



Transportation/Logistics

November Freight Flows

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Please refer to
Appendix - Important
Disclosures and
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Action

Freight trends generally exhibiting seasonality build better than recent years. However, transports have underperformed the market since fundamentals bottomed earlier this year. Behind stable fundamentals and cyclical upside potential, we recommend selective exposure to asset-based cyclicals; best ideas remain CSX, KNX, BNI, and JBHT.

November's Freight Flows discusses themes following 3Q results, as well as recent stock performance.

Summary

- **Transport stocks underperformed in October**, with every subsector lagging the broader market except the Rails, which were in line. October performance by mode: Rails -2%, Truckloads -3%, Integrators -4%, 3PLs -6%, and LTLs -14% against -2% S&P 500.
- **Demand seasonality evident in 3Q, better than recent years.** 3Q demand trends remain weak, but firming and seasonal sequential improvement evident across most transport modes. Stability to freight trends over past six months should provide for improving yoy comparisons through 4Q and into 2010.
- **TL capacity underinvestment equates to improving supply/demand imbalance.** TL industry (70% of domestic freight tons) capacity underinvestment over last three years has driven industry fleet age to generational high. As a result, truckload pricing has bottoming and transports (truckload, intermodal, rails) positioned to benefit from a renewed pricing cycle with the next economic upturn.
- **Rail pricing decelerating, but thesis intact.** Following 5-6% core industry pricing growth, rail pricing has decelerated excess industry capacity (particularly within truck). Western carriers (BNI, UNP) face greater incremental risk to aggressive truck pricing. Rail pricing likely to moderate in 2010; however, given our constructive view on truckload pricing, inflation-plus rail pricing should persist in the intermediate term, driving improved margins and capital returns.
- **LTL pricing suffering from excess capacity; and banks' unprecedented leniency with YRCW.** 3Q pricing deteriorated sequentially given excess industry capacity. Further, leniency among YRCW's banks is negatively impacting the outlook for LTLs. As a result, we expect pressure to consensus and now see the group's risk/reward as more balanced
- **Early-cycle call not over.** Despite bottoming fundamentals, transport stocks have underperformed since fundamentals bottomed earlier this year. We believe this leaves attractive upside to the early-cycle call on the group. Our best ideas include CSX (large-cap, cyclical value) and KNX (small-cap, cyclical growth). We also recommend JBHT (mid-cap, high-quality cyclical growth) and BNI (large-cap, high-quality cyclical) -- all of which possess higher full-cycle earnings potential and have fundamentals that have bottomed.

Details

Industry Themes Following 3Q Reporting

We recommend investors use the recent stock weakness to selectively build exposure to asset-owning domestic transports given that demand fundamentals have bottomed and stock upside in an economic recovery remains attractive, in our opinion. While the transports are up significantly from the March lows, the stocks have underperformed the broader market over this time period, which we believe leaves attractive upside to the early-cycle call on the group.

Our best ideas include:

