



Transportation/Logistics

May Freight Flows

Jon A. Langenfeld, CFA
jlangenfeld@rwbaird.com
414.298.1965

Benjamin J. Hartford, CFA
bhartford@rwbaird.com
414.765.3752

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Action

Unprecedented improvement in demand in past two months sets stage for strong 2Q freight environment and notable 2H10 pricing results. Above-seasonal demand improvement and tightening capacity driving spot market pricing in 1Q, which bodes well for upcoming freight contractual negotiations.

Our May Freight Flows contains a recap of the key industry themes that emerged through 1Q reporting.

Summary

- **April stock outperformance.** Transports outperform into reporting on firming fundamentals, but limited 1Q upside drives in-line performance over final two weeks. Each group outperformed market (S&P 500 +1%) in April; LTLs (+9%), 3PLs (+7%), Rails (+4%), Integrators (+3%), and TLs (+2%).
- **Domestic volumes improve at unprecedented pace.** Industry comments from the trucking world suggest accelerating demand through April, well ahead of the normal seasonal trend. Trucking and rail data support these anecdotes.
- **Better-than-expected volumes a key driver of 1Q operating leverage; is it sustainable?** Integrators' and Rails' EPS well above consensus on operating leverage from both rising volumes and sustained cost efficiencies achieved 2009. Some costs will return to support higher volumes; but permanent cost efficiencies support better peak earnings potential.
- **Truckload Freight Pricing Renaissance is upon us...** Given demand improvement and ongoing capacity attrition, supply/demand balance nearing equilibrium. Spot market pricing improved over 10% during 1Q, which bodes well for upcoming bid season. We expect accelerating rate growth through 2010 and healthy 2011 pricing.
- **...even LTL pricing showing improvement,** though still weak and lagging other modes. However, better demand is absorbing excess capacity, as LTL rates stabilized mid-1Q, with anecdotes of sequential improvement into 2Q. We expect LTL trends to continue to lag TL, but rate growth probable in 2H10.
- **International airfreight remains strong and yield pressure abating; but OF trends lagging.** 1Q10 Hong Kong exports at an all-time 1Q high, reflective of the strength of AF demand; volumes likely sufficient to offset abating yield squeeze in near term. Ocean freight volumes positive but lagging; modest OF volumes concerning, as a sustained improvement in OF necessary to the health of an international freight recovery.
- **Recommend exposure to domestic transports.** Commentary from managements through 1Q and industry anecdotes confirm improving supply/demand balance, which should aid carrier pricing beginning 2H10. Best ways to invest in accelerating pricing trends include CSX, UPS, and JBHT; we continue to like UTIW and KNX over the mid-term.

