

Industrial Research

March 19, 2015

2015 US Economic & Transportation Industry Outlook

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Three Key Focal Points

1. 2014: The year of pricing growth's "inflection"

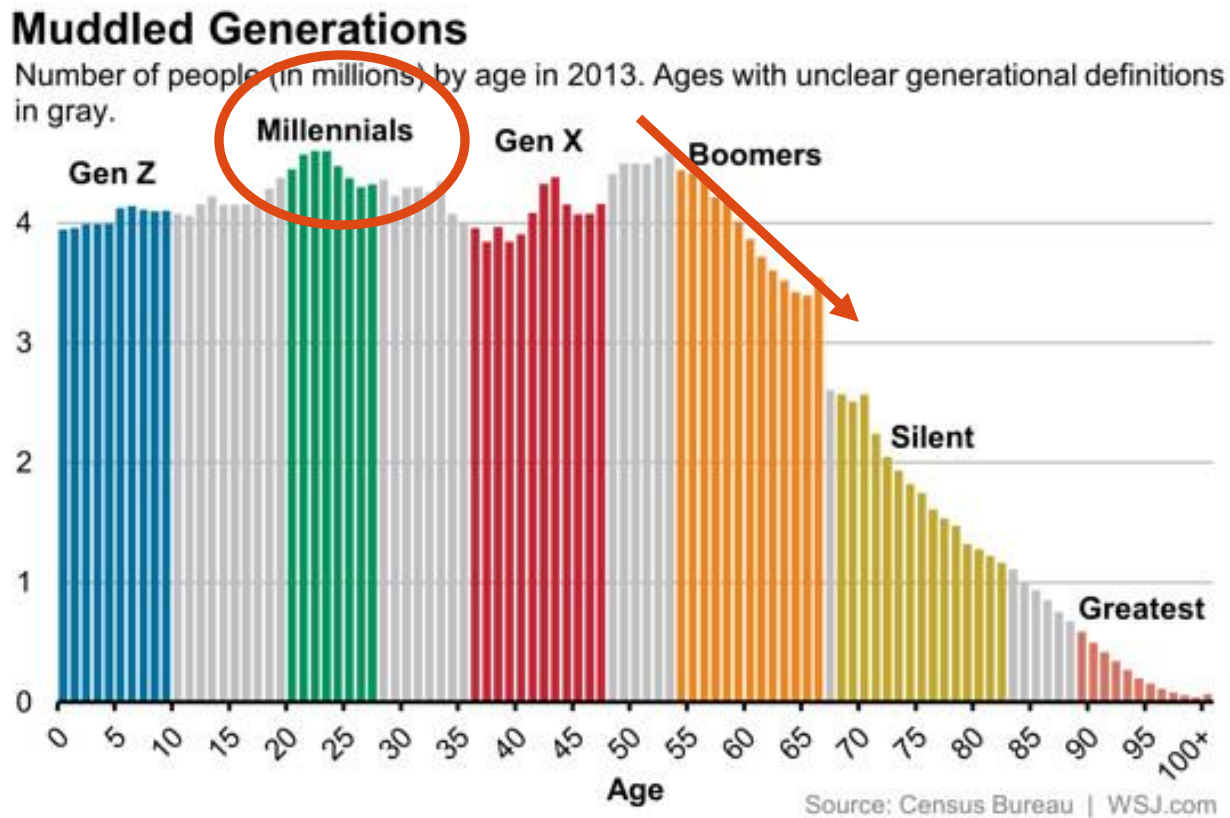
2. 2015: The year of "real" pricing growth
 - Volume growth: all eyes on the consumer

3. Trends affecting supply chain management this cycle
 - Regulations
 - Demographics
 - Technology

Shifting US Demographics Affect Both Growth & Supply Chain Strategies



“2015 is the year of the millennial customer” -- Forbes



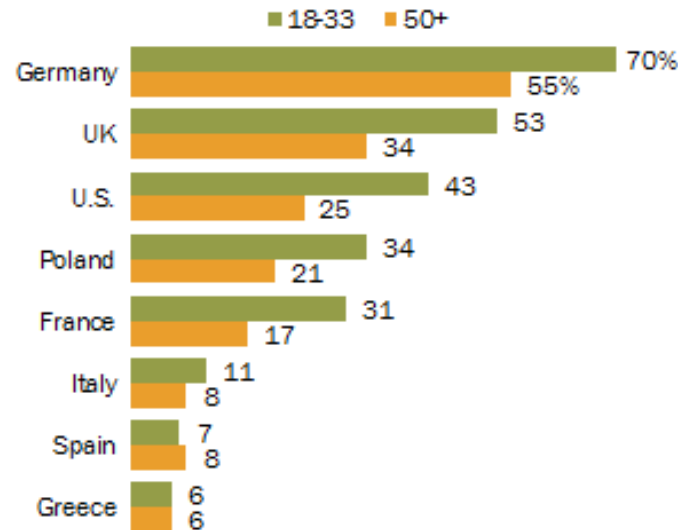
Shifting US Demographics Affect Both Growth & Supply Chain Strategies



Millennials' outlooks differ from Baby Boomers', too.

Millennials More Satisfied than Their Elders with Country Direction

Satisfied with the way things are going in our country today



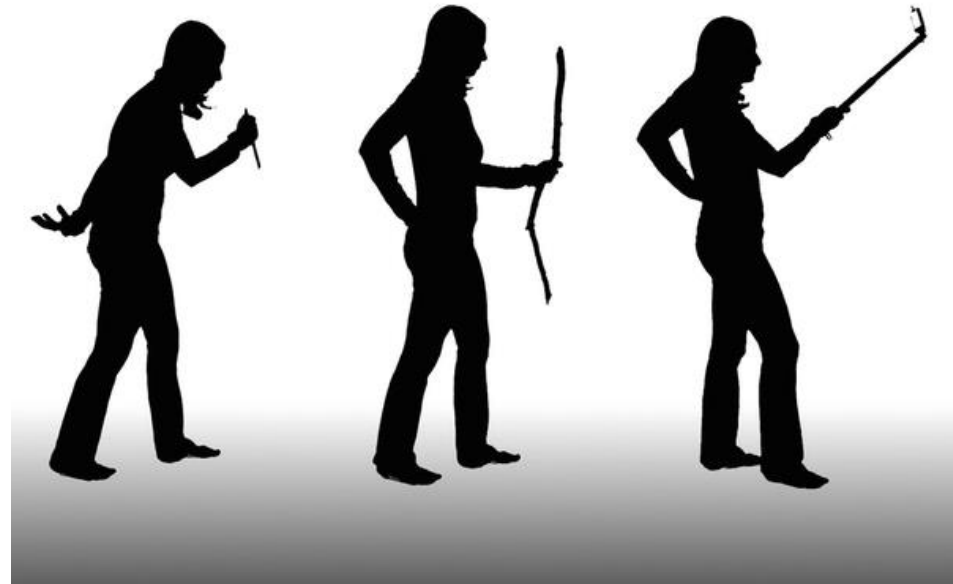
Source: Spring 2014 Global Attitudes survey.

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What We're Not Discussing: Millennials' Clothing...



...Or Other Forms of Self Expression



The Original Selfie?



A Look Back at an Eventful 2014

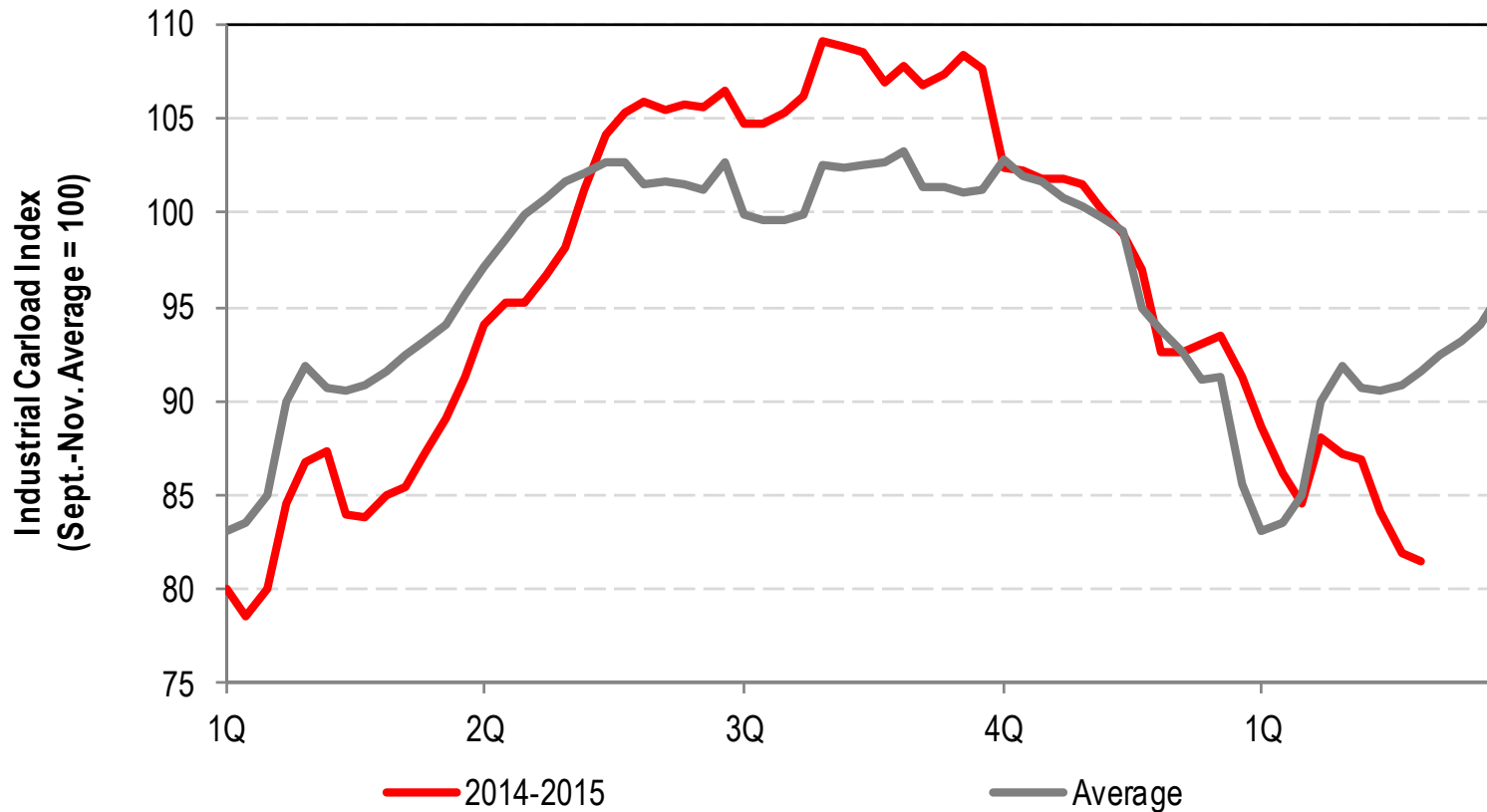
The tightest truckload market in a decade, triggered by:

1. The July 2013 drivers' hours-of-service modifications (**regulations**)
2. B2C's development and the 2013 peak season
3. Numerous winter weather events
4. Sharp recovery in demand beginning late 1Q14
5. Worsening driver shortage (**demographics**)
6. Rail service erosion (caused by factors 3 and 4)
7. US West Coast port labor dispute

Severe Winter Weather Hampered 1Q14, But Volumes Snapped Back in 2Q



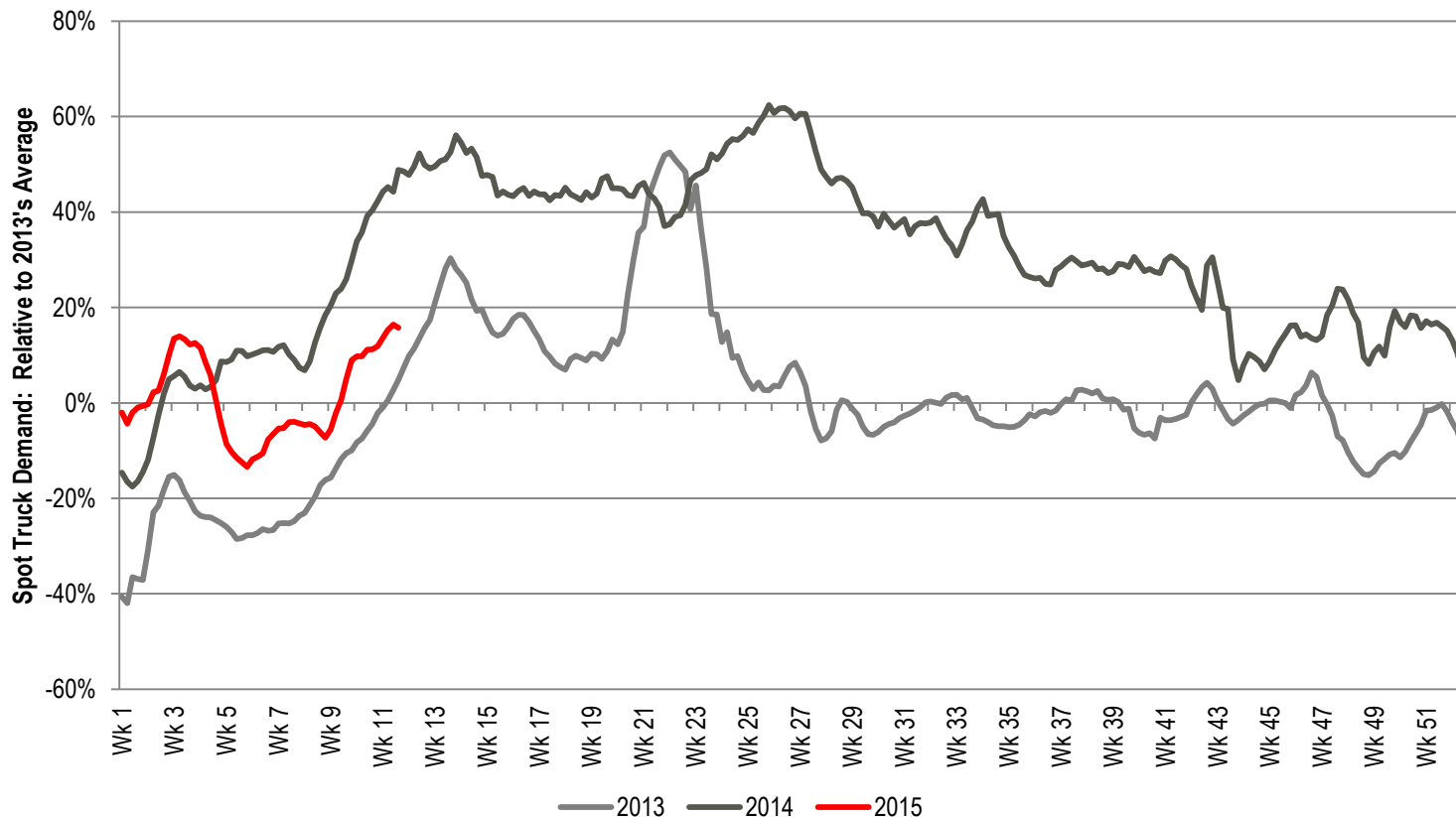
Notice the return to “normal” seasonal patterns in 2H14 and into 2015



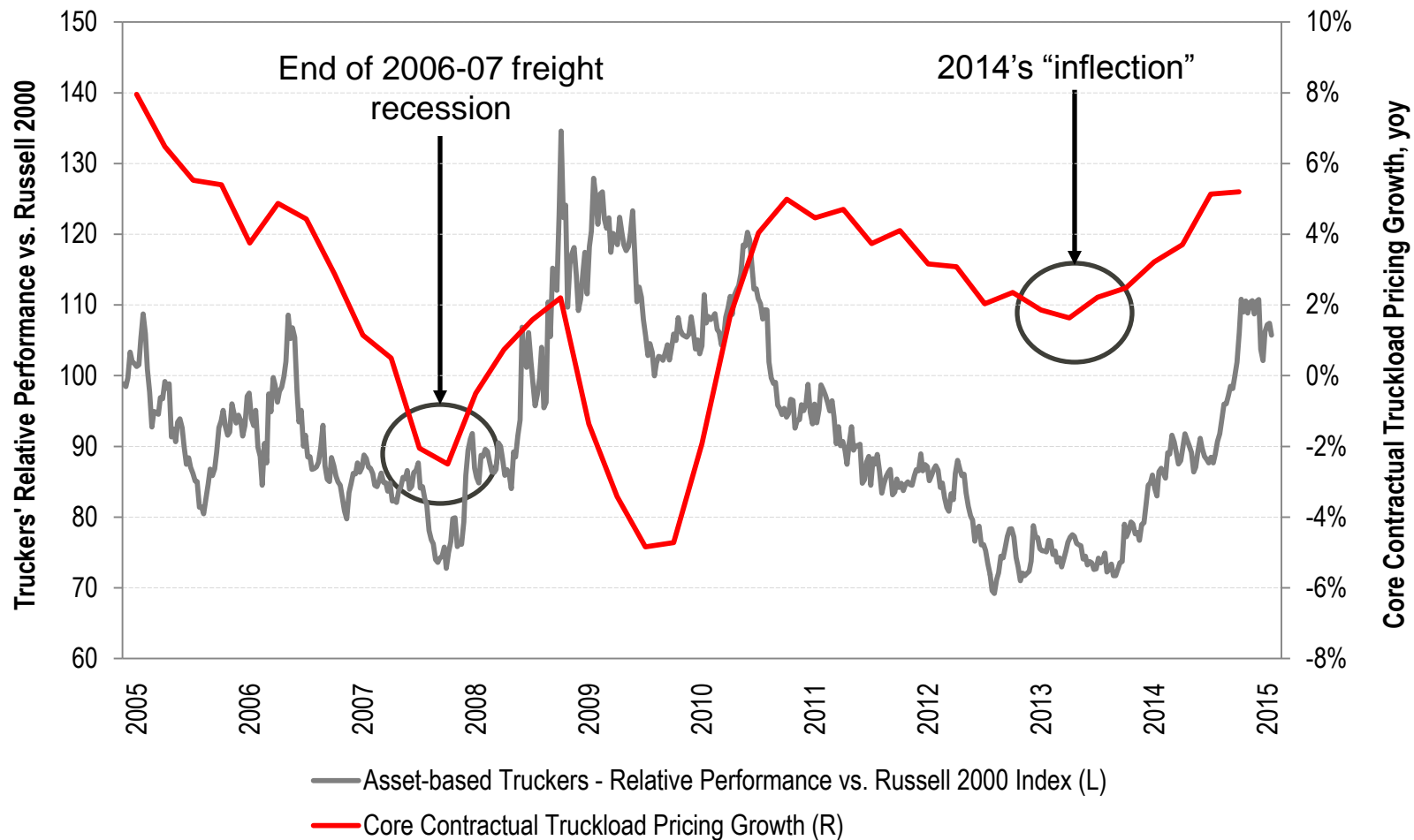
The Net Result: Truckload Tightness Throughout 2014...