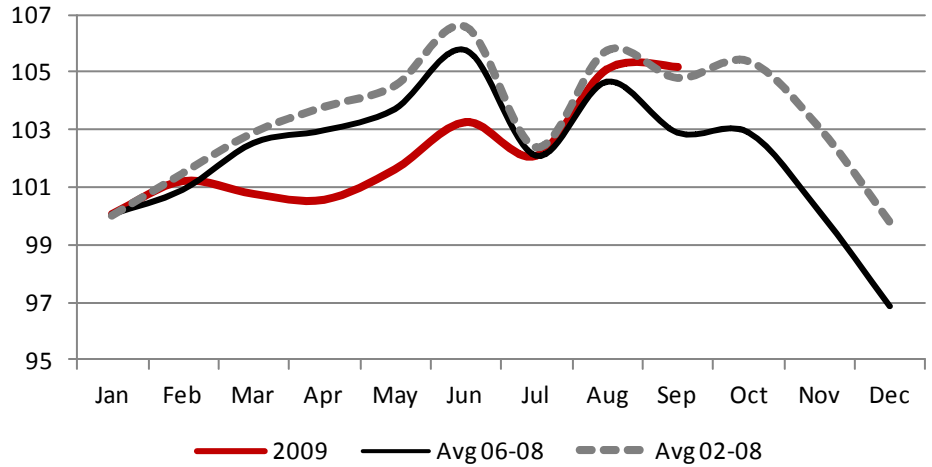
- **CSX Corp.** (CSX—large-cap, cyclical value) is our top pick within the railroad sector; attractive valuation on depressed earnings. CSX's earnings potential not fully realized in the last cycle, given its turnaround efforts were cut short by the recession. Margin upside surprise, continued positive pricing, and early-cycle attributes create attractive provide an attractive backdrop for the stock and meaningfully higher peak earnings potential.
- **Knight Transportation** (KNX—small-cap, cyclical growth) is the best in class truckload carrier and is well positioned to benefit from the eventual turn in the pricing cycle, which we expect to begin in 2010. Fundamentals have bottomed, and given KNX has done an excellent job of diversifying its business and protecting its base (volumes off only 5% from the peak), KNX is positioned to obtain meaningfully higher peak earnings.
- **JB Hunt** (JBHT—mid-cap, cyclical growth) is an attractive growth story. Intermodal is one of the only transport sectors that will grow as fast or faster in the next economic cycle compared to the last. Intermodal volumes are 20% higher than when JBHT achieved peak earnings, positioning JBHT for materially higher earnings this cycle. Near-term catalysts include strengthened NSC contract potential, Dedicated revenue acceleration, and possible PACR/UNP deal.
- **Burlington Northern** (BNI – large-cap, cyclical value) – a best-in-class railroad with the most attractive commodity mix (Ag, Intermodal, and Coal account for 74% of revenue). Excess truck capacity will weigh on near-term pricing growth, but pricing should remain positive; and BNI is most exposed to the eventual positive truckload pricing cycle.

Of our Neutral-rated stocks, we believe **Union Pacific** and **Heartland Express** are interesting positions for long-term holders. UNP stands to benefit from sustained industry pricing power and better peak margins during the next cycle. And though HTLD lacks a near-term catalyst and has lost market share in 2009, the company maintains best-in-class margins and stands to benefit from improved industry pricing power. Finally, we like Neutral-rated **Hub Group** in the low \$20s given its indirect exposure to stabilizing truckload trends, solid exposure to the long-term intermodal growth, and recent relative underperformance.

Demand showing a better seasonal trend compared with recent years. As we highlighted in our previous Freight Flows, 3Q demand trends generally reflected seasonal sequential improvement across most modes of transports. The charts below reflect 3Q's seasonality across the broader domestic freight environment, railroad carloads, and spot truckload demand.

The chart below depicts our Baird Freight Index, which has shown seasonal improvement from July through September. Positively, 2009's reading is consistent with a typical seasonal demand pattern (measured by the average from 2002-2008), but the 2H09 trend is stronger than the average 2H trend during 2006-2008. Overall demand trends remain weak and well below prior-year levels, but the stability to freight trends over the past six months should provide for improving year-over-year comparisons through 4Q and into early 2010.

