increases as they happen, not at some after-the-fact renegotiation of handling line agreements. Move more cars faster, get paid better and faster.

Union Pacific reported record first quarter operating revenue, operating income, net income, an OR breaking below 70 for the first time ever, and an all-time high for customer satisfaction. Moreover, they did it all with revenue units down 2 percent year-over-year. Operating revenue increased 3 percent to $5.3 billion on 2.2 million revenue units, down 2 percent. Operating income grew 8 percent to $1.6 billion thanks to ops expense growth being limited to 2 percent. Net income is up 11 percent to $957 million; earnings-per-share is up 13 percent to $2.05 due in part to a 2 percent reduction in diluted shares.

The volume changes over the quarter tell the tale of a railroad coping successfully with adversity. Coal started negative and gradually turned positive. Grain, food and metals stayed negative. Crude oil gave chems a boost and intermodal stayed above the line throughout. Within ag products, ethanol dropped by 4 percent with demand (the WSJ said Wednesday that changing driving habits and better fuel economy are keeping the 2013 estimated gasoline burn 20 percent less than previously thought). Crude oil is 17 percent of the chems mix and vols were up 107 percent YoY. UP puts frack sand in non-met minerals and that was up 11 percent; lumber increased 18 percent. The 10,000 unit industrial-products gain was partly offset by declines in hazardous waste, metallic scrap and export ore.

Pricing is the key to success this quarter. UP's repeating theme is pricing to reinvestibility and ahead of rail inflation. As a result system RPU is up 5.7 percent where mix allowed coal RPU to

increase 15.8 percent, intermodal 4.4 percent and merch carloads including auto and crude up 3.6 percent. I think the UP focus on customer satisfaction, measuring service deliveries in terms of as-advertised or not, hitting 95 percent, an all time high, is a major factor.

They are keeping the network fluid so shipment times are consistent and reliable; the capacity exists to add revenue units without increasing crew starts. Slow-order miles are down 25 percent; manifest cars per train and intermodal boxes per train achieved new records. With respect to intermodal, during the Q&A it turned out that UP has room to get 225 boxes per intermodal train start *vs*. the present 170 average.

The outlook is for flattish vols with increasing nat gas prices helping coal (north of $4 seems to be the break point), better crop projections ("Put a fork in the drought" -- Koraleski), continuing crude oil demand, housing (lumber, cement, re-bar plastic pipe and furniture... the list goes on) and more intermodal highway conversions pushing the upside. Offsets are high coal stock piles -- mainly in the east -- and weak iron ore exports. They are still targeting OR 65 by 2017 and will get there by remaining "agile in response to traffic shifts" and core pricing gains.

With the readily available supply and reliability of UP freight-hauling capacity far exceeding anything the truckers or barge operators can offer, it seems to me the old supply-demand equation is working much in favor of UP. The Street appears to think so, too. Share prices gapped up 4 percent to $142 at the open from $137 in the pre-market. And, yes, I am long UNP.

Kansas City Southern got hammered this quarter in its ag products commodity group. The midwest drought took carloads, sector revenue and RPU down 24, 5 and 28 percent respectively. Happily, the energy group (crude oil, coal, coke, frack sand) was up two percent, intermodal was up nine percent and automotive increased 18 percent, bringing total revenue units up two percent. RPU increased across the board ex-ag and coal/pet coke; the net was flat.

Quarterly freight revenue was $532.8 million, other items added $20.0 million for total system revenue of $552.8 million, up one percent. Operating expense was up one-tenth of one percent on declines in comp & benefits, purchased services and materials & other, this last partly from reduced casualty expense. Though KSC provided no personal injury data on the call, CFO Mike Upchurch did mention running a safer railroad and COO Dave Ebbrecht cited a significant reduction in slow-order miles, thus supporting my theme that a safer railroad runs for less.

Operating income was $162.9 million, up three percent and the Operating Ratio came in at 70.5, a 65 basis point improvement. Fuel expense increased 2.9 percent on a 6.3 percent fuel price increase against a 3.2 percent reduction in gallons consumed. GTMs came down 4.1 percent and GTMs per gallon slipped 0.9 percent. Net income after non-controlling interest and preferred dividends was $103.7 million, *up 38.5 percent(!!)*, thanks in part to a $12.9 million debt-retirement hit taken last year and not repeated this year.

Mexico continues to be the headline-grabber for KCS. Chief Marketing Officer Pat Ottensmeyer says Honda, Mazda, Nissan and Audi are opening new plants within the next twelve-month, putting down big enough footprints to expand as need be. Cross-border intermodal was up 71 percent and moves to and from the Lazaro-Cardenas port increased 14%. Were it not for the export corn fall-off (light green, below the line), KCSM would have been decidedly positive.

Ottensmeyer says that finished vehicles are only part of the story. There is a huge southbound parts move from the US moving in both intermodal and boxcar; raw materials such as steel for cars and stone for construction are showing positive trends. Collectively, the "Five Strategic Growth Areas" -- crude oil, cross-border intermodal, frack sand, Lazaro and automotive -- grew 36 percent in the quarter and represent 19 percent of total first-quarter KCS freight revenue.

Finally, KSC had to rein in its ag outlook for the balance of the year. And even though the "experts" (don't get me started on DOA corn-crop predictions) say conditions will be getting back to "normal" in 2013, Ottensmeyer said during the Q&A that they will "wait until September to gauge the drought effect on fiscal year revenues." Plans for a new heavy-crude terminal at Port Arthur are in their final stages, Mex auto production looks like it will be up about 30 percent, and the core pricing outlook is for gains in the "mid-single-digit" range.

My personal take on this call, based on what I've learned from and about the KCS team over the past 20 years, is they are adept at using adversity to make themselves stronger (anti-fragile in the truest sense), are creating significant competitive advantage and barriers to entry in Mexico, and have made giant steps in building a firm financial foundation. Yes, they're trading at growth business multiples, but IMHO they deserve it. And I'm long.

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