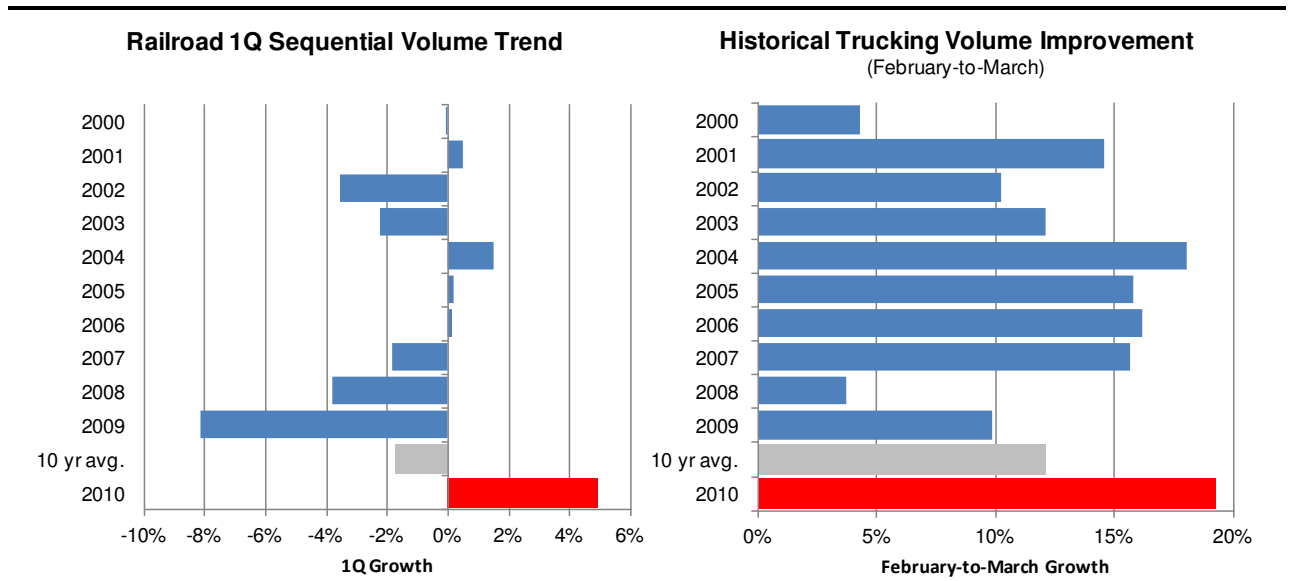
Details

Continue To Recommend Selective Transport Exposure

The transports' strong stock performance to begin 2010 and the extended rally off the March 2009 lows reflect the group's early-cycle characteristics and the firming of industry fundamentals in recent quarters from trough 1H09 levels. The improvement in fundamentals has accelerated through April, and transport stock valuations are reflecting strong pricing and volume growth into 2011. As a result, investors have begun asking the question: Is the early-cycle play over? We do not believe so, for three key reasons. First, the improvement in demand to begin 2010 has been unprecedented, since the end of February. We believe this demand recovery can continue to outpace expectations, providing additional upside as the cycle matures. Second, the looming pricing renaissance should support pricing gains on par with the very robust periods of 2004-05, assuming the economy remains solid. And third, the efficiencies of many business models today are as high as ever, given the aggressive cost actions taken during the recession. Though some of the removed costs will return as volumes recover, **permanency of cost takeouts will drive higher peak earnings during the next upcycle. As a result, we believe investors can continue to benefit from exposure to the transport space.**

Domestic Demand Improving At Unprecedented Pace

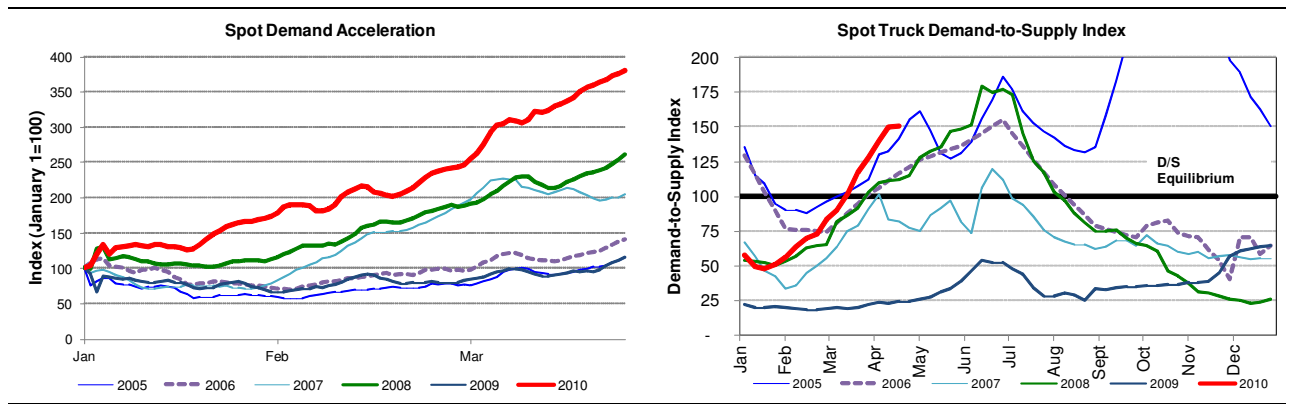
The prevailing theme through 1Q reporting in April was the improvement to freight demand throughout the quarter. Improving demand conditions were cited among many modes, including Intermodal, Rail, Truckload, LTL, Parcel and International Airfreight. The charts below reinforce above-seasonal 1Q demand trend. First, the chart below on the left depicts railroad volume growth from 4Q to 1Q. Sequential 1Q10 growth was roughly 5%, well above the 10-year average contraction of 2% and the previous 10-year high of +2%. Second, the chart on the right shows the ATA truck tonnage index's improvement from February to March, which in 2010 was the fastest February-to-March improvement in at least 10 years. Based on preliminary April results and commentary from a recently attended trade show, the improvement has continued into April, and **the pace of the volume acceleration over the past six to eight weeks has been unprecedented.**