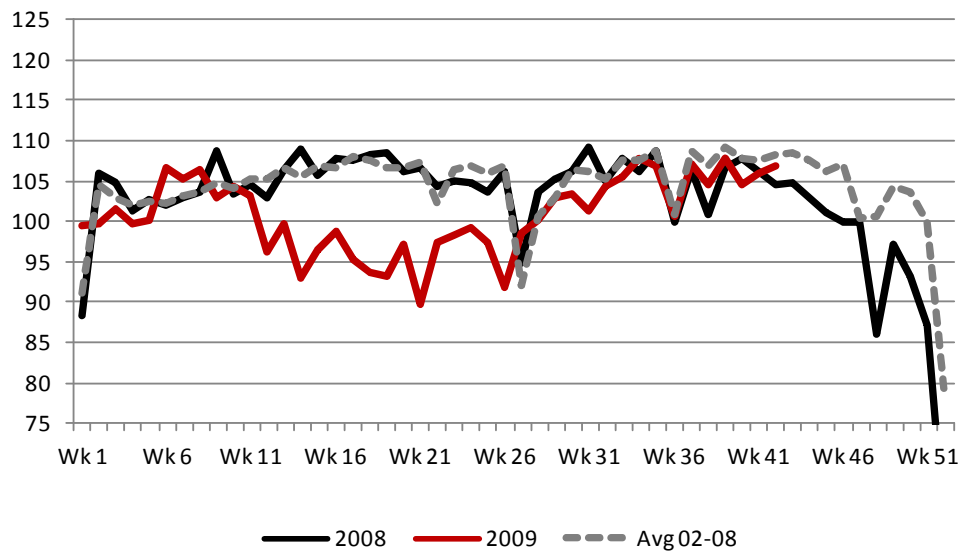
Baird Freight Index Seasonality



Source: Baird estimates

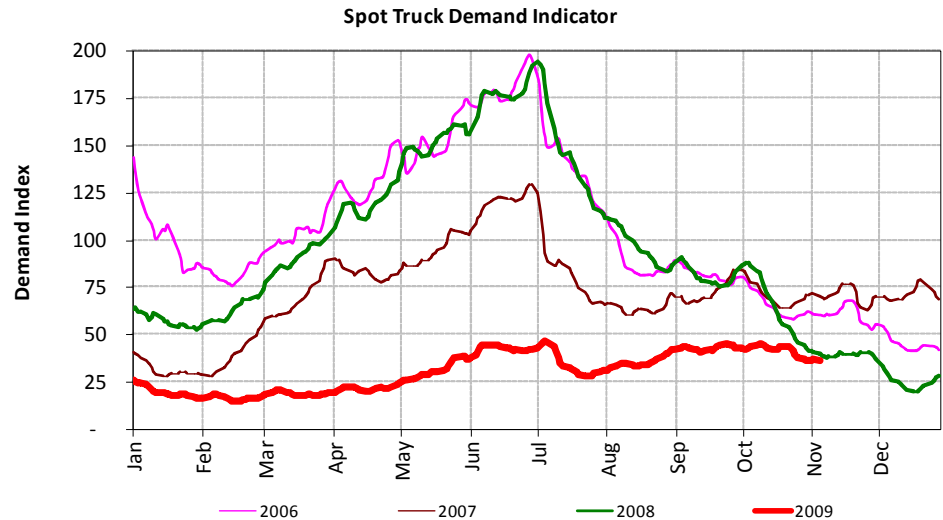
As the chart below highlights, railroad volumes troughed in 2Q09 and improved through 3Q09. Consistent with typical seasonality, each of the four US Class I railroads saw weekly carloads trends improve from July to September, with three of the four (CSX, NSC, and UNP) reaching a peak in weekly carloads for 2009 during 3Q. Aside from weak traffic holidays that accompany the November and December holidays, the potential for a healthy agricultural harvest and modest improvement in the demand outlook for coal should support 4Q volumes relative to 3Q.

Railroad Carloads Seasonality



Source: AAR, Baird estimates

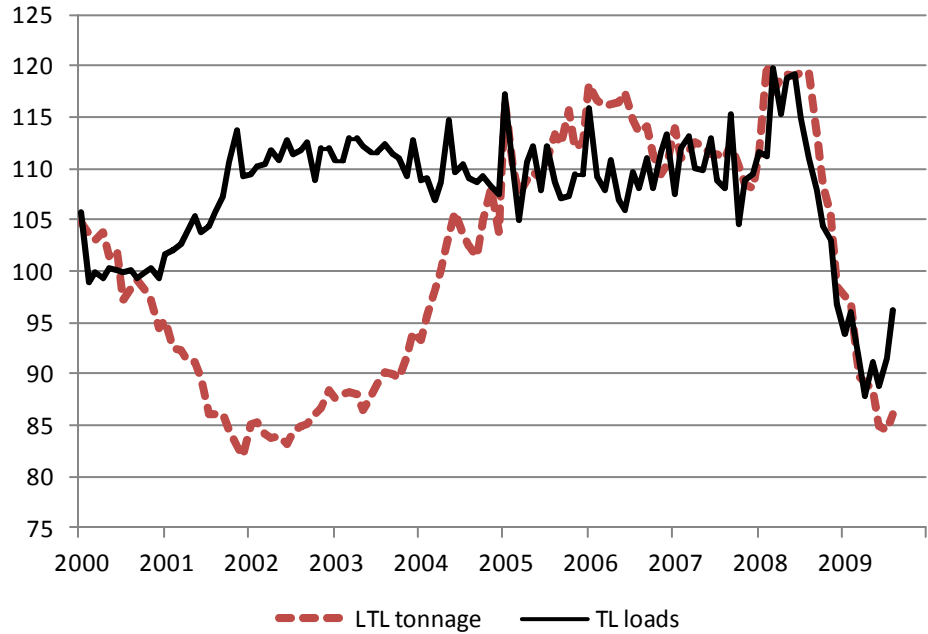
Lastly, our proprietary spot truckload demand chart, as seen below, similarly highlights the stability and seasonal strength through 3Q. Ongoing capacity reductions, primarily from the lack of new truck builds, and seasonal demand improvement through the quarter produced some pockets of spot market pricing for truckload. Though the industry's supply/demand equilibrium remains in the favor of the shippers, we believe recent demand stability and ongoing capacity attrition should produce flat-to-positive truckload rates in 2010, which is addressed in further detail below.