2014 spot demand was 30% higher than 2013 levels – but notice the normalization during 2H14 (which has continued into 2015).



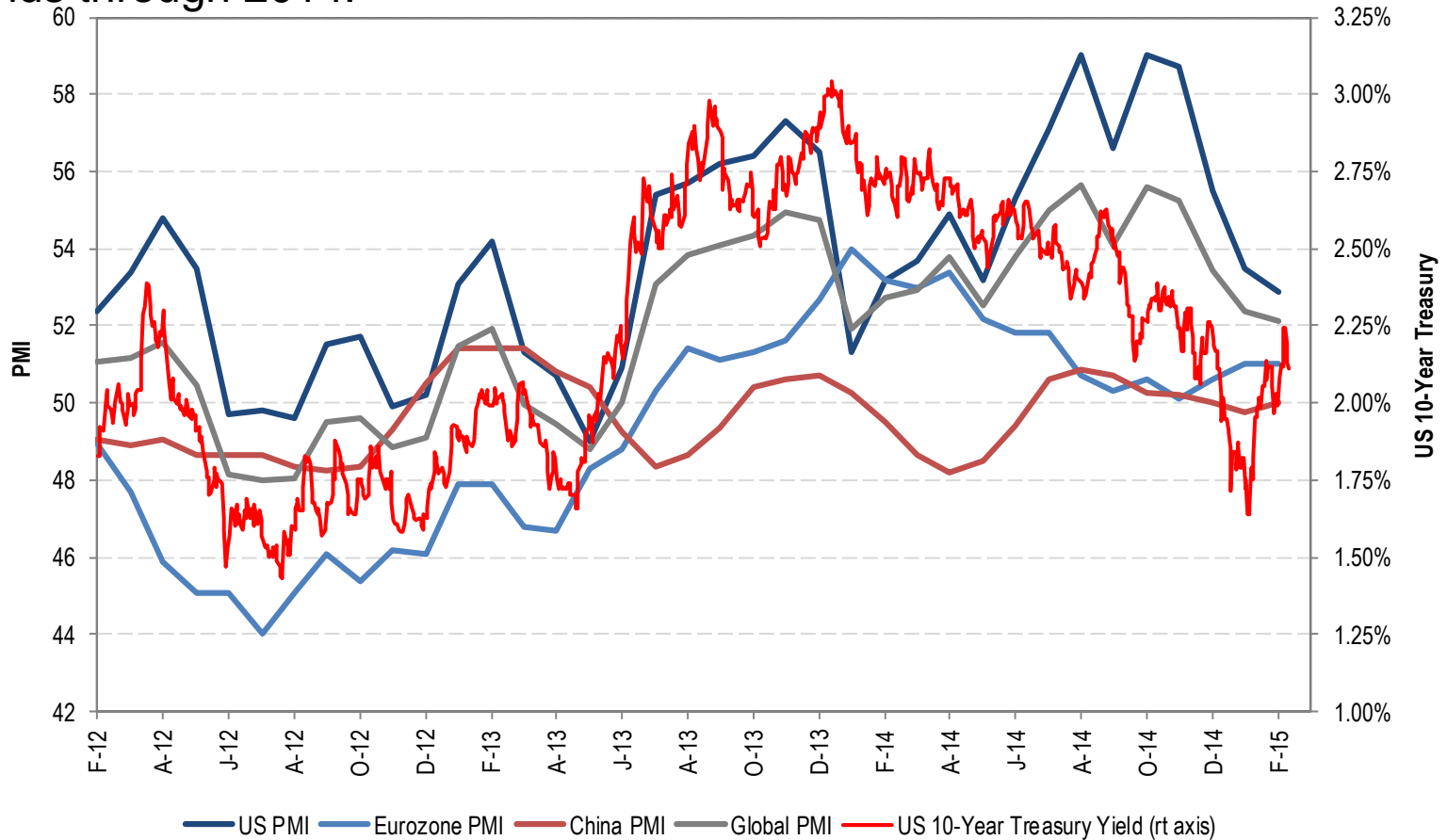
The Net Result: ...And a Pricing Growth “Inflection”



A Quick Look at 2015's Economic Landscape



The decline in yields (US and globally) consistent with slowing global growth trends through 2014.



A Quick Look at 2015's Economic Landscape

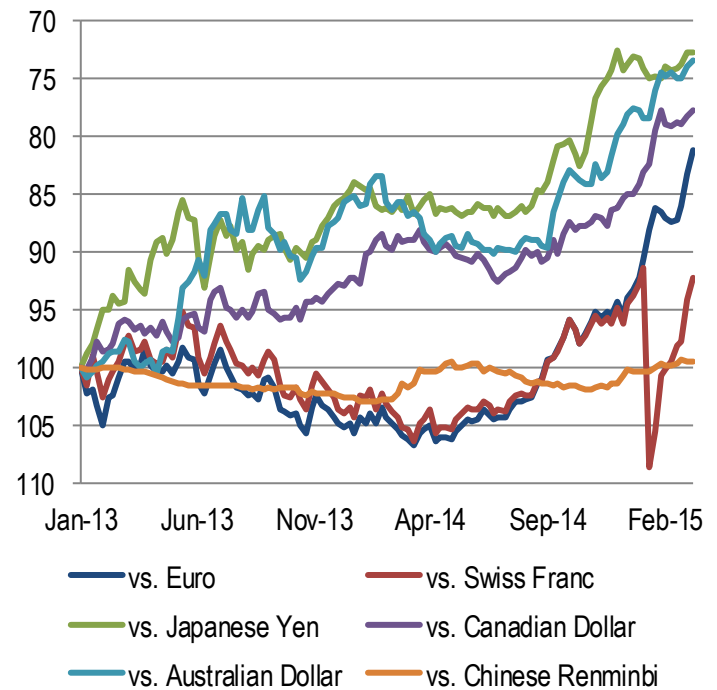


Two focal points into 2015:

Crude's Weakness



US Dollar's Strength



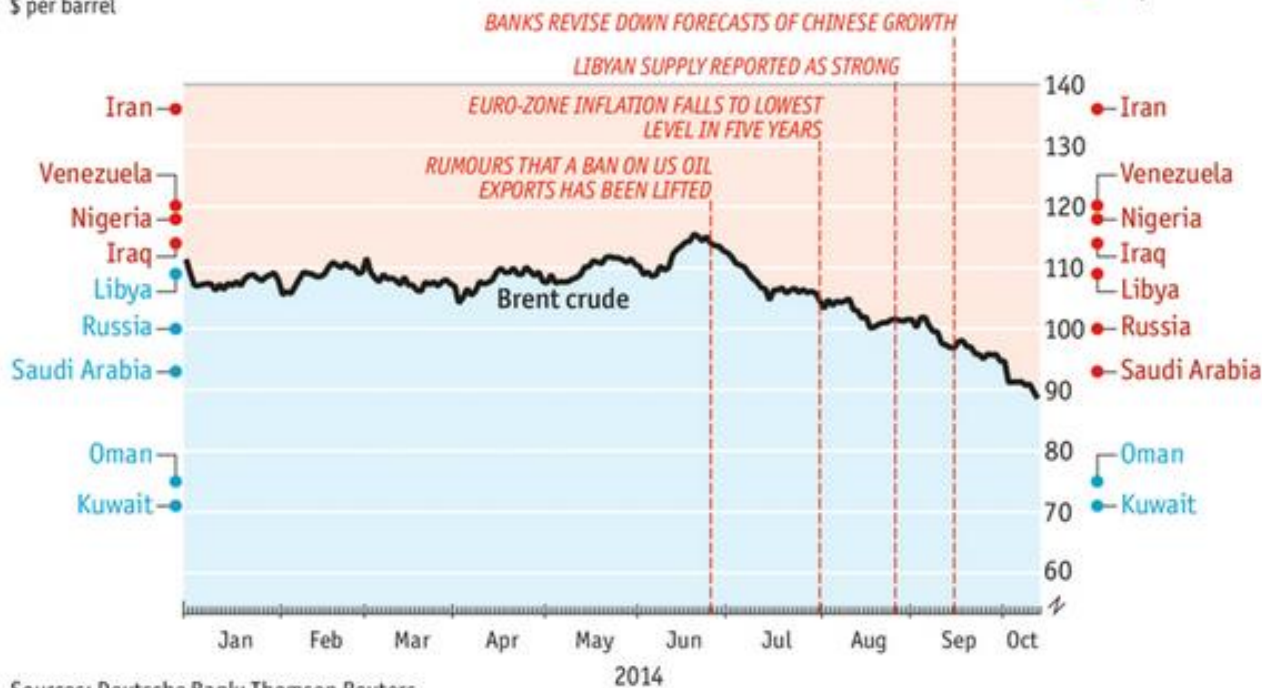
A Quick Look at 2015's Economic Landscape

Crude's collapse and the US dollar's strengthening creates emerging market risk (see below) and favors a healthier US consumer in 2015.

Breakeven prices

Oil price at which national budget breaks even from income and taxes
\$ per barrel

Budget: ● deficit
● surplus



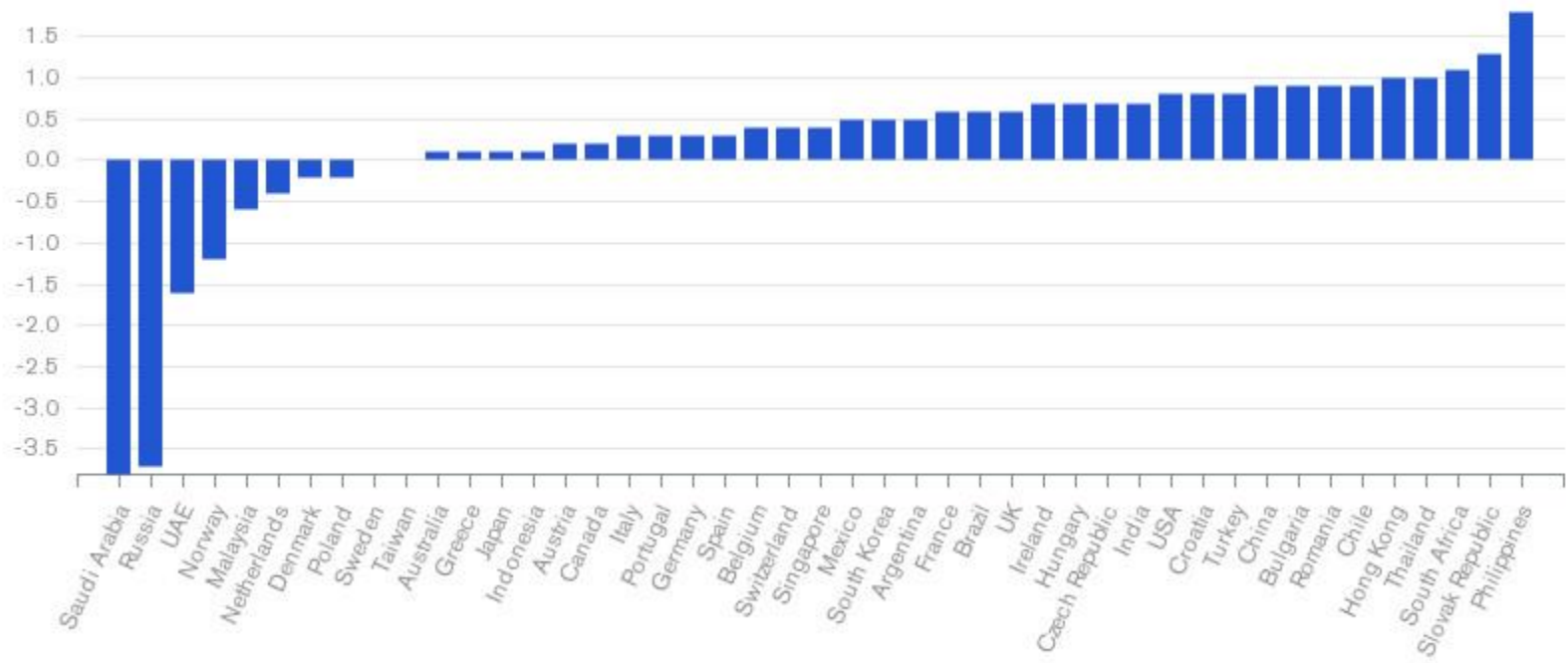
Sources: Deutsche Bank; Thomson Reuters

A Quick Look at 2015's Economic Landscape



This is Your World on \$40 Oil

Effect on GDP growth in 2015-'16 of oil at \$40 a barrel vs. \$84

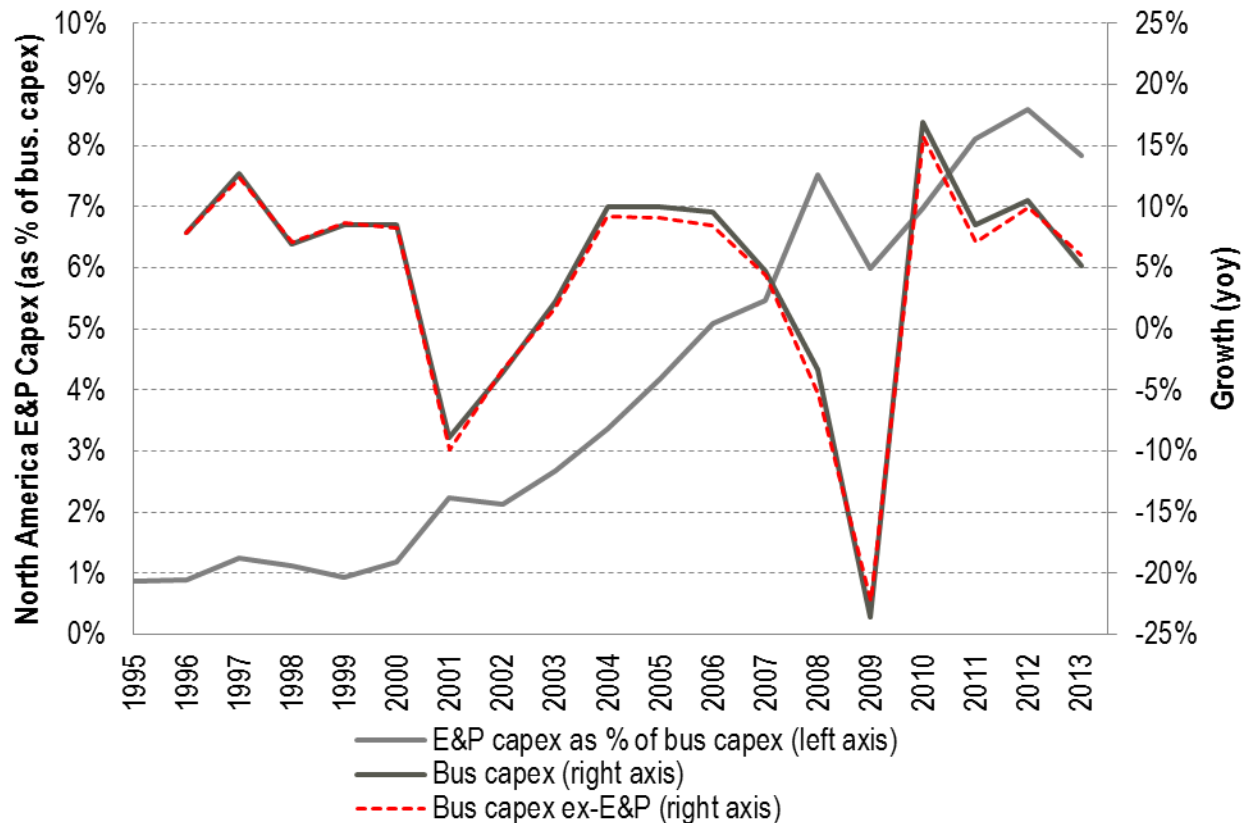


Source: Oxford Economics Ltd.



