Rails Beyond Coal – The Dawning of the Domestic Intermodal Age

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Green vs Black? The RR Renaissance & “the end of the coal age”

RailTrends 2012
November 1, 2012/December 10, 2012
Future Growth Potential

5 Secular stories (in order)....

- 1-Intermodal – International and now Domestic
- 2 –Shale/Oil – Problem and solution?
- 3-Chemicals/Re-Industrialization? Near-Sourcing
- 4 - Grain – the world’s breadbasket
- 5 – Cyclical recovery - Housing

Other Rail Opportunities exist but in smaller scale: The Manifest/Carload “Problem” (hub&spoke) vs. point-to-point “Unitization”/Industrial products/MSW (garbage) /perishables/others/Coal? Exports – “legs”?
Rail Intermediate term volume prospects

ABOVE GDP

• Intermodal – Domestic (+)
• Intermodal – International
• Shale/oil
• Agricultural products
• Export Coal
• Chemicals!

BELOW GDP

• Auto Parts (?)
• Domestic Coal (?)

GDP-GROWTH

• Autos (+?)
• Lumber (+?)
• Aggregates
• Metals (+?)

UNCERTAIN

• Paper
• Ethanol
Near Term

• Q1 – EPS +30% despite: coal, grain, economy- beats Street expectations
• Q2 – up ~20/20 RRs again beat expectations, reiterate Goals/Targets
• Q3 – Coal takes its toll as cyclical contracts, slightly....
• Q4/13 outlook perhaps a bit more muted- non-coal traffic up 5% or so – Cliff dancing?
• End of coal decline? Revitalization in grain? Where are we in recovery? Pricing?
• Cash flow – still “balanced” use? Capex will still be supportive of growth segments
Current Issues

• What’s true? *RR (cyclical) traffic or business headlines?*
• *End of the Coal Age?*
• *Capex – Strategic or Tactical plans prevail? $13B!*
• *PTC*
• After the Rereg Fight what? *STB? TSW?*
• Govt role – partner? Or preoccupied & broke?*
• The Green mantle – two-edged sword.….
• *PE & Infrastructure – and activist? – funds: back for good? CP….*
• New “Golden Age”? *Service*
Underlying Themes or “Givens’”

• Green is here to stay
• Oil Prices will remain high (price points at $65, $45, $25/bl)
• Governments spending will be problematic
• Infrastructure will be challenged
• Trade will be dynamic but remain strong
• Near-sourcing and in-sourcing remain themes
• Trucking Productivity has peaked
• Driver shortages are a secular/demographic issue exacerbated by govt regs (CSA/HoS)
Coal in Trouble

- Domestic in secular decline due to regs/legislation, accelerated by weather, economy and, especially NG price
- Exports tied to global economy (ie; China); competition – and infrastructure access
- What was once “stable” and base business is the most uncertain
- Solution: invest elsewhere….
Exports to the rescue?

Expected Increase in Seaborne Thermal Demand 2010 – 2015

<table>
<thead>
<tr>
<th>Region</th>
<th>2010</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlantic</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td>Other Pacific</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>China</td>
<td>50</td>
<td>160</td>
</tr>
<tr>
<td>India</td>
<td>100</td>
<td>200</td>
</tr>
</tbody>
</table>

Expected Increase in Seaborne Thermal Supply 2010 – 2015

- 50-75 Million Tonne Shortfall
- Other Colombia
- S. Africa
- Russia
- Indonesia
- Australia
Shale

- Frac Sand, brine & water, pipe and aggregates inbound
- In cases of Oil, “Rolling Pipelines” out....
- Hess – 286 cars, 9 trainsets now, 27 in a few years (followed by Phillips 66, others)
- Pipeline companies developing rail terminals in ND
- Tar Sands and pipelines
- Chemical Industry – secondary impact
- Industrial Development – tertiary impact
## Estimated Delta In RR Revenues/Prologistics Group

<table>
<thead>
<tr>
<th></th>
<th>Approx Annual Carloads</th>
<th>Approx Rev/ Car</th>
<th>Change In Rev</th>
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<tbody>
<tr>
<td><strong>2008</strong></td>
<td><strong>2011</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Coal</td>
<td>8,320,000</td>
<td>7,120,000</td>
<td>$1,700</td>
</tr>
<tr>
<td>Oil</td>
<td>6,000</td>
<td>92,000</td>
<td>$3,700</td>
</tr>
<tr>
<td>Sand</td>
<td>160,000</td>
<td>360,000</td>
<td>$3,500</td>
</tr>
<tr>
<td>Total</td>
<td>8,486,000</td>
<td>7,572,000</td>
<td>($1,021,800,000)</td>
</tr>
</tbody>
</table>
Lower 48 states shale plays

Source: Energy Information Administration based on data from various published studies.
Updated: May 9, 2011
Why move crude by rail?