Source: Industry data, Baird estimates

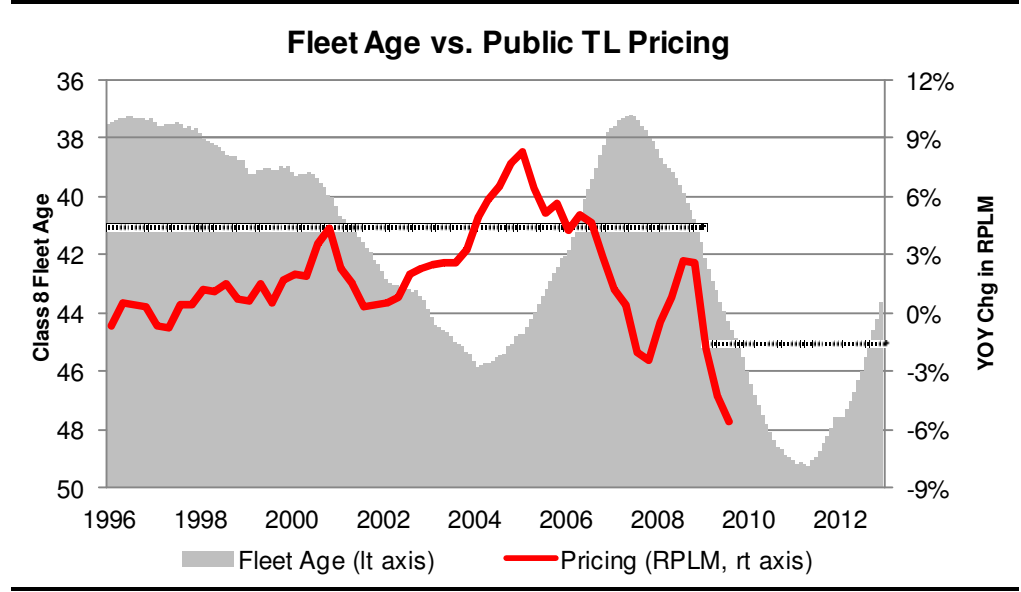
LTL demand is lagging, but consistent with the previous cycle. The LTL industry (and UPS ground parcel results) was the one notable area that did not show widespread improvement from 2Q to 3Q. As demand fundamentals improved sequentially from July through September among most modes (truckload, rails, express parcel, international freight), LTL freight demand underperformed the market. However, as the chart below indicates, LTL demand improvement was not widespread. During the previous cycle, TL volumes bottomed over 12 months before LTL volumes bottom; though the LTL stocks moved coincidentally to TL stocks. As a result, we do not view the recent lag in LTL fundamentals as any secular shift occurring within the industry but rather a divergence common for this point in the freight cycle.

Truckload vs LTL Volume Growth



Source: ATA

Truckload capacity underinvestment improving supply/demand imbalance; setting stage for the Freight Pricing Renaissance. Over the past three years, the truckload industry (which moves 70% of domestic freight tons) has underinvested in capacity due to unsustainably low freight rates. As a result, the age of the nation's truck fleet is at a generational high. Further, 2010 federal engine emission standards will temper truck purchases next year. As a result, transports (trucks, rails, and logistics providers) are positioned to benefit from a renewed pricing cycle with the next economic upturn. The chart below reflects the inverse relationship between truckload pricing and fleet age.