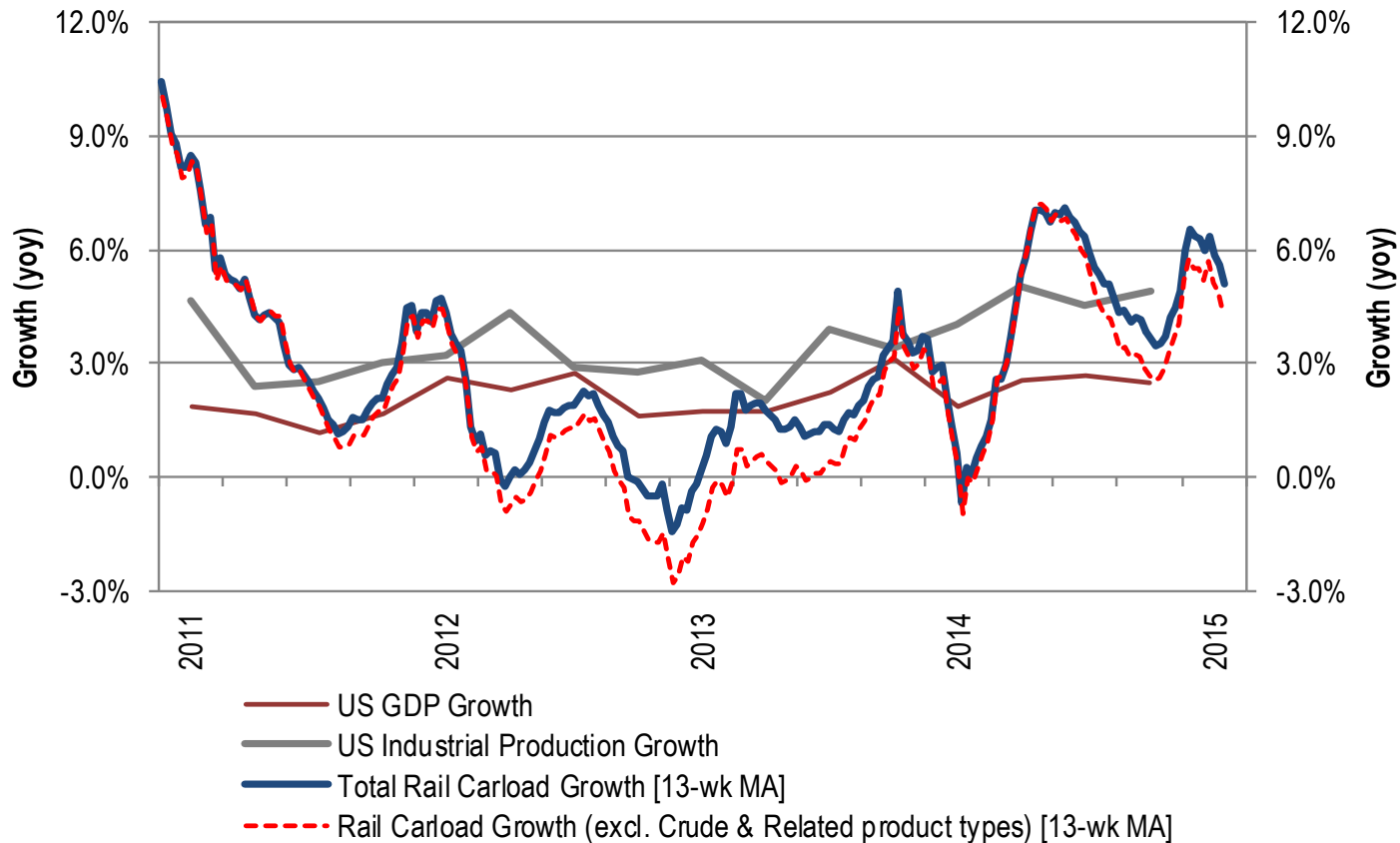
Oil's Decline a 2015 Growth Headwind

Energy Exploration & Production (E&P) capital expenditures (as a percent of total US business capex) have risen this cycle, but capex growth (ex-E&P) is only marginally affected.



Oil's Decline a 2015 Growth Headwind

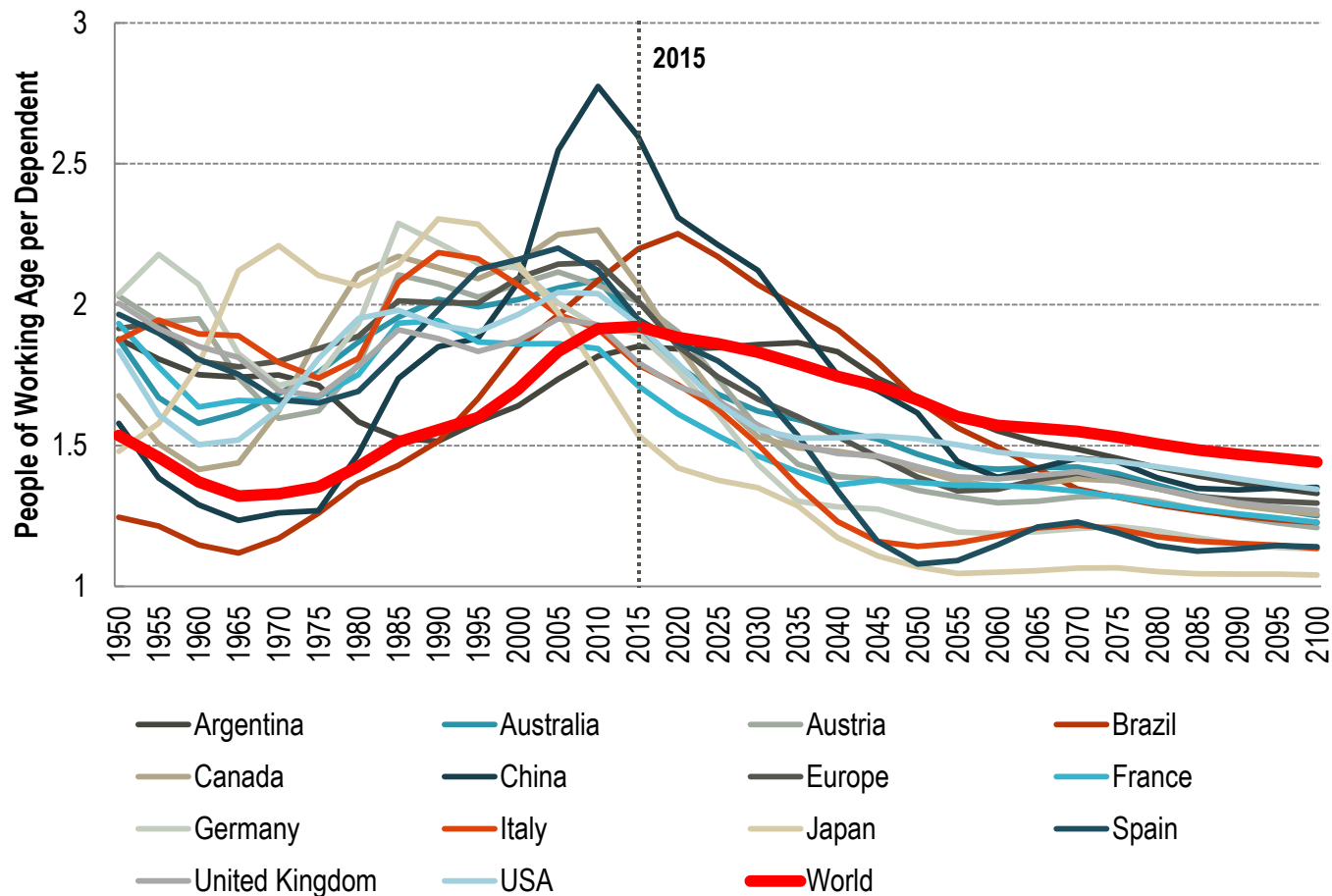
A similar story holds true for transportation (i.e., rail) volume growth this cycle. Despite healthy growth in Crude & Related products (~+7% p.a. in aggregate since 2010), rail carload growth (ex-crude) has remained solidly positive.



2015 Demand Risk Not Just About Oil



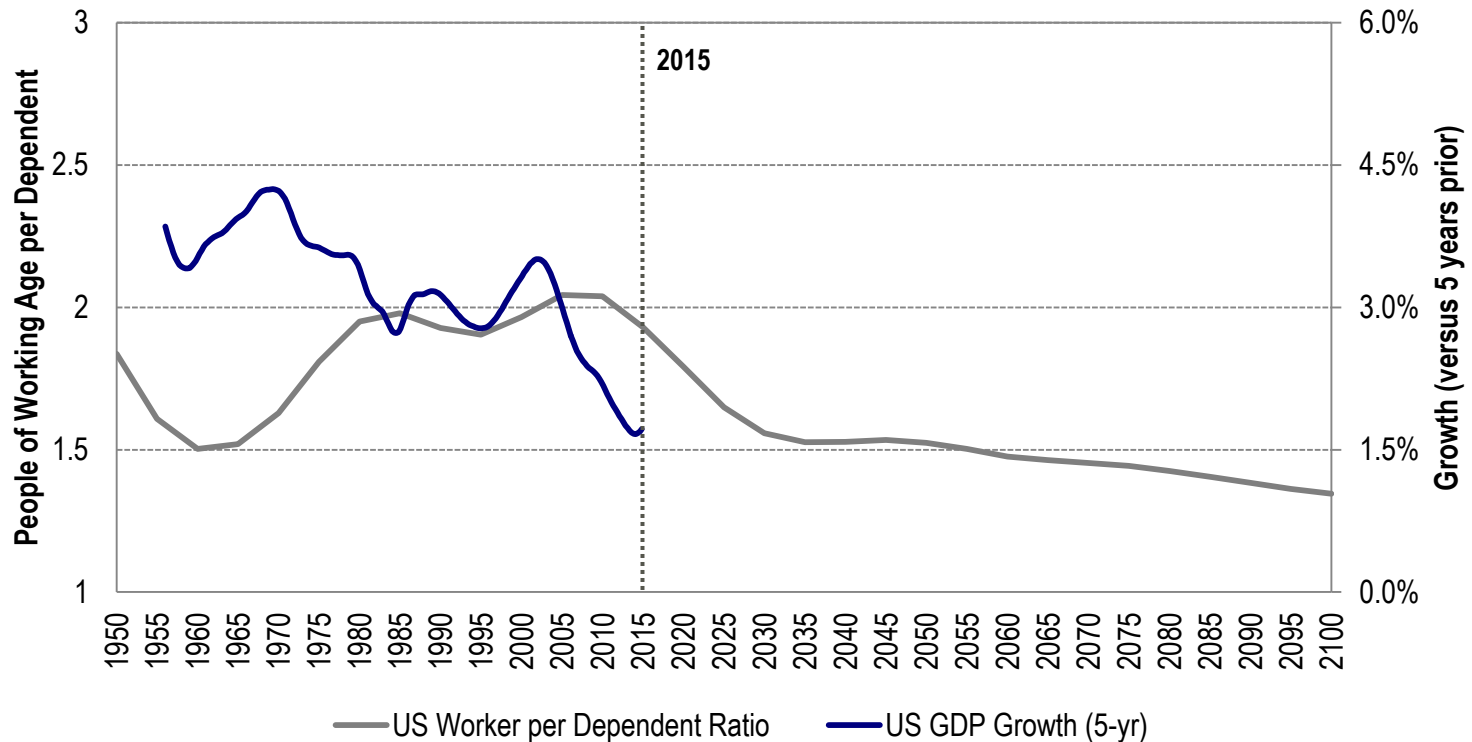
Demographics matter, too.



2015 Demand Risk Not Just About Oil



US growth since WWII heavily influenced by demographics.



The Long Baton Toss to the Consumer Creates 2015 Growth Risk...



Volume growth will likely decelerate in 2015 – and specifically beginning in 2Q as prior-year growth comparisons strengthen.

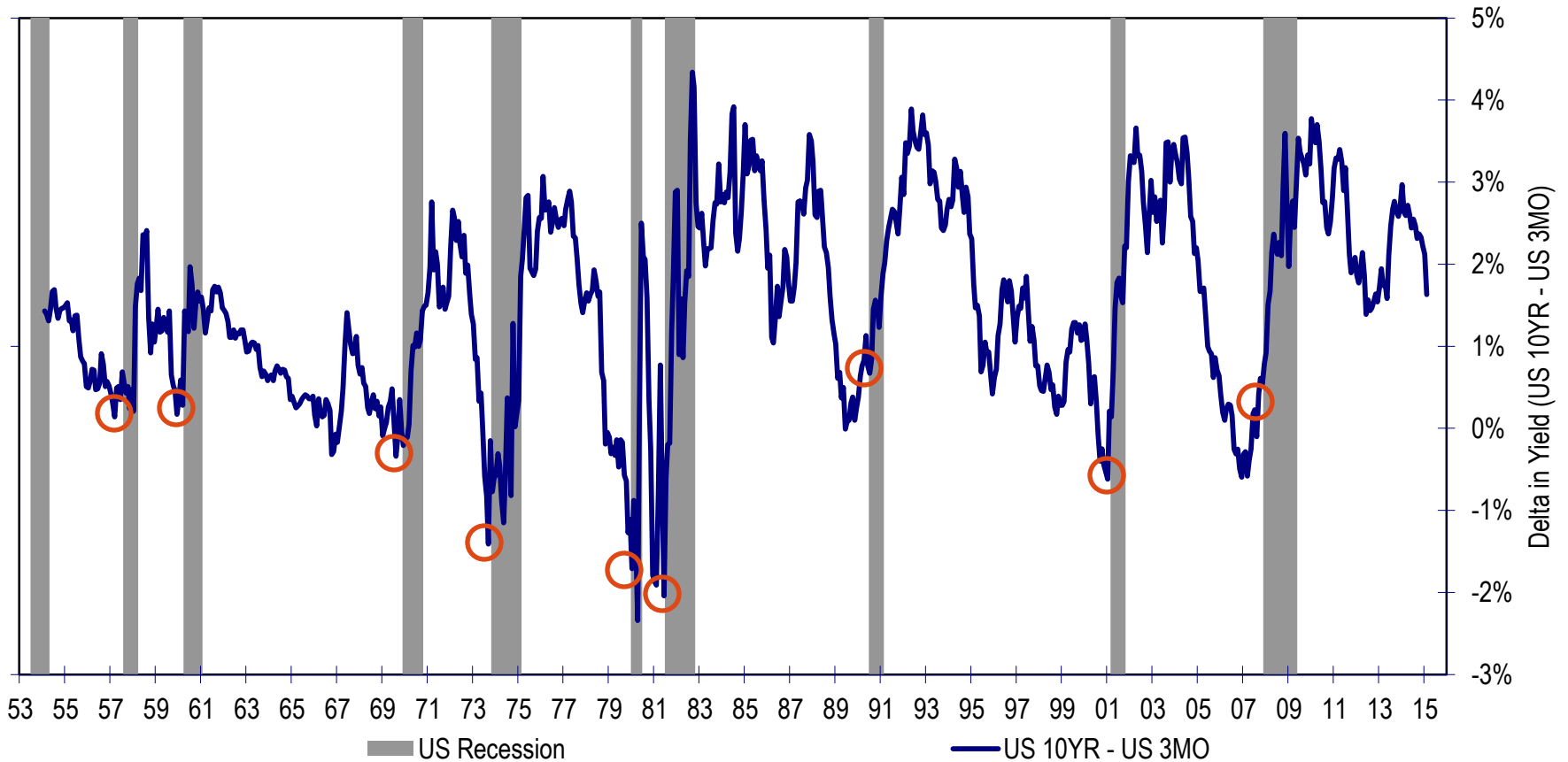
RAILROAD VOLUME GROWTH BY RAIL, COMMODITY (1Q13 - 2Q15P)

	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	1QTD	RWB Estimates	
										1Q15E	2Q15E
Total Cars & Intermodal											
BNI	4.2%	3.6%	4.6%	5.8%	1.0%	4.9%	-1.0%	2.8%	-0.4%		
CNI	3.3%	2.3%	2.3%	3.0%	0.4%	11.0%	10.8%	10.2%	9.8%		
CP	2.2%	3.9%	-2.2%	1.4%	-7.0%	3.4%	1.2%	0.4%	2.6%		
CSX	-1.6%	1.0%	2.6%	6.1%	2.9%	7.6%	6.9%	6.0%	1.2%	3.2%	0.4%
NSC	3.9%	2.1%	3.4%	3.9%	-1.2%	8.1%	7.6%	3.7%	1.8%	4.3%	1.5%
UNP	-1.4%	-0.6%	-0.6%	1.5%	5.1%	8.3%	7.0%	6.9%	-2.4%	3.3%	3.1%
KSU	2.6%	2.9%	3.1%	2.1%	3.2%	7.4%	4.3%	5.2%	2.0%		
TOTAL	1.4%	1.5%	1.9%	3.6%	1.2%	6.8%	4.8%	5.1%	1.8%		
Commodity Totals											
Ag	-7.6%	-5.9%	-6.7%	5.2%	5.2%	15.6%	8.9%	1.0%	5.1%	4.6%	-2.9%
Auto	0.0%	2.9%	4.2%	6.2%	-3.4%	5.3%	8.3%	0.3%	0.7%	3.0%	-0.5%
Chemical	13.2%	10.6%	4.7%	6.4%	1.7%	3.8%	8.6%	5.9%	4.6%	4.4%	2.1%
Coal	-6.4%	-0.6%	-1.9%	-4.0%	-1.0%	3.1%	-2.6%	3.9%	-0.5%	0.1%	-2.7%
Industrial	-0.3%	-0.4%	4.2%	0.8%	-4.1%	5.1%	6.4%	11.0%	5.7%	6.3%	0.6%
Intermodal	5.1%	2.4%	3.4%	6.7%	3.4%	8.3%	5.6%	4.6%	0.4%	-0.4%	0.6%
TOTAL	1.4%	1.5%	1.9%	3.6%	1.2%	6.8%	4.8%	5.1%	1.8%	1.7%	-0.9%

*1Q15 and 2Q15 projections based on Week 1-7 totals against 1Q and 2Q historical sequential trends from 2000-2014

...And This Recovery Is Extended...