- Moving a barrel by rail can cost $7 to $14, compared with $2 to $5 by pipe, depending on destination. But that price difference pales in comparison to a $15 to $30 premium for reaching the right markets.

- Producers are working shale everywhere and rail transload terminals are a cost-effective, very quick way to start moving crude to market.

- **Flexibility to serve all markets using existing N.A. rail infrastructure.** Existing rail routes have capacity to reach East and West Coast markets in the U.S. that may not have sufficient pipeline capacity.

- Isolation of commodity to provide a “pure barrel” to the destination.

- **Speed to market** – 12 months to build a unit train rail terminal.

- Comparatively low entry level capital requirements.

- Source: Watco
What, me worry?

- Coal – its price not community
- Quick then suddenly – 10% hit?
- Activists – what's next?
- Compensation: shale (+++)?
- Compensation: chemicals? (Secondary Shale Effect)
- Compensation: export coal?
- Compensation: domestic intermodal?
- Re-Industrialization (Tertiary Shale Effect)
Revenue Share
Percent of Total Revenue for Major US Railroads

* 2012 estimated based on first half of year

Source: AAR analysis of 10-K reports for BNSF, CSX, KCS, NS & UP
Intermodal Growth Drivers Domestic \textit{and} International

- Globalization
- Trade
- Railroad Cost Advantages
- Fuel prices
- Carbon footprint
- Share Recovery From Highway
- Infrastructure deficit & taxes
- Truckload Issues; regulatory issues, driver issues
US Railroad Intermodal Traffic
TOFC-COFC Units

* 2012 estimated based on first 35 weeks of year

Source: AAR analysis of 10-K reports for BNSF, CSX, KCS, NS & UP
TRANSLOADING REACHING NEW HIGHS

Source: TTX, IANA, Piers

Source TTX, IANS, Piers

Ron Sucik
RSE Consulting
International Intermodal

- Still game in the old vet
- Even with near-sourcing
- Even with changing flows (which may disadvantage rail)
- Retail still tied to Asia
- MLB still tied to rail service
- Growth of 1-2.5X GDP
Intermodal Issues 2012+

- International: trade flows, retail sales, exports & balance – UNP’s vision vs NRF, TTX
- Panama Canal? *On time? How much? Etc….*
- Emerging Developments – Rupert, Lazaro, Miami
- Domestic – development of “Corridors” & “Gateways”, etc
- Domestic – bimodal partners, shipper developments
- Domestic – service & pricing?
- Q1/12 – up 5.9% (*domestic* +9%, *int’l* +3%, IMC+11%)
- “There’s somethin’ happening here….”
Re-industrialization?

- Near-Sourcing: *Mexico*, CA
- Gas effect round two:
- CHEMICAL INDUSTRY
- Fertilizers
- Steel/Autos/White Goods etc
- Northeast, etc back “in play”
Growth is Expensive:
Rail Capex in 2011/12/13?

• Record $12B last year
• Record $13B this year – many rails pegging at 17-18% of revenues (rising by double digits)
• Corridor developments, NG, terminals, locos, cars, shale buildouts, etc
• PPPs – in decline?
• Still emerging as DPS plays, buying in shares

• 2013 Capex Plans will be very, very interesting
Railroad Capital Expenditures
Class I Railroads

Source: Railroad Facts & Analysis of Class I Railroads, AAR
RR CoC vs. ROIC – RR Stocks have done well but… they still trade at a discount to all stocks

Source: Surface Transportation Board
Note: Cost of equity estimation method changed by Board effective 2006 and 2008.
ROI is everything

• Rails must retain price (@”rail-inflation plus” levels, or +3-5% YOY)
• Productivity – through capex, IT, scheduling, service
• Must remain de-regulated (even if not directly an intermodal issue)
Simple Math

• Rates
• Returns
• Capital Expenditures
• Capacity
• Service

ARE ALL CONNECTED!

Virtuous Circle (’03-07) or Disinvestment?
Election 2012

- Republicans pro-coal
- Dems pro-gas
- Labor not a near term issue
- Tea-Party and Infrastructure
- PPPs?
- $- “no matter who wins, who can pay?”
- Policy continuation – mildly pro-rail/anti-coal
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CP

• OY. 2\textsuperscript{nd} (3\textsuperscript{rd}) Proxy Fight since 1954
• Not a takeover – CHURCH OF HUNTER
• HH track record vs recent CP (OR, weather, M&A, growth)
• HH goal 65% OR by 2016 – likely….
• CP goal 70-72% in three years (YE’11 83.1%; C1 avg 71%)
• (as example) CSX goal 65% OR 2015
• CP’s new management team yet to be fully revealed…. (“the closer”)