THE RAILROAD WEEK IN REVIEW

August 14, 2015

"U.S. raw materials are more expensive and therefore less desirable to overseas users as well as foreign investors." — Economist Gary Shilling

BNSF second quarter total revenue came in at $5.4 billion, down seven percent. BNSF only breaks out carloads and revenues by YTD, so we don't have firm Q2 revenue or volume counts. I approximate the first from the commodity year-over-year revenue changes presented in the "Railroad" portion of the Berkshire 10-Q and come within a few percentage points of the official revenue total. I approximate the second with the weekly AAR car-counts ending June 27.

Per BNSF, each of the four reported commodity groups — industrial products, agricultural, consumer products (intermodal and automotive) and coal/coke — was down in revenues based on the percentage deltas in the 10-Q. For six months, The Berkshire Q gives us some detail:

> — Industrial products saw lower vols primarily due to the impact of lower crude oil prices, which resulted in lower freight volume for petroleum products and frac sand.
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> — Agricultural product decreases were attributable to stronger global competition for export grains and lower demand for fertilizer, partially offset by increased shipments of domestic grains.
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> — Coal decreased one percent in the second quarter but increased three percent for the first six months.
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> — Consumer products recovered somewhat from [earlier] losses from lower international intermodal volume attributable to diversions of freight from U.S. West Coast ports to other import gateways as a result of the port productivity slow-down from port labor disruptions in the first quarter of 2015.

To back up these four broad breaks I use the BNSF weekly carload reports to the AAR, sorting the 20 "official" commodity groups into the four groups (houses, for Potter fans) BNSF uses. My source is commodity mapping data I got from BNSF a year or two ago and the commodity group totals thus derived below are very close to the 10-Q. Thus the individual lines have to be close enough in orders-of-magnitude to get a sense of what's moving and what's not so robust.

Where there is a wide spread, I suspect it has to do with things like ethanol and ferts that may be chemicals and ag for the AAR and in industrial for BNSF. Also, BNSF, like every Class I and the AAR, does not break out the petroleum products heading into STCC 29 petrol products and

STCC 131 crude oil. For that, use the STB's Quarterly Commodity Statistics (QCS) tables and see BNSF runs a pretty consistent 60,000 cars a quarter in the STCC 29s. From this it appears all the YOY change is in crude oil, down two percent.

Second quarter operating income was $1.8 billion, up five percent; net income was $963 million, also up five percent. The operating ratio was 67.05 vs. 70.71 a year ago. Compared with the other US Class Is across six months, BNSF posted the smallest decrease in operating revenues, the only positive delta in revenue units (all right, only 0.3 percent, but still positive, and all of it in merch carloads, thank you Dave Garin).

BNSF is the only Class I deriving less than half its freight revenues from the non-coal carload sector, and, among its US peers, posted the best six-month ops income gain and the second-lowest OR with the best year-over-year improvement. From this one might conclude BNSF does the best job of managing yield on its carload business, zeroing in on those commodity lanes that are up to scratch and forsaking all others. Eastern roads, take note.

Genesee & Wyoming July carloads for railroads in the US and Canada declined 11.4 percent, including roads acquired since July, 2014 — the Arkansas Midland Railroad, the Prescott & Northwestern Railroad and the Warren & Saline River Railroad. These railroads contributed 1,554 carloads of minerals & stone traffic, 616 carloads of lumber & forest products traffic, 378 carloads of chemicals & plastics traffic and 394 carloads from all other commodities.

Same-store names were off 13.2 percent or just under 21,000 units. Coal/coke was off due mainly to declines in the Midwest, Central, Ohio Valley and Mountain West regions. The metals loss came mostly in the Ohio Valley, Southern and Northeast regions. Ag products losses came in the Midwest, Mountain West and Ohio Valley regions.Three of the seven commodity groups that account for 80 percent of GWR vols — coal/coke, ag products, metals — were off double-digits.