Source: AAR, ATA, Baird estimates

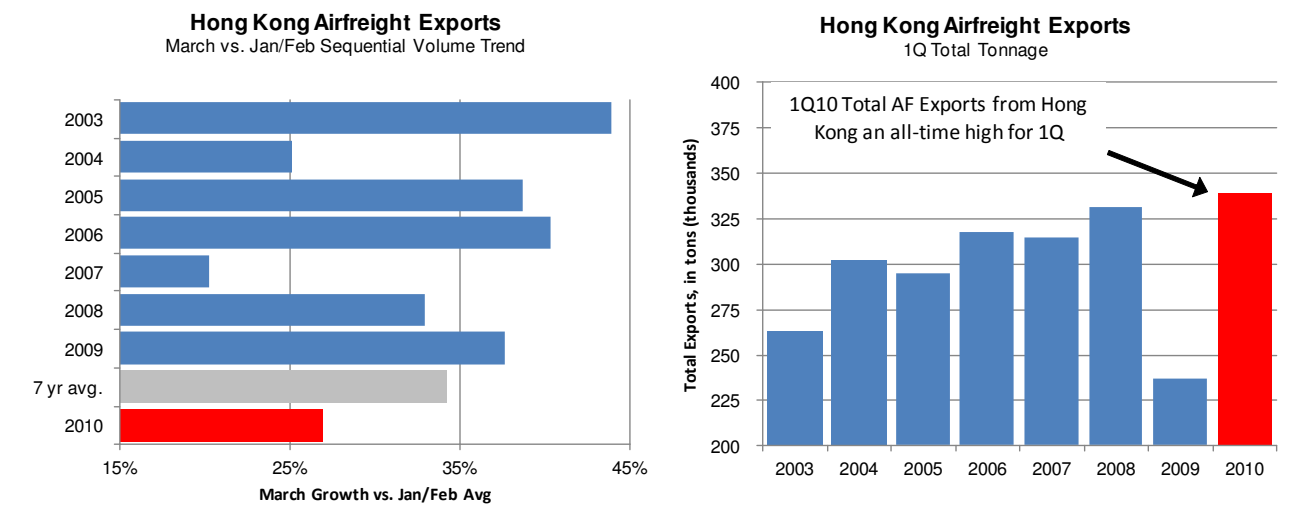
Undoubtedly, some of the perceived improvement is driven by weak demand levels through 2009 and the seasonally weak January and February months. Further, the impact of severe weather conditions in February called into question the sustainability of March's demand improvement, given some of the improvement owed to the "catching up" of freight levels lost due to the storms. But the continuation of above-demand trends and broad-based strengthening bodes well for 2H peak season demand; and healthy demand levels support efforts among carriers to improve rates that remain below adequate levels. **As a result, carrier rates across modes have bottomed, and we expect pricing to accelerate through 2010 and into 2011.** We expect strongest improvement to be realized in the Truckload/Intermodal/Rail space (5%+ pricing in 2H), followed by Parcel (2-4%), with LTL rates positive by 2H10 (2%) but lagging its peers.

Reinforcing of the point of above-seasonal demand strength in 1Q, the left chart below depicts spot truckload demand on a daily basis. Spot demand improved sequentially through March, at a rate faster than that experienced over the previous five years. This trend continued into April. This above-seasonal demand strength, coupled with ongoing truckload capacity rationalization, has helped absorb excess industry capacity. As a result, truckload demand/supply balance has not been this strong since 2004, which is reflected in the 10%+ spot rate increases experienced during 1Q, and supports accelerating core truckload pricing gains through 2010.