Source: ACT, Baird Estimates

Railroad pricing deceleration an incremental headwind to investor sentiment; but pricing thesis intact. Railroad pricing growth has decelerated through 2009, following years of 5-6% core pricing growth as carriers benefited from capacity rationalizations and the upward repricing of below-market legacy contracts with shippers. The rail industry’s ability to capture above-inflation pricing growth is essential to improving industry capital returns and promoting continued capital investment. Though we continue to believe in the secular pricing power of the rail industry, near-term rates are not immune from the broader pricing pressures. Competing modes, particularly truckload, have been aggressively pursuing freight through price reductions in order to attract density. As a result, rail industry pricing power has waned through 2009, as evidenced by the chart below, though we note that rails’ pricing growth remains well above the broader transportation average.

Carrier Provided Core Railroad Industry Pricing

	2007	1Q08	2Q08	3Q08	4Q08	2008	1Q09	2Q09	3Q09
CSX	6.7%	6.8%	6.4%	6.2%	6.5%	6.5%	6.5%	6.6%	6.3%
NSC	4.0%	7.0%	9.0%	9.5%	7.1%	8.6%	8.5%	7.4%	6.2%
BNI	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	5.0%	4.0%	3.0%
UNP	6.1%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%	5.1%	4.0%

Like-for-Like Calculated Core Railroad Pricing

	2007	1Q08	2Q08	3Q08	4Q08	2008	1Q09	2Q09	3Q09
CSX	6.8%	8.1%	9.7%	9.4%	7.4%	8.6%	7.9%	6.9%	5.7%
NSC	4.0%	7.0%	9.0%	9.5%	9.0%	8.6%	8.3%	6.9%	5.4%
BNI	6.4%	7.2%	7.1%	7.7%	6.4%	7.0%	6.0%	6.5%	4.0%
UNP	7.4%	7.2%	8.0%	10.4%	10.6%	9.0%	8.1%	6.2%	3.5%

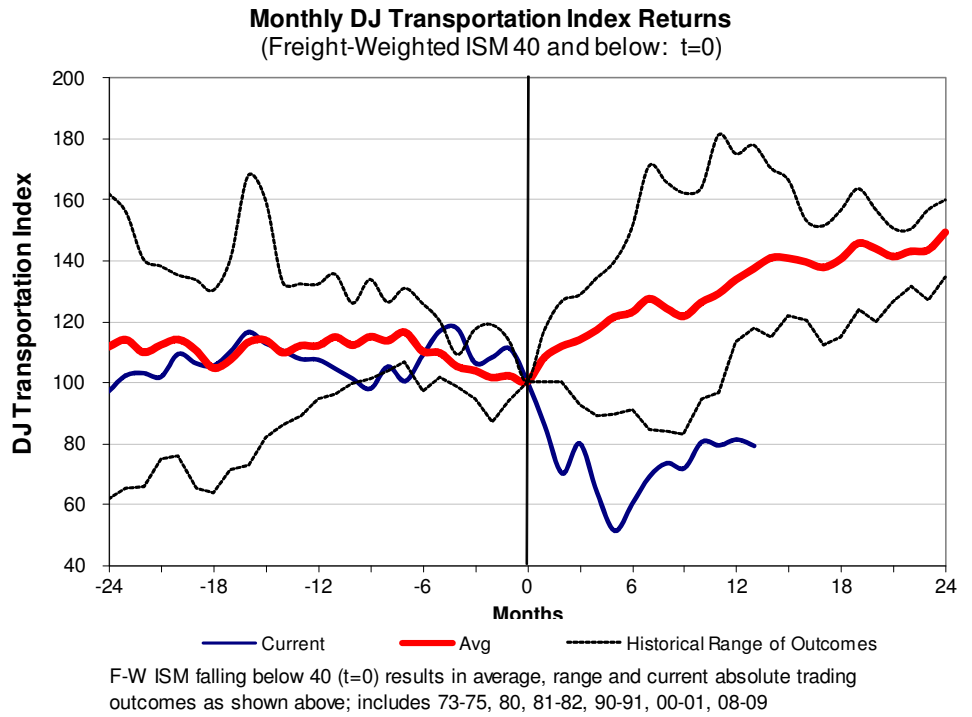
Source: Company data, Baird estimates

Despite rails' solid pricing growth through this downturn, we recognize that investors widely view 3-4% 2010 pricing gains to be necessary to support the secular rail investment thesis. We note that the Western rail carriers (BNI and UNP) have experienced greater pricing deceleration than the Eastern rails (CSX and UNP). We attribute this differential to the fact that while both Eastern and Western carriers face truck competitive freight (within intermodal and its broader commodity base), **the Western carriers face a greater level of incremental truck competition as truckload freight rates have fallen, given the geography, length of haul and freight mix.**