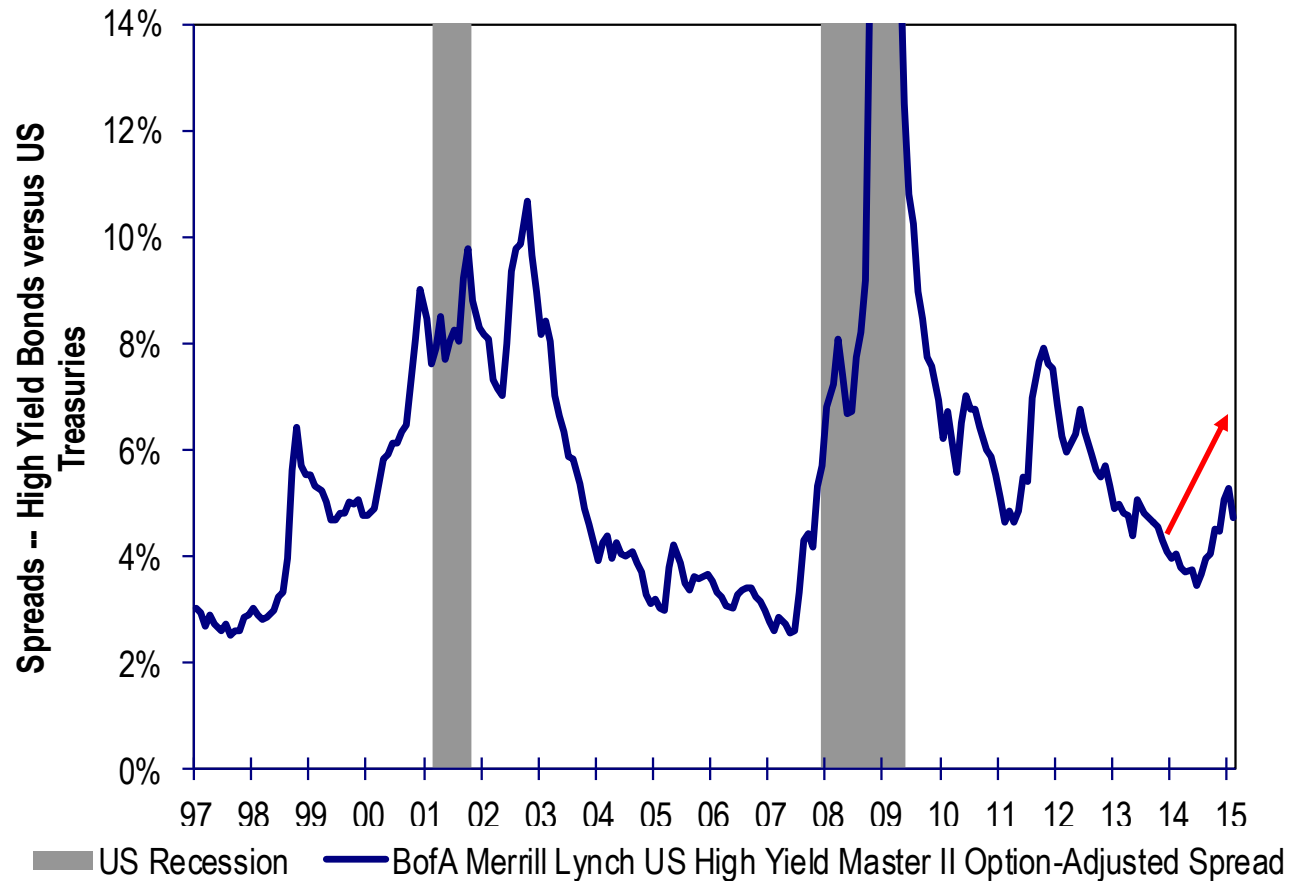
US Treasury yield curve hasn't inverted, but it is flattening...



...And This Recovery Is Extended...



...And spreads between high-yield bonds and US Treasuries are widening.



...But There's Room to Go



US Industrial Production trends, since WWII, suggest more room for growth this recovery.

Peak	Trough	Peak-to-Peak Duration (months)	Peak-to-Peak Growth
February-45	October-45	45	-10%
November-48	October-49	56	36%
July-53	May-54	49	11%
August-57	April-58	32	8%
April-60	February-61	116	65%
December-69	November-70	47	18%
November-73	March-75	74	12%
January-80	July-80	18	-1%
July-81	November-82	108	21%
July-90	March-91	128	45%
March-01	November-01	81	11%
Average		69	20%
December-07	June-09	86	5%*

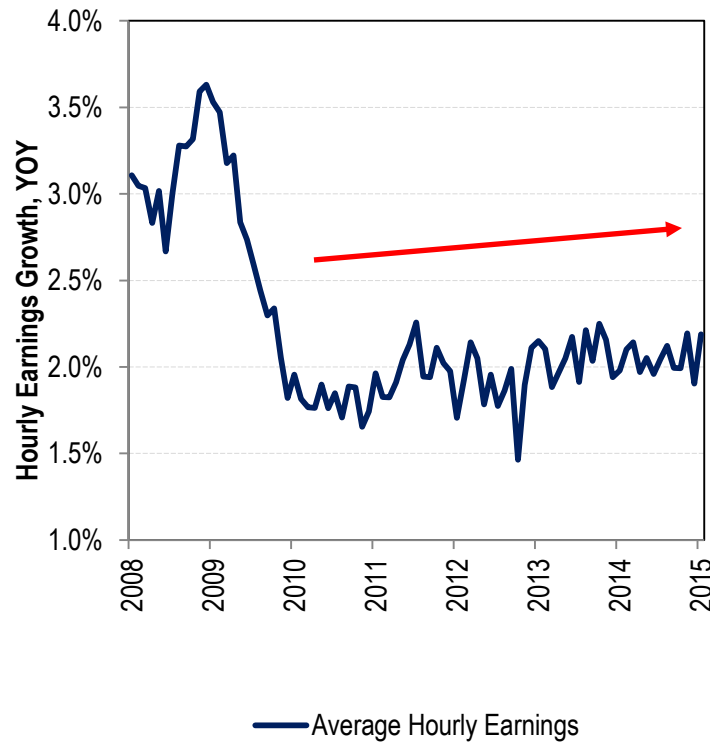
*Through 1/31/15

Hope/Optimism for Consumer-Led, US-Centric Growth in 2015

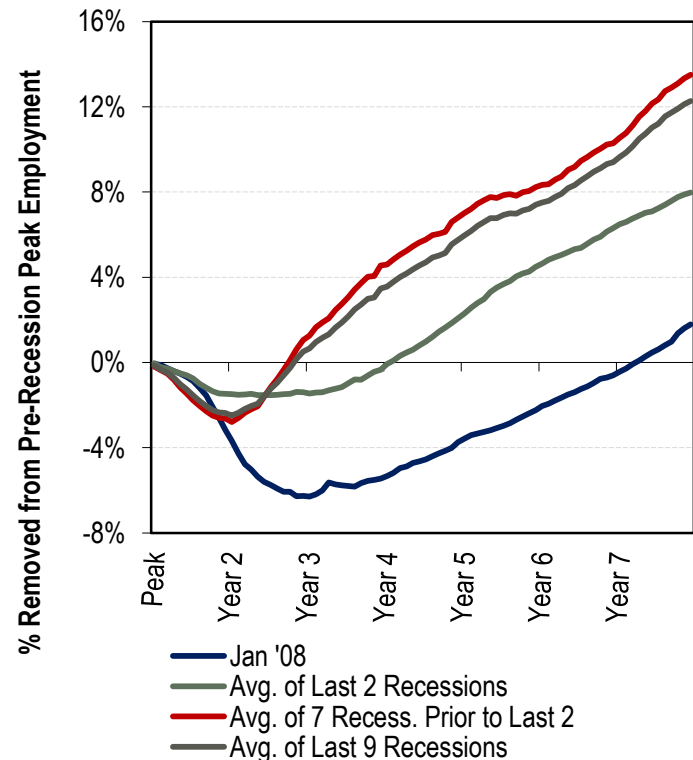


Signs of progress in the US this recovery; watch for accelerating wage growth.

Hourly Wage Growth



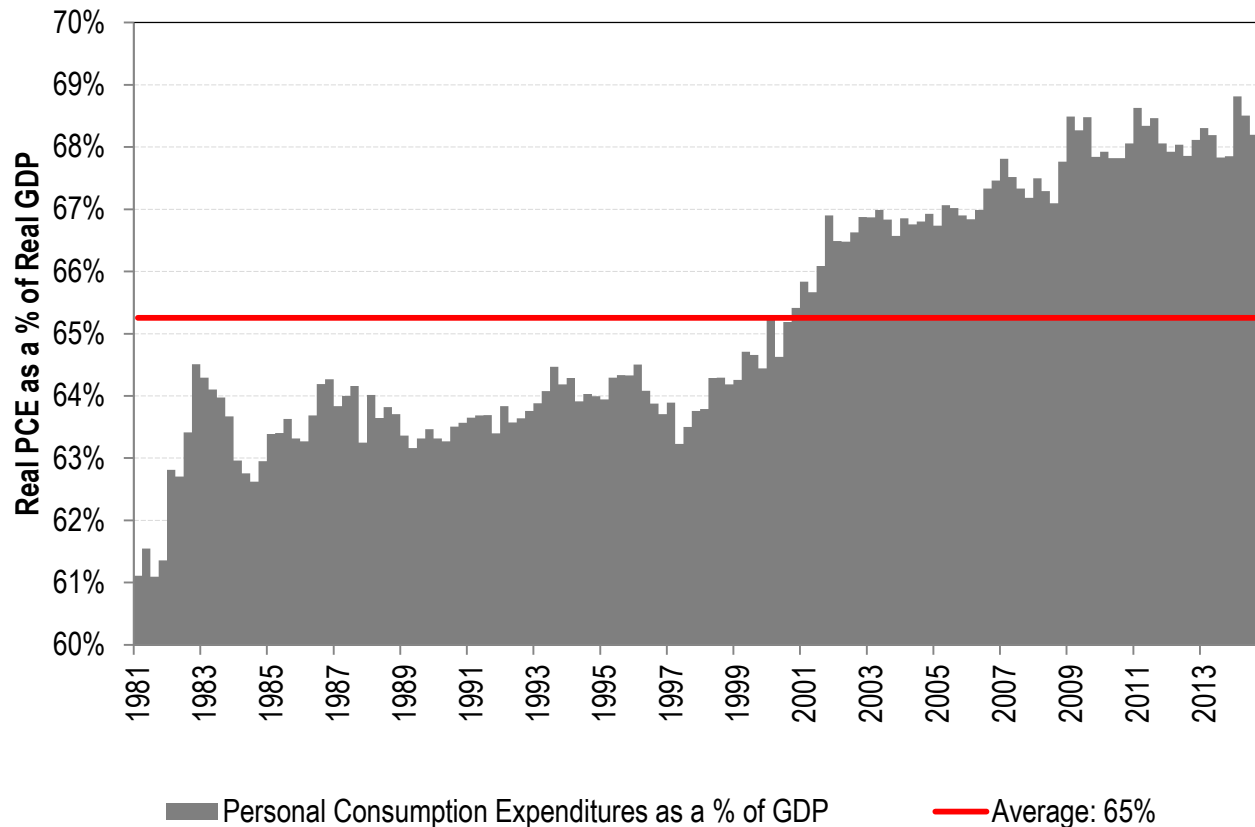
US Employment



Hope/Optimism for Consumer-Led, US-Centric Growth in 2015

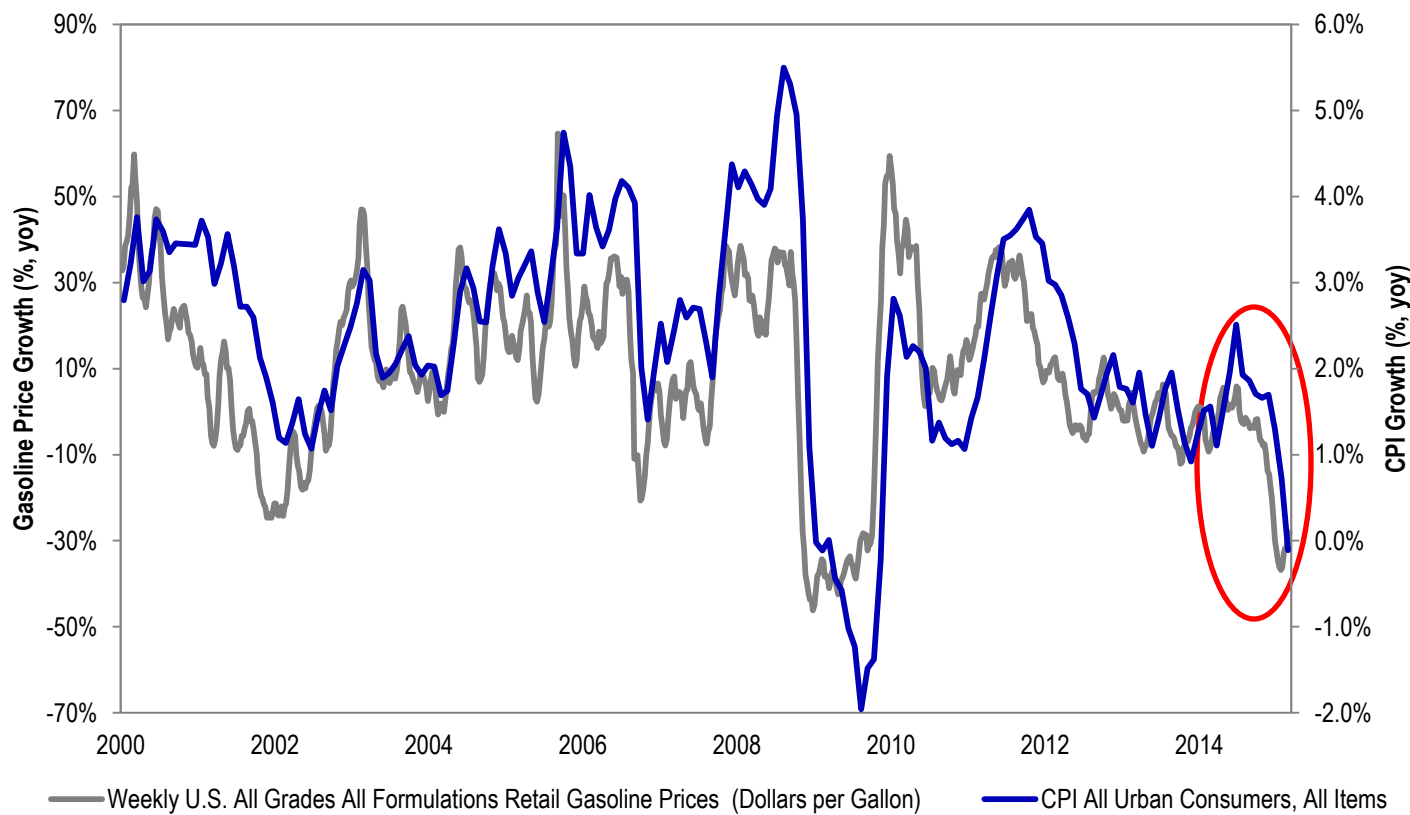


Don't discount the US consumer.



Hope/Optimism for Consumer-Led, US-Centric Growth

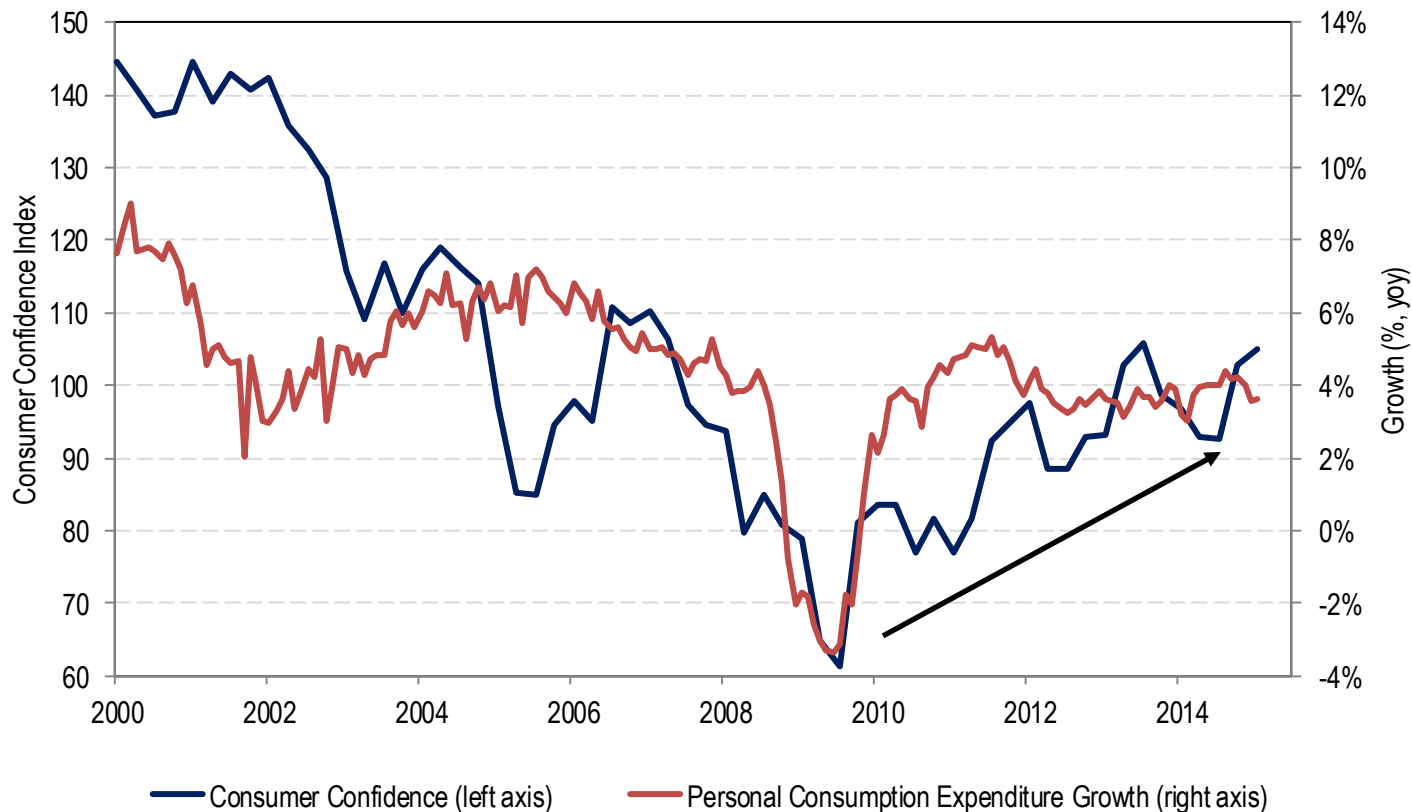
Falling fuel prices no doubt add to disinflationary/deflationary pressures, but they bring positive implications to the consumer...