Source: Baird estimates

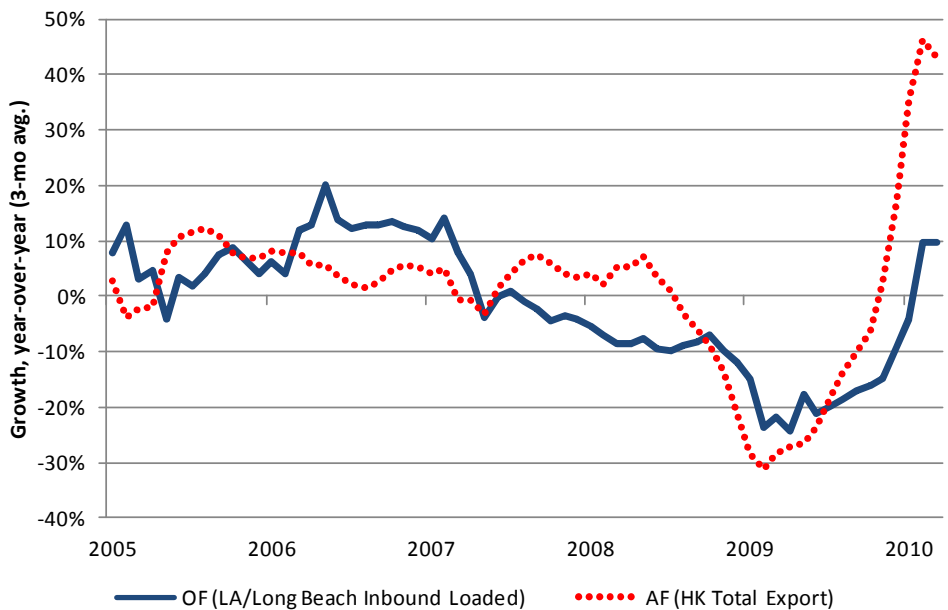
This improvement in domestic demand trends follows the robust improvement in international freight demand, particularly airfreight. The charts below highlight the strength in absolute airfreight volumes from Hong Kong. Though March's seasonal improvement was roughly in line with seasonal averages, year-over-year growth rates remain very strong (given weak 1Q09 levels) and absolute tonnage levels are near all-time highs. To this end, total Hong Kong exports were at an all-time 1Q high during 1Q10, and were up 43% yoy from weak 1Q09 levels. However, Mar-10 tonnages were up 27% from January/February's average, below the 34% average sequential improvement over the previous seven years.



Source: HACTL, Baird estimates

Ocean freight (OF) volumes have similarly begun to show signs of recovery off of weak 2009 levels, but OF volume growth has lagged airfreight (AF) improvement. We attribute the lag in OF trends to its absolute size advantage relative to AF, as well as AF's characteristics (exception and expedited freight mode). More modest growth recovery relative to AF and other domestic modes is modestly concerning, and we will watch near-term OF trends to confirm an international freight recovery, but recent growth trends (including a return to double-digit growth) are encouraging.

OF Volume Growth Lagging AF, But Volumes Recovering



Source: HACTL, Port of LA/Long Beach, Baird estimates

Post-1Q Thoughts

Below we outline our key takeaways by mode following 1Q reporting:

Integrators. The integrators are showing better-than-expected operating leverage in the early phases of the up cycle, reflected in both FDX and UPS' recent quarterly results. International parcel volumes accelerated much faster than domestic, with strength particularly notable out of Asia. Domestic US parcel volume improvement has lagged the International recovery; but, importantly, domestic parcel pricing has firmed in 1Q, consistent with the stated strategy from UPS and FDX. UPS expects domestic parcel pricing to improve throughout 2010, important for sustained margin improvement for both carriers.

We expect parcel volume growth and improved pricing dynamics to drive positive operating leverage during 2010, partially tempered by costs returning to the model to support higher business levels, as both FDX and UPS restore some of the cost initiatives taken during 2009. However, **we believe the overall health of the parcel market to be sustainable, and UPS remains one of our best ideas and we continue to recommend UPS.** We would look to become more constructive on **FDX** into the mid-\$80s. **Cautious F2011 guidance could be the catalyst to create a more attractive buying opportunity for FDX.**

Railroads. The six publically traded Class I rails (CSX, NSC, UNP, CNI, CP, KSU) each produced 1Q upside relative to expectations, as better-than-expected volumes, firmly positive core rate growth, and operational efficiencies drove positive operating leverage. We believe this momentum can continue through 2010. The rail industry is much healthier than previous cycles, owing to core real pricing growth following a multi-decade reduction in industry capacity. As a result, capital returns are higher, and operating leverage is lower. Though costs will return to these models to support additional volumes, limiting operating leverage moving forward, we believe the secular margin expansion story for the rails remains intact. **CSX** remains a best idea, and we like **UNP** at current levels. We would look to become more aggressive on **NSC** in the mid-\$50s.