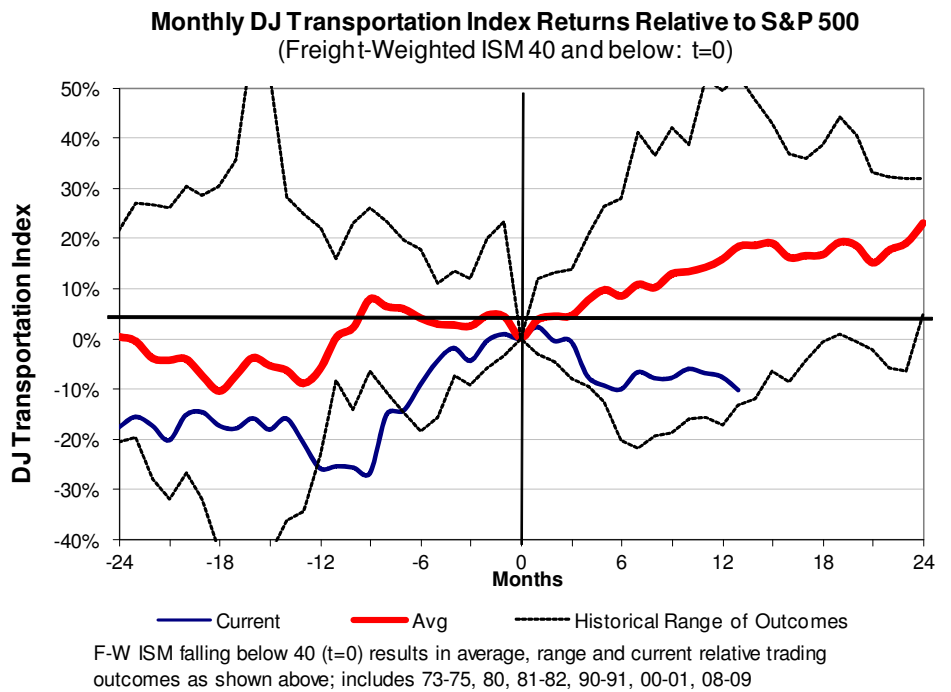
However we remain constructive on pricing (and our positive rail thesis) given: 1) bottoming demand and pricing fundamentals in truckload, 2) given our previous comments on the potential for Freight Pricing Renaissance once the economy improves, 3) given the unsustainable nature of current truckload rates, and 4) given the permanent truckload capacity reduction from the underbuy of new trucks since early 2007.

Permanency of expense controls should drive margin surprises as volumes improve. Given the dislocation of freight volumes in 2009, all transport modes have been forced to aggressively remove costs and improve efficiencies in recent quarters to react to 10-25% lower volumes and protect profitability. 3Q reporting provided relatively solid earnings driven by strong cost controls. This was particularly evident in the rail sector, but we believe it applies broadly to our group. Though a portion of these cost savings will be temporary, as expenses return to handle greater volume levels, some of the cost savings will be permanent as companies benefit from efficiency improvements. These improvements should support margin surprises during the next economic cycle.

The early-cycle investment thesis is not yet over. Since operating fundamentals bottomed, transports have generally underperformed both the broader market and the group's average relative trading performance compared to previous post-recession periods. As the chart below highlights, the Dow Jones Transportation Index has underperformed the S&P 500 Index by 10% since the Freight-Weighted ISM first fell below 40 in October 2008, which we use to define the bottom of trucking fundamentals. Over the previous five downturns in which the Freight-Weighted ISM has fallen below 40, transports outperformed the broader market by roughly 23% over the subsequent two-year period. We remain selectively positive on the transports given: 1) this relative underperformance, 2) the bottoming fundamentals, and 3) the potential for meaningfully positive upward pricing (during the next up-cycle), which should correlate well with stock performance.



Source: Factset, Institute of Supply Management



Source: FactSet, Institute of Supply Management

Weak October Stock Performance

Transport stocks underperformed in October, with every subsector lagging the broader market except the Rails, which were in line. However, within the Rail group performance was mixed, with the Eastern rails outperforming the Western rails on more resilient 3Q pricing. Meaningful underperformance in LTLs as the YRCW bankruptcy trade wound down and industry fundamentals lagged the other transport modes. Transport performance by mode was Rails -2%, Truckloads -3%, Integrators -4%, 3PLs -6%, and LTLs -14% against -2% for the S&P 500. YTD, the transports have underperformed the broader market, with Rails (+14%), LTLs (+7%), Integrators (+3%), 3PLs (-2%), and TLs (-2%) all lagging the market (S&P 500 +15%).