Hope/Optimism for Consumer-Led, US-Centric Growth



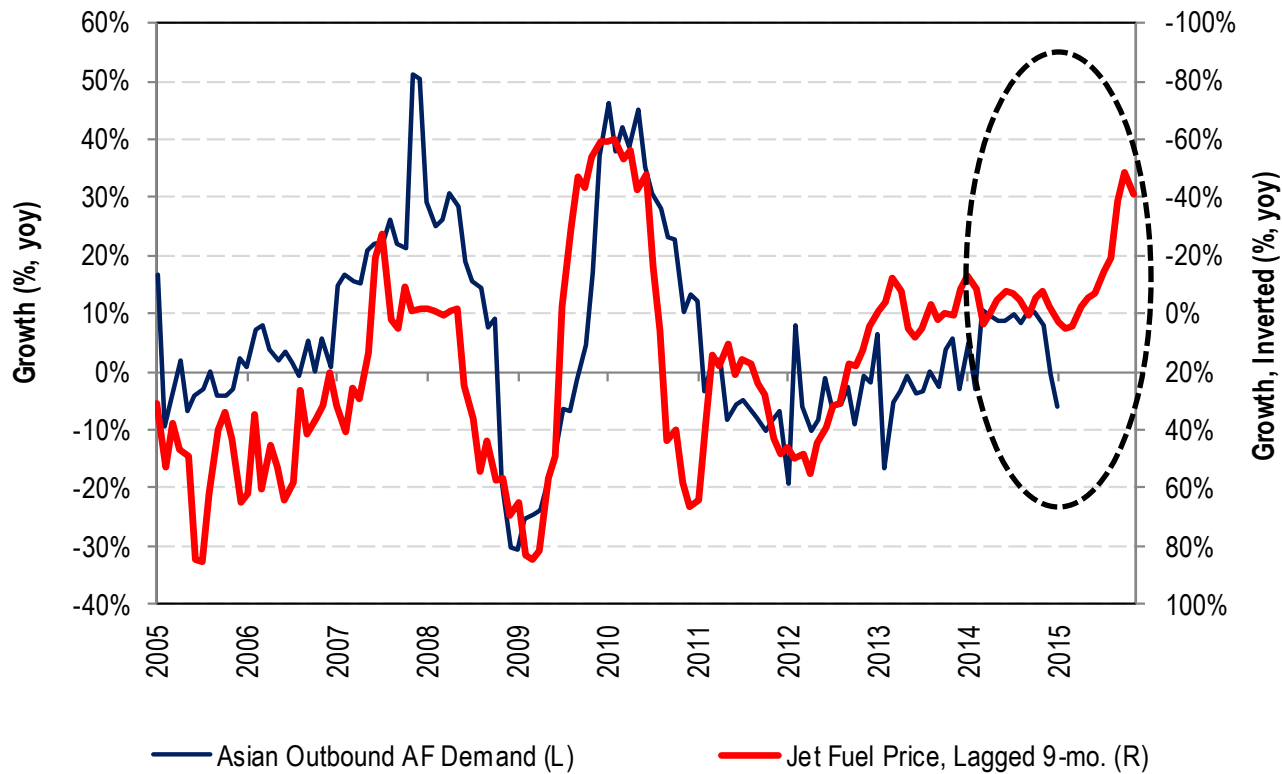
...Supported by both rising consumer confidence and accelerating personal consumption expenditure growth.



Hope/Optimism for Consumer-Led, US-Centric Growth



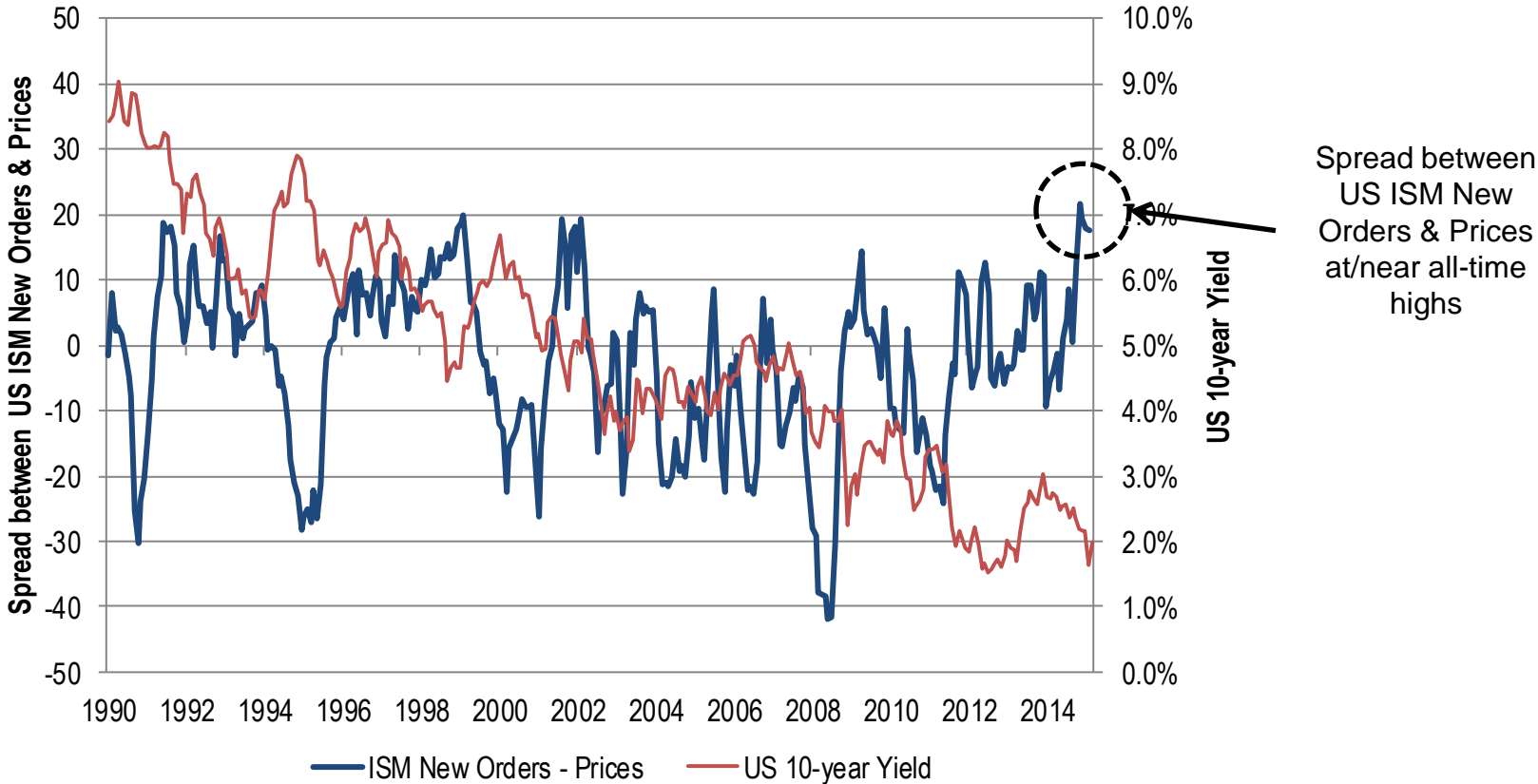
Historical relationship between falling fuel (in this case, jet fuel) prices and underlying airfreight demand is encouraging for 2015 volumes.



Hope/Optimism for Consumer-Led, US-Centric Growth



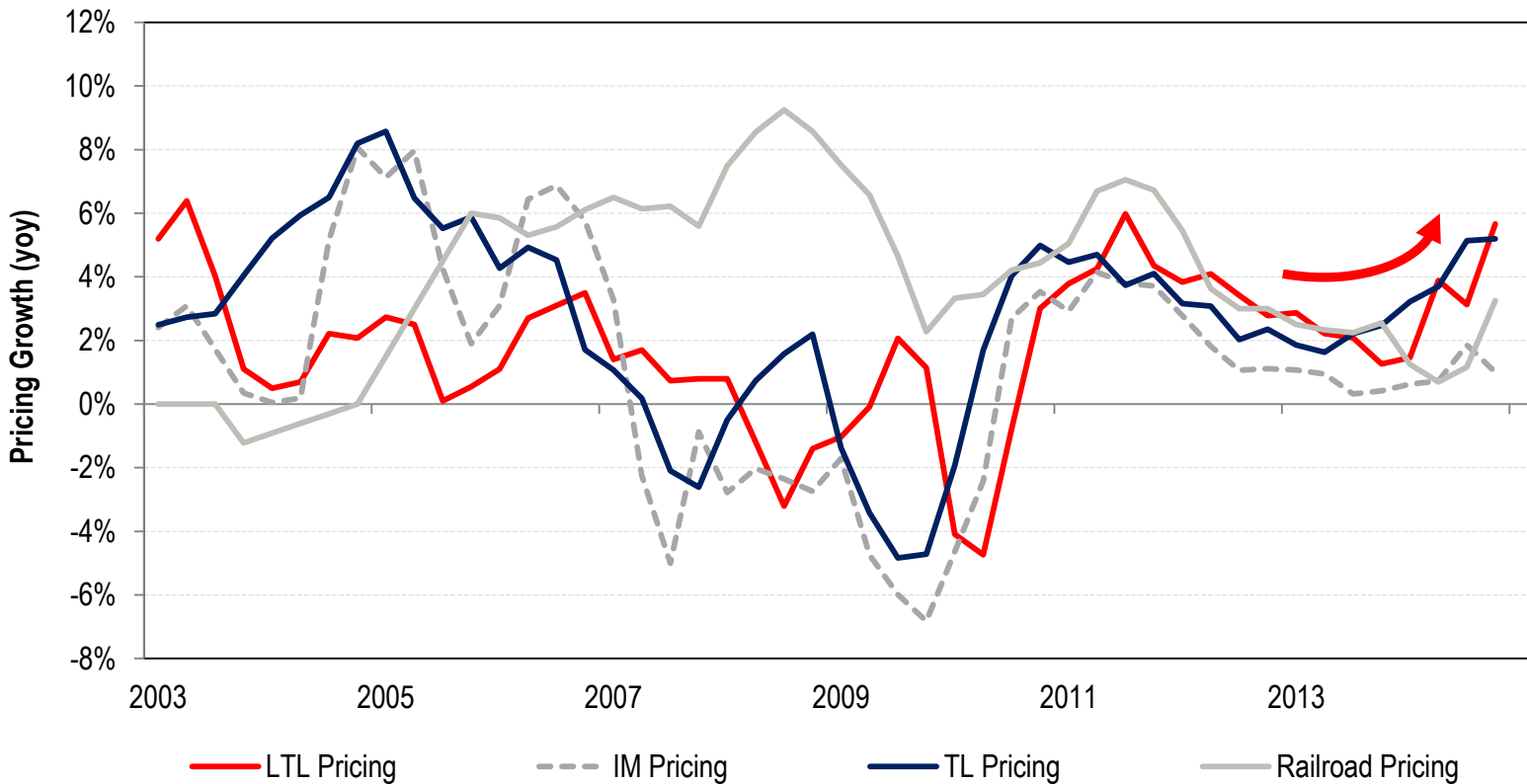
In total, signs of optimism have emerged for consumer-led, US-centric real growth in 2015 given global disinflationary pressures.



Back to 2015's Transportation Industry Fundamentals



After 2014's inflection, we expect "real" pricing growth in 2015, led by Truckload (+5% yoy). But for how long?



Some of 2014's Factors Will Go, but Some Will Stay



We expect “real” pricing growth in 2015, led by Truckload (+5% yoy).
But for how long?

Some factors to 2014's truckload market will go, but two important factors will remain:

1. Regulations
2. Demographics

Both factors, in our view, will lead to higher operating costs in the industry – and promote consolidation among transportation service providers.

Some Easing of Regulations in Early 2015, But Long-Term Productivity Headwinds Are Real

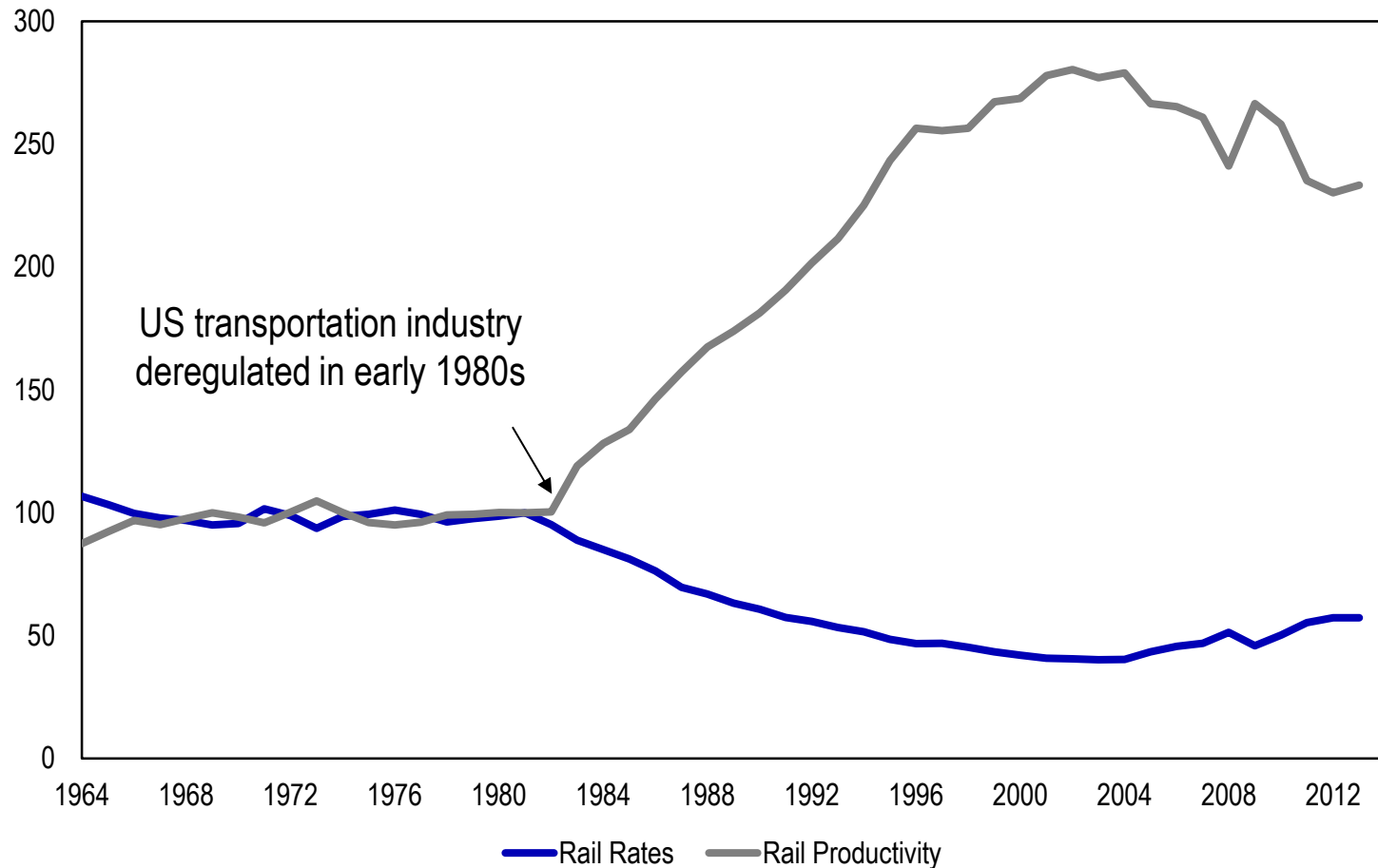
BAIRD

Two items of note in the FY2015 Omnibus Appropriations Bill

1. July 2013 HOS modifications suspended (~2-4% tailwind to productivity among compliant carriers)
2. Final regulatory action on industry-wide Electronic Logging Device (ELD) adoption by September 30, 2015 (a potential 4-8% headwind to productivity over the next 2-3 years)

Long-Term Productivity Headwinds Are Real

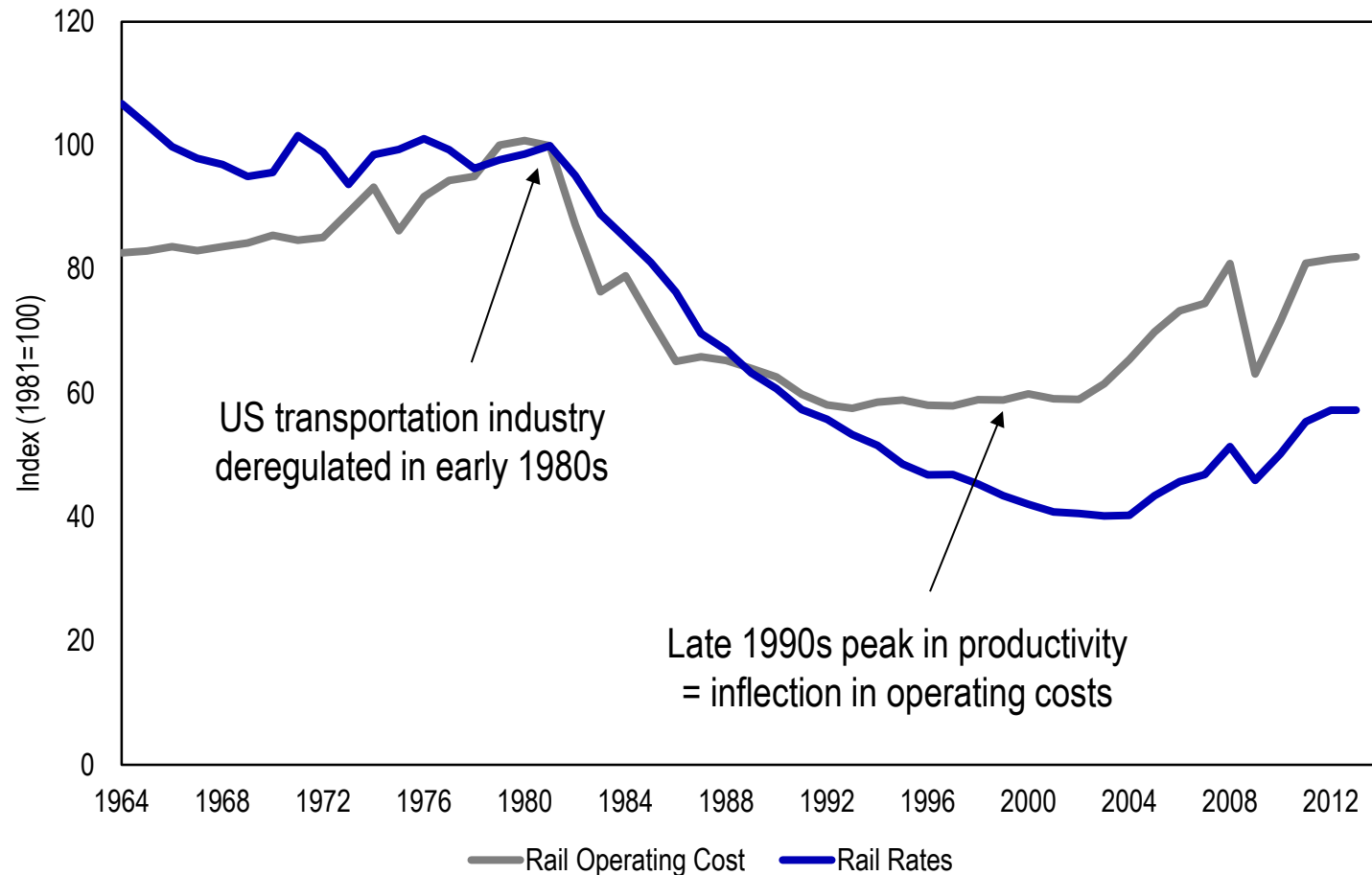
Rail industry trends since deregulation are instructive for transports broadly.