Year-to-date North American vols through July are down 5 percent, though July itself was up a point from June, perpetuating a pattern of wide month-to-month swings — up 14 percent one month, down 2 percent the next. I think this is critical because NA accounts for roughly three out every four dollars of GWR operating income; Australia is 14 percent and UK/Europe ops contribute the remaining 11 percent. By way of comparison, Australia vols were dragged down 12 percent by the loss of significant iron ore business, while there are no comps for the UK/Europe segment because it's so new.

I also think the segment realignment is critical because of the volume shortfalls in North America and Australia. When nearly four of the top seven commodity groups commodities are down a combined 40 percent, and there is little relief in sight, it's time to widen one's horizons. Ergo the Freightliner acquisition.

The Chinese currency devaluation took its toll on Tuesday, dragging the S&P Materials commodity sector down 2 percent on the day, more than any other sector. The rationale

according to the CNBC talking heads was that the yuan devaluation would make commodities traded in dollars more expensive in China, therefore orders could come down.

Shares of companies in the metals & mining sub-sector came down 4.7 percent, followed by steel at -3.8 percent, aluminum at -2.9 percent, chems -1.5 percent, and forest products at -1.4 percent. In the metals & mining sector, Freeport McMoran shares sank 12.3 percent; Teck took a 7.6 percent hit; and BHP was off 4.9 percent, for example.

Shares of the rails sank to or approached 52-week lows. NSC was hardest hit, -3.1 percent, followed by CSX, -2.4 percent; CNI, -2.1 percent; KSU, -1.4 percent; UNP, -1.25 percent; CP, -0.8 percent; and GWR actually managed to eke out a gain of 0.1 percent. So if you combine drops in the energy sector (coal, oil, gas and related), lack-luster intermodal results, uneven ag products volumes, and erratic ops performance, it's easy to see why the rails are not Number One on the investor hit parade.

A note from Wolfe Research suggests Union Pacific may be on the mend ("Potential Catalysts Emerging," Aug. 13) and grain may be a contributor. "While 3Q is off to a rough start, we see potential catalysts ahead for UP from stronger grain vols. Crop conditions are much better in the western part of the U.S. and UP has high-end exposure to a rebound in U.S. grain vols."

That is assuming greater supply does not meet flat demand, pushing prices down, in which case farmers could very well wait for supply and demand to come back into balance and UP's potential for stronger grain may not materialize. Recall both revs and vols for ag prods at UP dropped seven percent year-over-year in the 2015 second quarter.

Two days later John Mauldin's *Outside the Box* quoted economist Gary Shilling's "deeper insight into the global economic trends that have led to China's headline-making, market-shaking devaluation of the renminbi." [emphasis added - rhb]

> Shilling: As manufacturing shifted from North America and Europe to China – with China now consuming **more than 40 percent of annual global output** of copper, tin, lead, zinc and other nonferrous metal while stockpiling increased quantities of iron ore, petroleum and other commodities – many thought a permanent commodity boom was here.
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> Mauldin: Think again, Australia; not so fast, Brazil. Copper prices, for instance, have been cut nearly in half as world growth, and Chinese internal demand, have weakened. Coal is another commodity that is taking a huge hit: China's imports of coking coal used in steel production are down almost 50 percent from a year ago, and of course coal is being hammered here in the US, too.
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> And the litany continues. Grain prices, sugar prices, and – the biggie – oil prices have all cratered in a world where the specter of deflation has persistently loomed in the lingering shadow of the Great Recession. (They just released grain estimates for the US, and

apparently we're going to be inundated with corn and soybeans. The yield figures are almost staggeringly higher than the highest previous estimates. **Very bearish for grain prices.**)

Also, most major commodities are priced in dollars; and now, as the U.S. dollar soars and the Fed prepares to turn off the spigot, says Shilling, "raw materials are **more expensive and therefore less desirable** to overseas users as well as foreign investors." As investors flee commodities in favor of the US dollar and treasuries, there is bound to be a profound shakeout among commodity producers and their markets.

If it's a given that global economics don't stop at the shortline interchange, then the best defense for the short lines is to build out their non-commodity franchises, figure out strategies to beat the truckers at their own game, and force the connecting Class Is to behave by measuring everything and by holding certain feet to the fire. The alternative is becoming another Fallen Flag.

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