A complete chart of stock performance is shown below:

Ticker	Name	10/31/09		Trading Performance				
		Rating	Price	Oct	3Q	1H09	YTD	2008
Integrator Index				(4%)	20%	(11%)	3%	(24%)
UPS	United Parcel Service	N	53.68	(5%)	13%	(9%)	(3%)	(22%)
FDX	FedEx Corp	N	72.69	(3%)	35%	(13%)	13%	(28%)
Third-Party Logistics Index				(6%)	9%	(4%)	(2%)	(12%)
EXPD	Expeditors Intl	N	32.22	(8%)	5%	0%	(3%)	(26%)
CHRW	C.H. Robinson	N	55.11	(5%)	11%	(5%)	0%	2%
JBHT	J.B. Hunt Transportation	O	30.06	(6%)	5%	16%	14%	(5%)
LSTR	Landstar	N	35.24	(7%)	6%	(6%)	(8%)	(9%)
UTIW	UTi Worldwide	O	12.47	(14%)	27%	(21%)	(13%)	(27%)
HUBG	Hub Group	N	24.86	9%	11%	(22%)	(6%)	(0%)
FWRD	Forward Air Corp	N	21.34	(8%)	9%	(12%)	(12%)	(22%)
PACR	Pacer International	N	2.86	(26%)	73%	(79%)	(73%)	(29%)
UACL	Universal Truckload	NR	16.44	(0%)	5%	11%	16%	(26%)
Leasing								
R	Ryder	N	40.55	4%	40%	(28%)	5%	(18%)
TAL	TAL International Group	N	11.86	(17%)	30%	(23%)	(16%)	(38%)
Truckload Index				(3%)	0%	1%	(2%)	5%
WERN	Werner Enterprises	N	18.75	1%	3%	4%	8%	2%
HTLD	Heartland Express	N	13.60	(6%)	(2%)	(7%)	(14%)	11%
KNX	Knight Transportation	O	16.04	(4%)	1%	3%	(0%)	9%
CLDN	Celedon Group	NR	9.76	(14%)	35%	(2%)	14%	(7%)
MRTN	Marten Transport	NR	17.54	3%	(18%)	9%	(7%)	36%
USAK	USA Truck	NR	11.23	(12%)	(6%)	(2%)	(19%)	(10%)
CVTI	Covenant Transportation	NR	5.04	3%	(11%)	175%	152%	(70%)
Less-Than-Truckload Index				(14%)	6%	17%	7%	(27%)
CNW	Con-way	N	32.99	(14%)	9%	33%	24%	(36%)
YRCW	YRC Worldwide	U	3.65	(18%)	157%	(40%)	27%	(83%)
ODFL	Old Dominion	N	25.99	(15%)	(9%)	18%	(9%)	23%
ABFS	Arkansas Best	N	25.82	(14%)	14%	(12%)	(14%)	37%
SAIA	Saia	NR	14.66	(9%)	(11%)	66%	35%	(18%)
VTNC	Vitrans Corporation	NR	8.56	(5%)	(9%)	58%	37%	(56%)
Railroad Index				(2%)	14%	2%	14%	(20%)
UNP	Union Pacific	N	55.14	(6%)	12%	9%	15%	(24%)
BNI	Burlington Northern	O	75.32	(6%)	9%	(3%)	(1%)	(9%)
NSC	Norfolk Southern	N	46.62	8%	14%	(20%)	(1%)	(7%)
CSX	CSX	O	42.18	1%	21%	7%	30%	(26%)
CNI	Canadian National	NR	48.24	(2%)	14%	17%	31%	(22%)
KSU	Kansas City Southern	NR	24.23	(9%)	64%	(15%)	27%	(45%)
GWR	Genesee & Wyoming	NR	29.01	(4%)	14%	(13%)	(5%)	26%
SPX	S&P 500			(2%)	15%	2%	15%	(38%)

* Indices are market-cap weighted.

Sources: FactSet, Baird estimates

Transportation/Logistics

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