Long-Term Productivity Headwinds Are Real



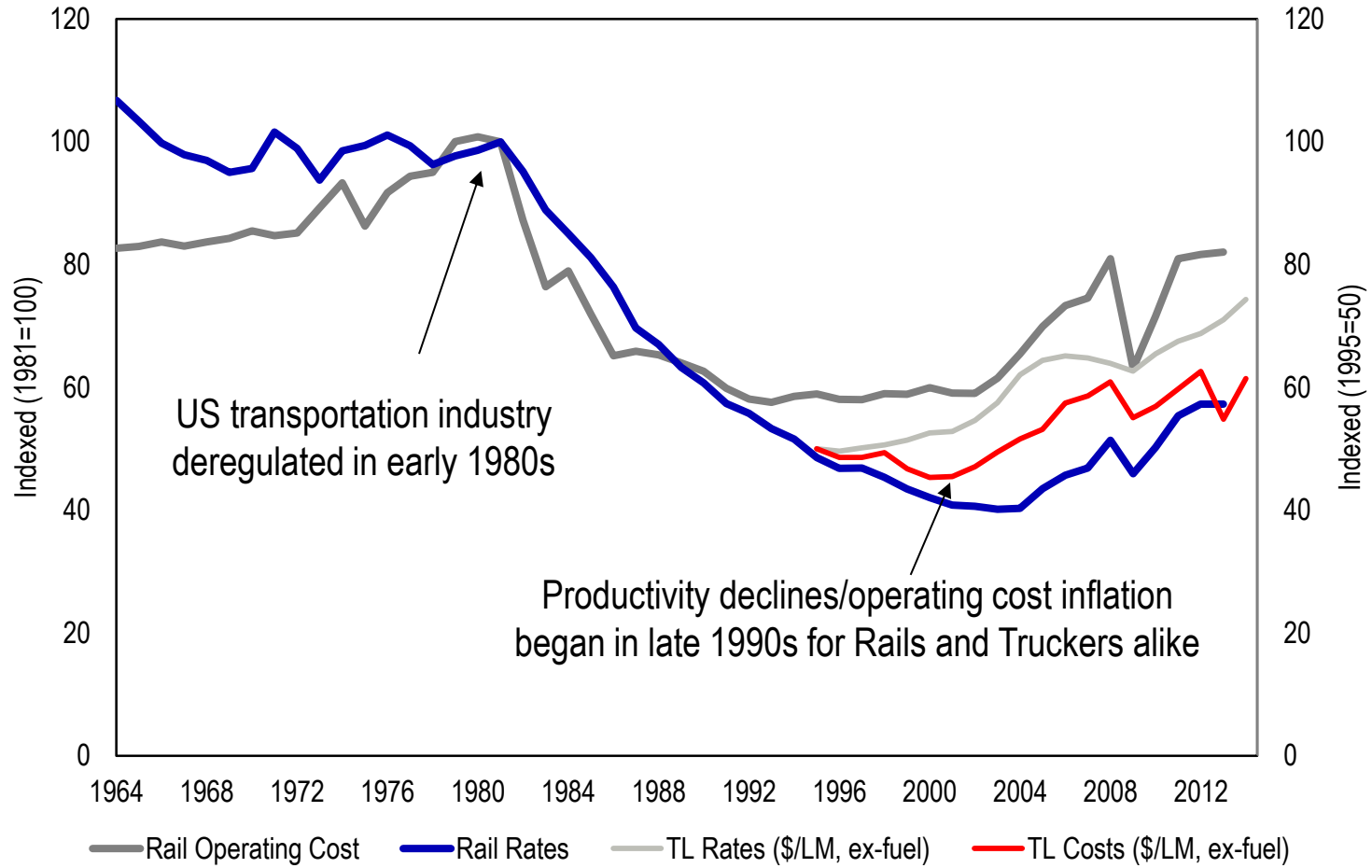
Peak in productivity/trough in operating costs provided basis for real rate gains.



Long-Term Productivity Headwinds Are Real



Trucking has followed a similar trend line since the mid-1990s.

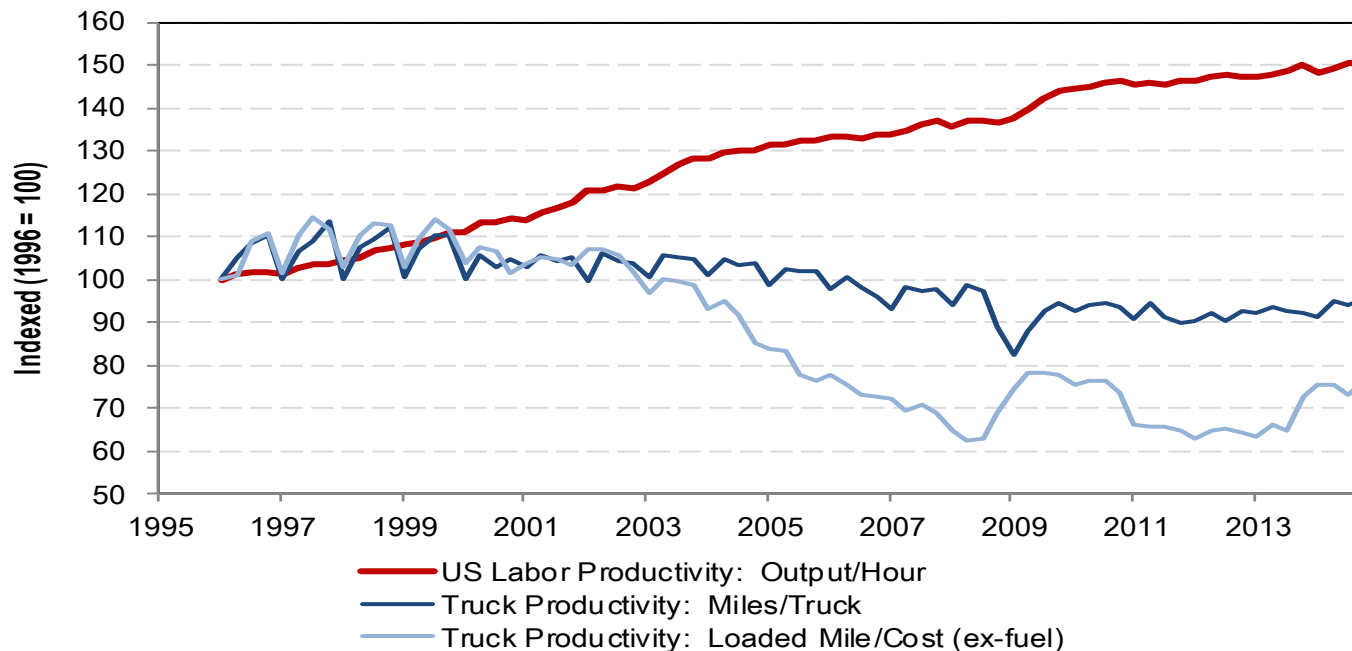


Some Easing of **Regulations** in Early 2015, But L-T Productivity Headwinds Are Real



Since 2003, large public truckload carriers' fleet **productivity has fallen ~10%** due to the cumulative effect of various drivers' hours-of-service regulations.

Over the same period, **US labor productivity has risen ~20%**.

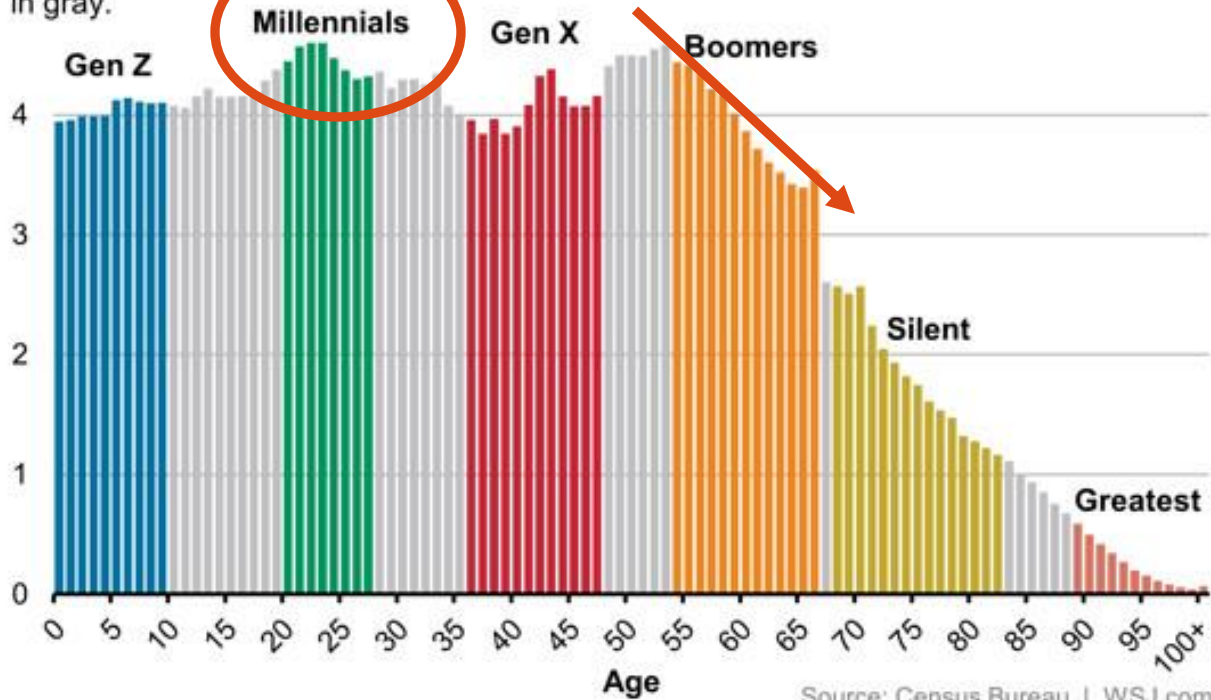


Shifting US **Demographics** Limit the Available Driver Pool, Creating Cost Pressures



Muddled Generations

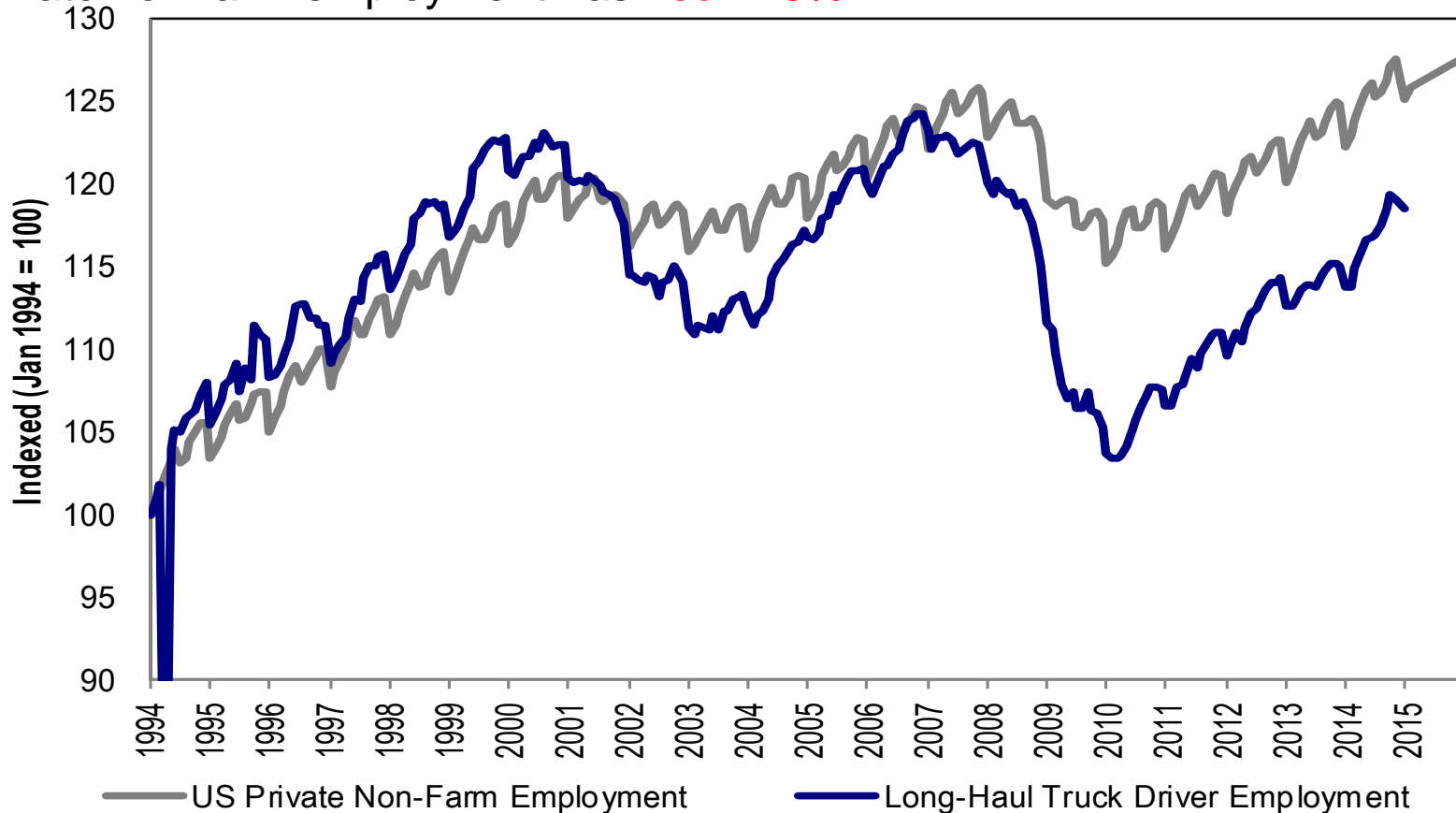
Number of people (in millions) by age in 2013. Ages with unclear generational definitions in gray.