Truckload. Truckload fundamentals have firmed into 2010, consistent with the group's early-cycle characteristics. Reflective of these firming fundamentals, the group's stock performance outperformed both the broader market and its peers during 1Q10. However, largely in-line results among truckload carriers during 1Q reporting did not meet elevated near-term investor expectations.

However, **we have strong conviction that based on the trajectory of improving demand and pricing during the first four months of 2010, contractual pricing will improve in 2H10.** Spot market rates rose at a 10%+ pace in certain markets during the quarter, indicative of the tightness in capacity and the low base off of which spot rates were operating. Industry fundamentals remain attractive, as the oldest industry fleet age in more than a decade, under-maintained industry fleets, and limited access to capital combine for a potential sustained improvement to industry pricing. We believe **KNX** and **HTLD** are well positioned to capitalize on this looming truckload freight pricing renaissance, which could produce 4-6% annualized pricing growth in upcoming years if demand remains firm.

Intermodal. Though overall rates continued to be pressured by 2009's aggressive bid results, signs emerged during 1Q that suggested more industry pricing discipline within Intermodal. Planned rate increases by UNP and NSC go into effect during 2Q, and importantly during the 2010 bid season, which should support rates as bids are awarded during 2H10. Additionally, tightening truckload capacity and accelerating

truckload pricing growth should support Intermodal rates moving forward. And we expect continued truckload modal conversions to Intermodal, particularly in the Eastern US, given high rail service levels, greater fuel efficiency, and a systemic cost advantage relative to truckload, all of which should support sustained above-market volume growth. We view both **JBHT** and **HUBG** as ways to play this secular Intermodal theme; we like JBHT at current levels, and would be more aggressive buyers of HUBG in the upper-\$20s.

Less-than-truckload. LTL trends continue to lag broader domestic transport trends, typical for this part of the cycle. Additionally, LTL pricing has been pressured by excess capacity, given YRCW's ability to successfully restructure its balance sheet at the end of 2009. However, YRCW's operations continue to struggle; and the unprecedented demand recovery in late 1Q/early 2Q has helped absorb the roughly 15% excess in capacity. Our contacts, coupled with commentary from public LTLs during 1Q reporting, suggest that the sequential build of freight demand since February has been unprecedented. This better-than-expected recovery has helped firm industry pricing more quickly than expected. If demand levels hold, we expect LTLs to realize modest rate growth by 2H10. We recognize Neutral-rated **ODFL** as the best-in-class LTL and a solid holding for long-term buyers. However, given full valuations across the group and lagging fundamentals, we remain cautious overall on LTLs.

International Airfreight and Ocean Freight. AF volume growth remains very healthy, with +43% 1Q volume growth for Hong Kong Total Exports representing a strong harbinger of aggregate airfreight activity. Further, ocean freight growth has turned positive into 2010 in most lanes, aided by stable-to-improving volumes and easy comparisons. However, AF's strength, OF volume stability, and unprecedented domestic US freight improvement in recent weeks bode well for sustained improvement to international demand trends. According to commentary among European freight forwarders, AF yields largely normalized during 1Q following peak 4Q levels. However, OF yields remain pressured by carrier rate restoration efforts, which could pressure OF net revenue levels among forwarders in the near term. That said, we expect 1Q upside from **EXPD** on strong Asian AF levels. And firming international demand and normalizing yields during 2010 support UTIW's turnaround efforts, with progress expected later in 2010. We remain Outperform-rated on **UTIW** and continue to view long-term risk/reward as attractive.

Transport Stocks Outperformed in April

Transports outperformed the broader market during the first two weeks of April and into reporting, powered by commentary regarding industry fundamentals firming at an above-seasonal pace. However, limited near-term (i.e., 1Q) upside during reporting led to in-line performance, as the trough and broader market were roughly flat during April's final two weeks. For the full month, each mode outperformed the broader market; LTLs (+9%), 3PLs (+7%), Rails (+4%), Integrators (+3%) and TLs (+2%) each better than the S&P 500 (+1%). A complete chart of stock performance is shown below:

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Ticker	Name	Rating	04/30/10 Price	Trading Performance						
				Last 2 Wks	First 2 Wks	Apr	1Q	YTD	2009	2008
Integrator Index				(2%)	5%	3%	12%	13%	13%	(24%)
UPS	United Parcel Service	O	69.14	0%	7%	7%	12%	21%	4%	(22%)
FDX	FedEx Corp	N	90.01	(6%)	2%	(4%)	12%	8%	30%	(28%)
Railroad Index				(2%)	6%	4%	9%	14%	35%	(20%)
UNP	Union Pacific	O	75.66	(2%)	5%	3%	15%	18%	34%	(24%)
NSC	Norfolk Southern	N	59.33	(2%)	8%	6%	7%	13%	11%	(7%)
CSX	CSX	O	56.05	1%	9%	10%	5%	16%	49%	(26%)
CNI	Canadian National	NR	59.79	(6%)	5%	(1%)	11%	10%	48%	(22%)
CP	Canadian Pacific	NR	58.86	0%	5%	5%	4%	9%	61%	(48%)
KSU	Kansas City Southern	NR	40.55	4%	8%	12%	9%	22%	75%	(45%)
RA	RailAmerica	NR	12.89	(1%)	10%	9%	(3%)			
GWR	Genesee & Wyoming	NR	39.10	5%	9%	15%	5%	20%	7%	26%
Third-Party Logistics Index				0%	7%	7%	3%	11%	6%	(12%)
EXPD	Expeditors Intl	N	40.71	2%	8%	10%	6%	17%	5%	(26%)
CHRW	C.H. Robinson	N	60.32	2%	6%	8%	(5%)	3%	7%	2%
JBHT	J.B. Hunt Transportation	O	36.80	(2%)	5%	3%	11%	14%	23%	(5%)
LSTR	Landstar	N	44.22	(3%)	8%	5%	8%	14%	1%	(9%)
UTIW	UTi Worldwide	O	15.84	(8%)	13%	3%	7%	11%	(0%)	(27%)
HUBG	Hub Group	O	32.01	0%	14%	14%	4%	19%	1%	(0%)
FWRD	Forward Air Corp	N	28.02	1%	6%	7%	5%	12%	3%	(22%)
PACR	Pacer International	N	6.64	(2%)	13%	10%	91%	110%	(70%)	(29%)
ECHO	Echo Global Logistics	NR	13.49	(1%)	5%	4%	2%			
UACL	Universal Truckload	NR	18.26	(2%)	6%	4%	(3%)	1%	28%	(26%)
Leasing										
R	Ryder	N	46.52	6%	13%	20%	(6%)	13%	6%	(18%)
TAL	TAL International Group	N	25.99	18%	10%	30%	51%	96%	(6%)	(38%)
Truckload Index				(1%)	3%	2%	13%	15%	10%	5%
WERN	Werner Enterprises	N	22.42	(6%)	3%	(3%)	17%	13%	14%	2%
HTLD	Heartland Express	O	16.52	1%	(1%)	0%	8%	8%	(3%)	11%
KNX	Knight Transportation	O	21.29	(0%)	1%	1%	9%	10%	20%	9%
CGI	Celedon Group	NR	14.93	(1%)	9%	7%	28%	38%	27%	(7%)
MRTN	Marten Transport	NR	21.85	3%	8%	11%	10%	22%	(5%)	36%
USAK	USA Truck	NR	18.42	4%	10%	14%	29%	47%	(9%)	(10%)
CVTI	Covenant Transportation	NR	7.40	5%	17%	23%	43%	76%	111%	(70%)
LTL Index				(3%)	12%	9%	(3%)	17%	17%	(26%)
CNW	Con-way	N	38.84	(1%)	12%	11%	1%	11%	31%	(36%)
YRCW	YRC Worldwide	U	0.56	(16%)	23%	3%	(35%)	(33%)	(71%)	(83%)
ODFL	Old Dominion	N	35.88	(4%)	12%	7%	9%	17%	8%	23%
ABFS	Arkansas Best	U	30.54	1%	1%	2%	2%	4%	(2%)	37%
SAIA	Saia	NR	16.57	7%	12%	19%	(6%)	12%	36%	(18%)
VTNC	Vitrans Corporation	NR	15.24	9%	16%	26%	11%	40%	74%	(56%)
SPX	S&P 500			(2%)	4%	1%	5%	6%	23%	(38%)

* Indices are market-cap weighted.

Source: FactSet, Baird estimates

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