Source: Census Bureau | WSJ.com

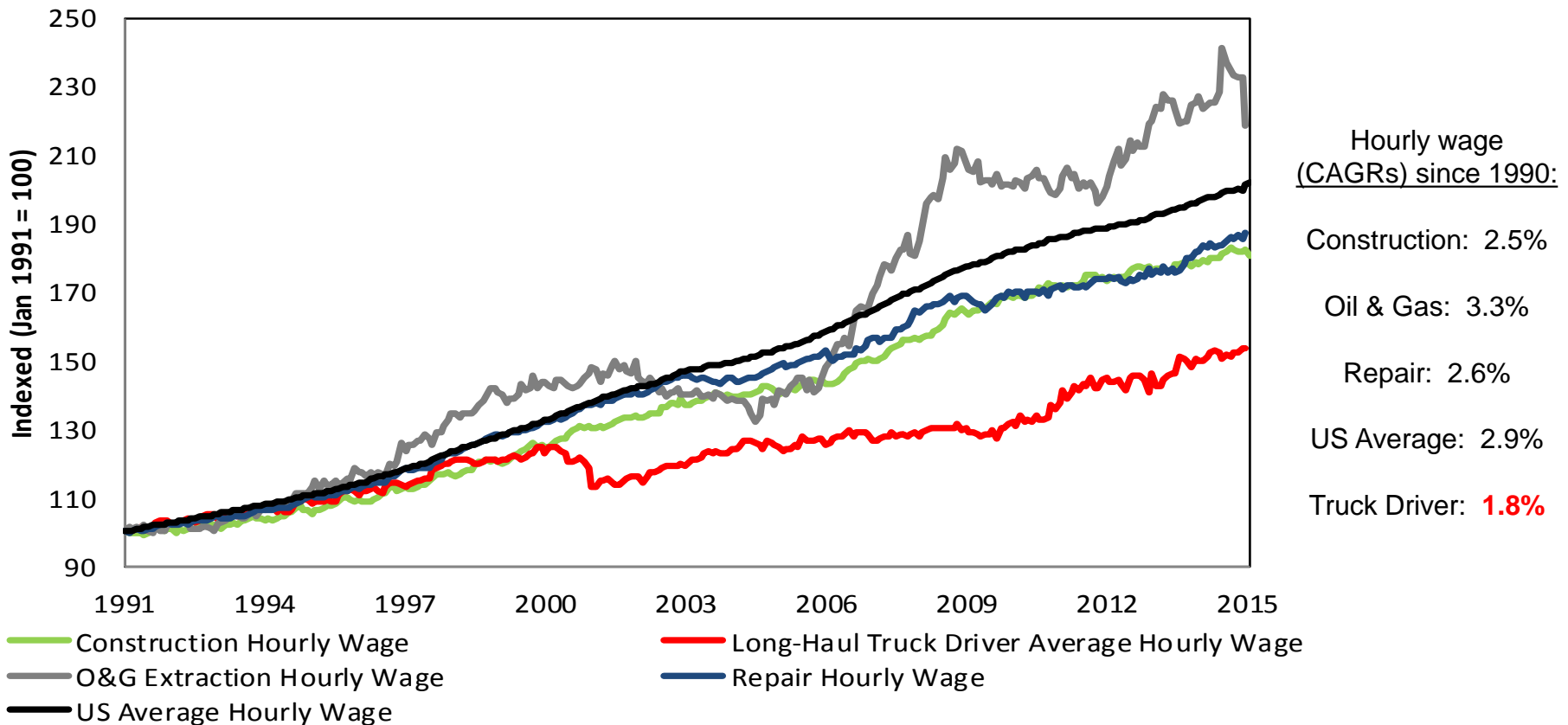
Rates Need to Rise in Order to Address The Demographic Issue

Since 2000, long-haul truck driver employment has **fallen ~2%**, while US private non-farm employment has **risen ~8%**.



Rates Need to Rise in Order to Address The Demographic Issue

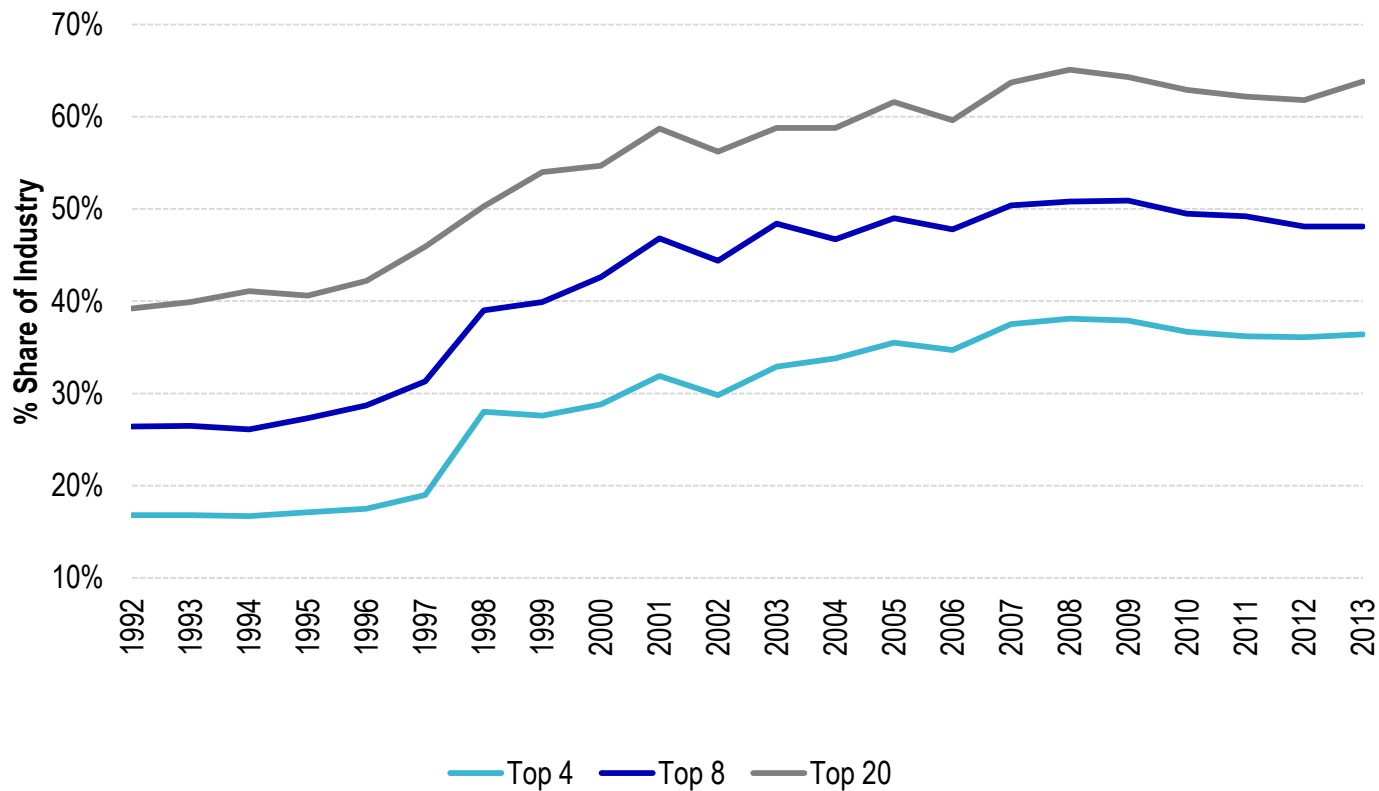
Truck driving wage growth has lagged competing jobs and broader US labor wage growth over the past 25 years.



Shippers' Consolidation Also Promote Transportation Industry Consolidation

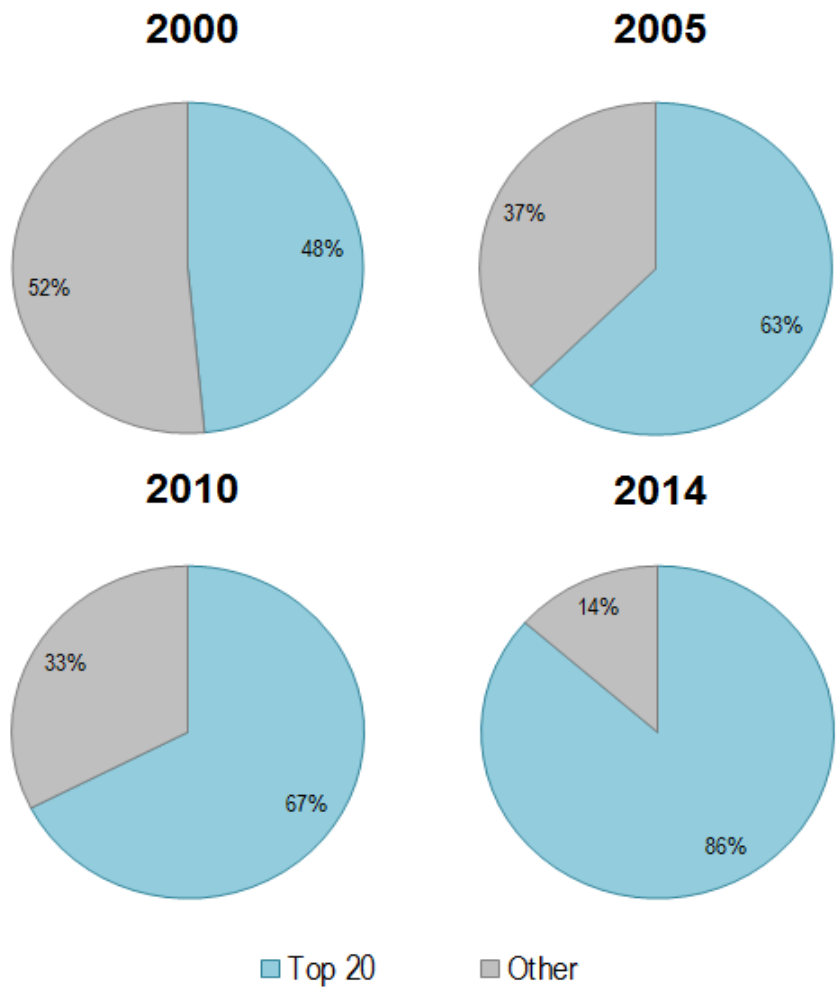


Consolidation among US grocery store sales over the past 20+ years **likely representative of the broader retail market as a whole.**

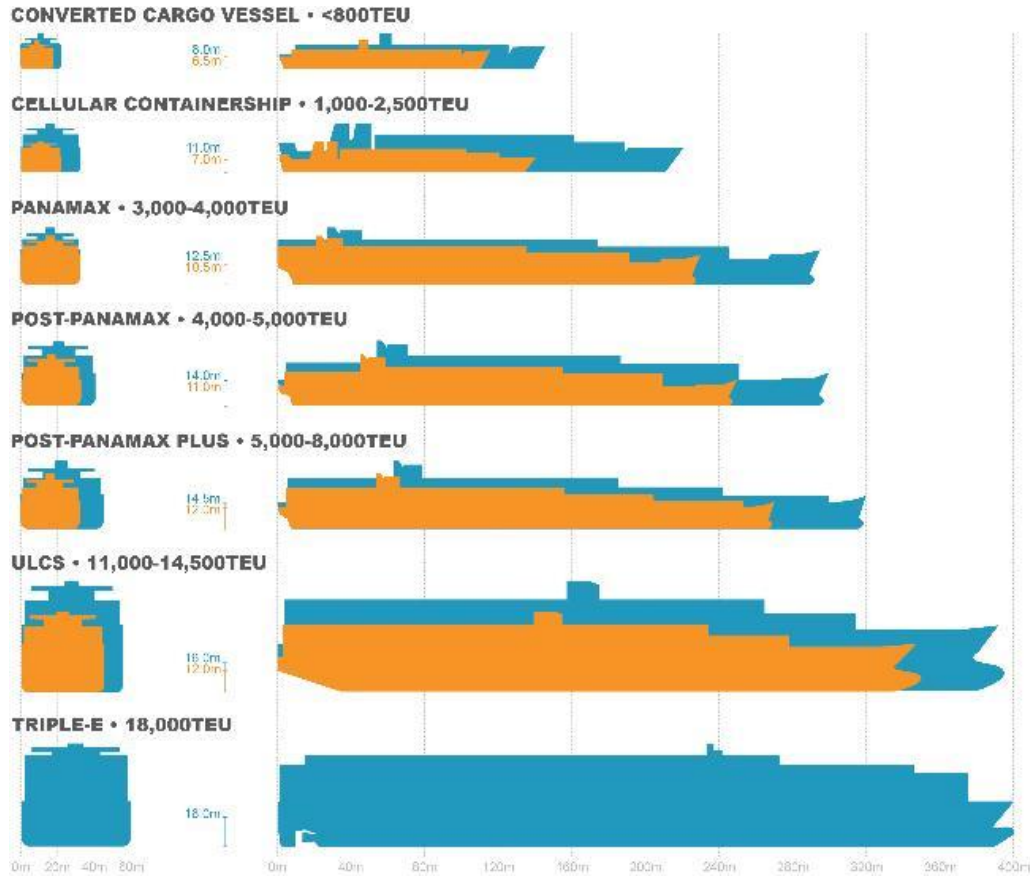


Ocean Freight Carriers Also Consolidating..

...Carriers (OF)



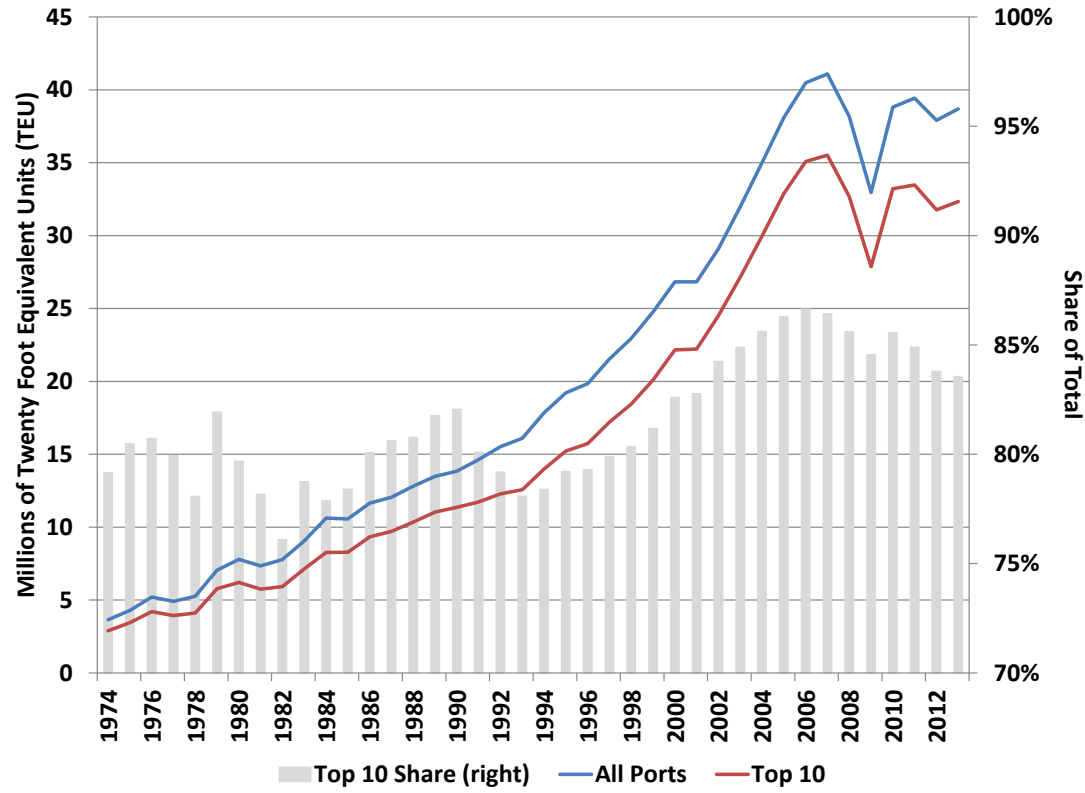
Larger Ships = Greater Concentration at Ports



Larger Ships = Greater Concentration at Ports



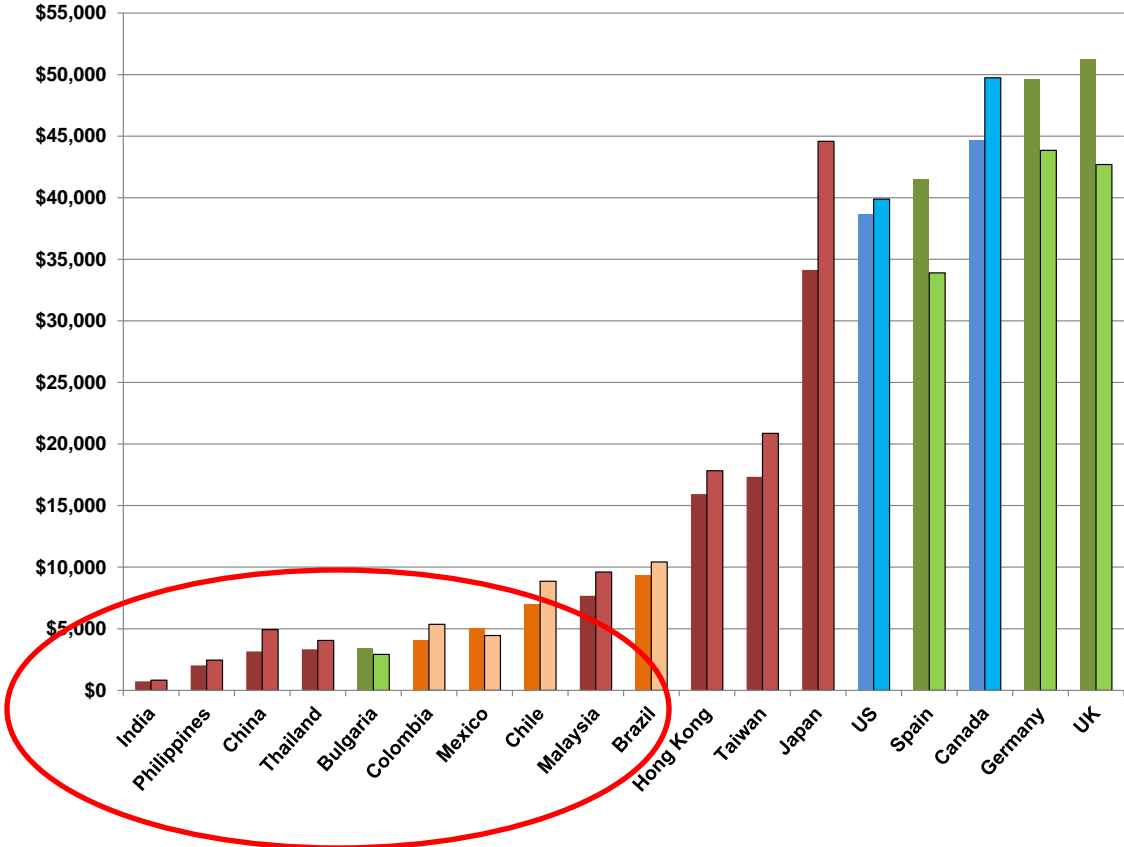
US international container volumes and port shares: 1974-2013



Sourcing Patterns Will Also Change



Manufacturing wage trends favor Central America and South Asia.



In the Interim, Freight Rates Are Likely To Continue to Rise

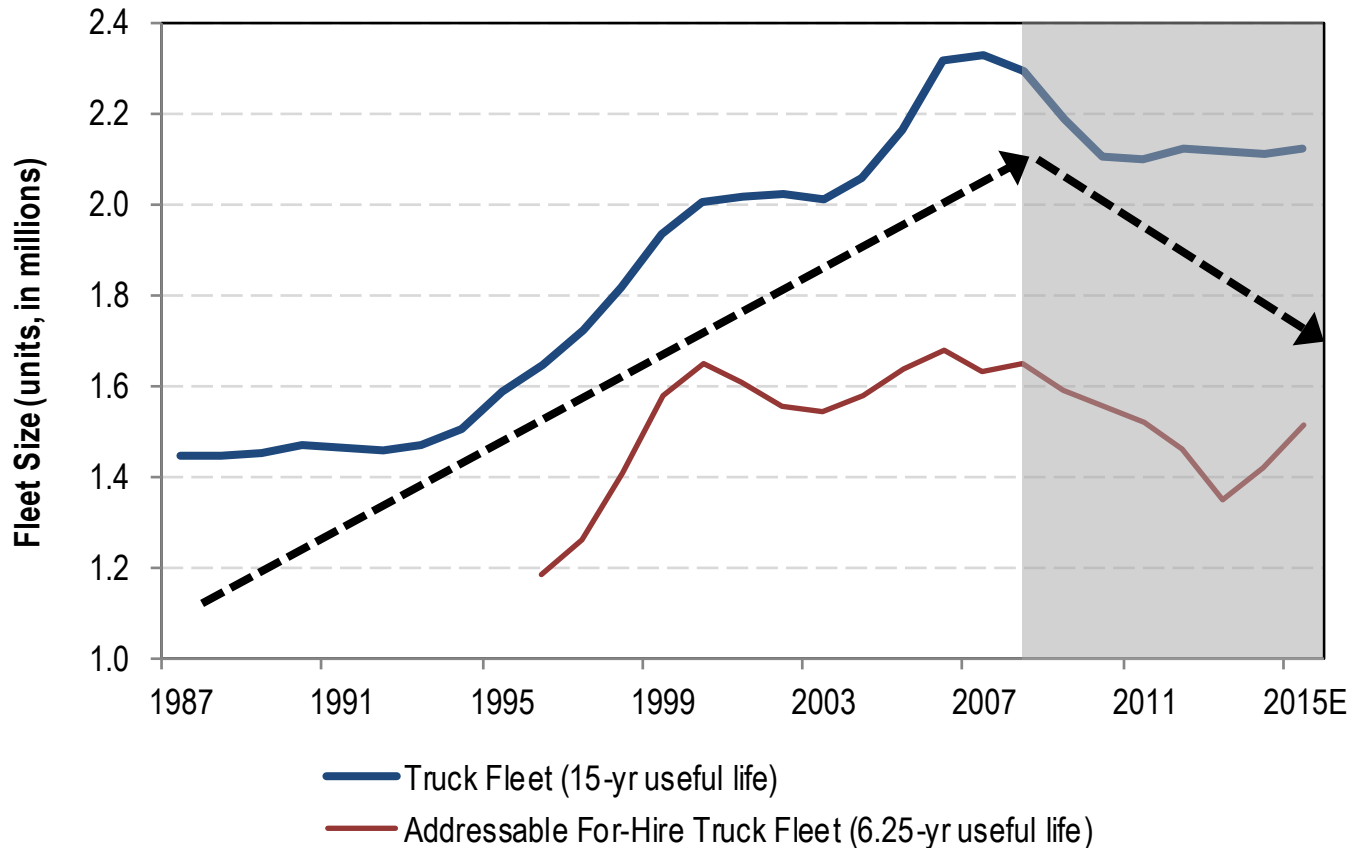


Given these two important factors (**regulations** and **demographics**), we expect to see:

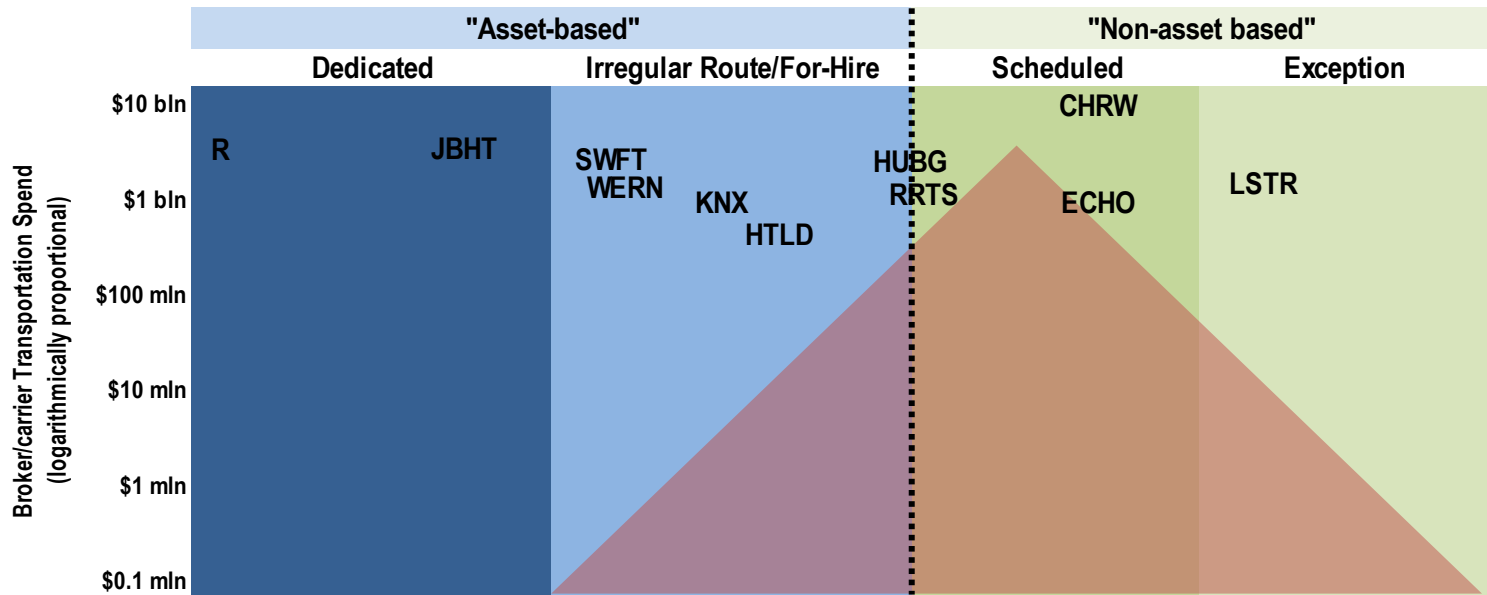
- Upward bias to US surface transportation rates
- Slower consumption/volume growth
- Continued consolidation among carriers and brokers
- Greater concentration of freight into key international gateways

Who Is Going to Invest in Capacity?

Small and medium-sized carriers still comprise 80-90% of the truckload industry fleet, and shoulder the burden of regulatory and demographic changes.



In Our View, Carriers and Brokers with Scale



	Dedicated	Irregular Route/For-Hire	Scheduled	Exception
Dynamics this cycle	<p>*Pressures to shippers operating private fleets (rising equipment costs, capital scarcity, driver regulations) leading to elevated inquiries about outsourcing management to dedicated fleet operators</p>	<p>*Core carrier concept among shippers highlights credible concerns about access to reliable capacity</p> <p>*Carriers with scale strategically positioned to protect margins and expand service offering</p> <p>*Small carriers/individual owner-operators facing numerous headwinds, limiting</p>	<p>*Pressures to small carriers/owner-operators (~80% of TL market) limit available capacity base</p> <p>*Coupled with slower end-market growth and increasing competition, expect gross margin pressure for brokers lacking</p>	<p>*Constraints to capacity base similarly pressures gross margins</p> <p>*But, brokers filling need (exception/emergency freight) or niche (specialized equipment) in position to deliver value, particularly among small/medium-</p>

Three Key Focal Points



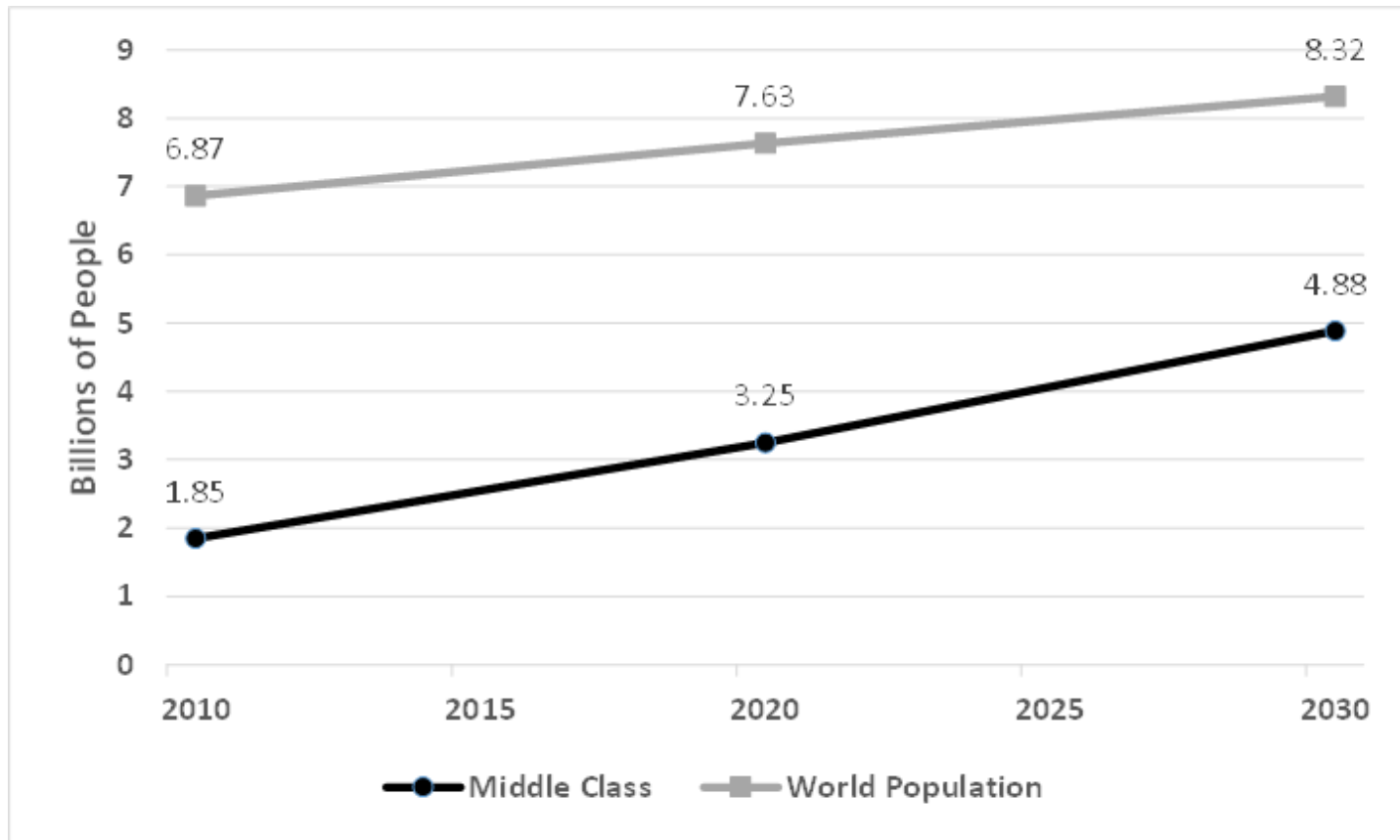
1. 2014: The year of pricing growth's "inflection"

2. 2015: The year of "real" pricing growth
 - Volume growth: all eyes on the consumer

1. Trends affecting supply chain management this cycle
 - Regulations (**supply headwind**)
 - Demographics (**supply headwind**)
 - Technology (**supply tailwind**)

Long-Term Growth Opportunity

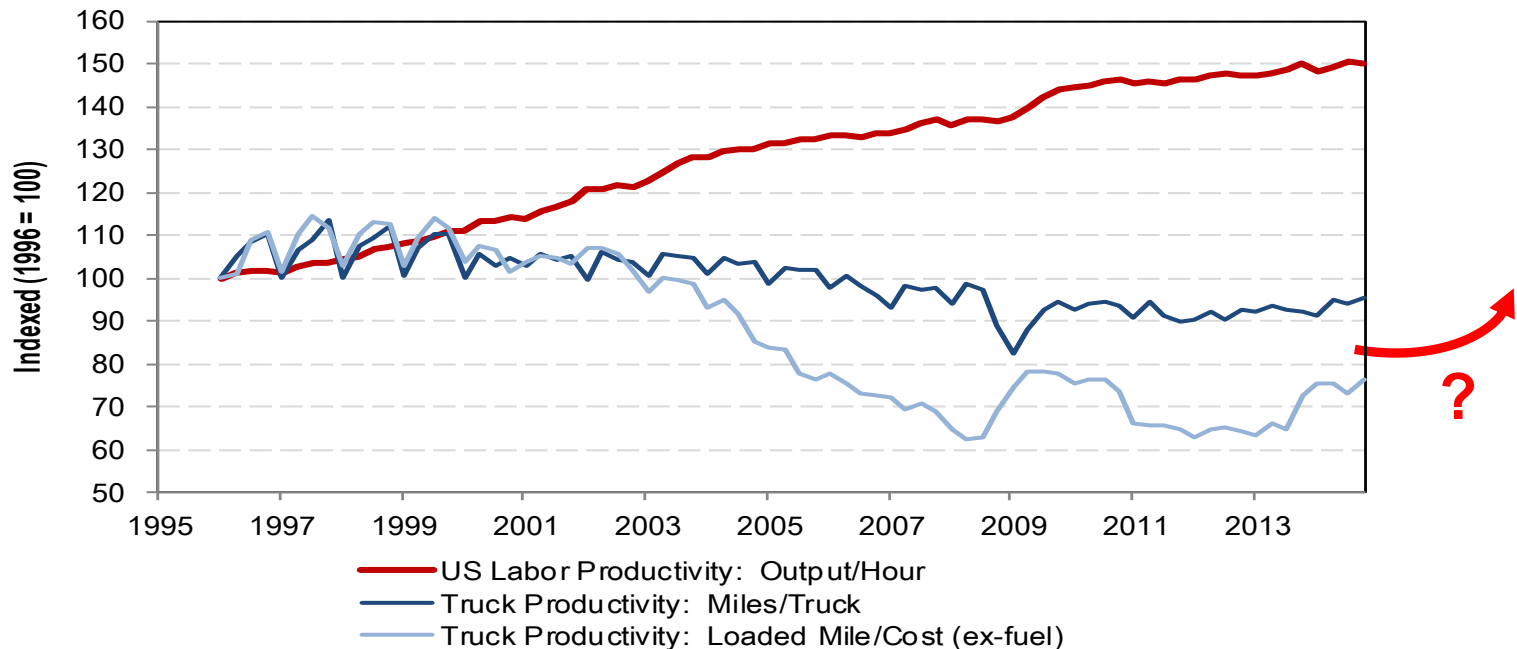
Don't lose sight of the long-term growth potential. **Rising global middle class creates growth potential, resource constraints, and logistics challenges.**



How Do Models React? “Bend the Curve”

ELD Math: $80\% * 10\% = 8\%$ potential incremental capacity reduction

We believe opportunity is presented this cycle to models that can “bend the curve” into the regulatory and demographic constraints. Models (carriers and brokers alike) with robust IT platforms can benefit from “network effect” economies of scale and expected industry consolidation.



Thank You for Listening

Our key focal points:

1. 2014: The year of pricing growth's "inflection"
2. 2015: The year of "real" pricing growth
 - Volume growth: all eyes on the consumer
3. Trends affecting supply chain management this cycle
 - Regulations
 - Demographics
 - Technology

Appendix – Important Disclosures and Analyst Certification

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Investment Ratings: **Outperform (O)** - Expected to outperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months. **Neutral (N)** - Expected to perform in line with the broader U.S. equity market over the next 12 months. **Underperform (U)** - Expected to underperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months.

Risk Ratings: **L - Lower Risk** - Higher-quality companies for investors seeking capital appreciation or income with an emphasis on safety. Company characteristics may include: stable earnings, conservative balance sheets, and an established history of revenue and earnings. **A - Average Risk** - Growth situations for investors seeking capital appreciation with an emphasis on safety. Company characteristics may include: moderate volatility, modest balance-sheet leverage, and stable patterns of revenue and earnings. **H - Higher Risk** - Higher-growth situations appropriate for investors seeking capital appreciation with the acceptance of risk. Company characteristics may include: higher balance-sheet leverage, dynamic business environments, and higher levels of earnings and price volatility. **S - Speculative Risk** - High-growth situations appropriate only for investors willing to accept a high degree of volatility and risk. Company characteristics may include: unpredictable earnings, small capitalization, aggressive growth strategies, rapidly changing market dynamics, high leverage, extreme price volatility and unknown competitive challenges.

Valuation, Ratings and Risks. The recommendation and price target contained within this report are based on a time horizon of 12 months but there is no guarantee the objective will be achieved within the specified time horizon. Price targets are determined by a subjective review of fundamental and/or quantitative factors of the issuer, its industry, and the security type. A variety of methods may be used to determine the value of a security including, but not limited to, discounted cash flow, earnings multiples, peer group comparisons, and sum of the parts. Overall market risk, interest rate risk, and general economic risks impact all securities. Specific information regarding the price target and recommendation is provided in the text of our most recent research report.

Distribution of Investment Ratings. As of February 27, 2015, Baird U.S. Equity Research covered 722 companies, with 50% rated Outperform/Buy, 49% rated Neutral/Hold and 1% rated Underperform/Sell. Within these rating categories, 17% of Outperform/Buy-rated and 8% of Neutral/Hold-rated companies have compensated Baird for investment banking services in the past 12 months and/or Baird managed or co-managed a public offering of securities for these companies in the past 12 months.

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