

# THE RAILROAD WEEK IN REVIEW

## FEBRUARY 26, 2010

*“We have strengthened our balance sheet and we are well positioned to pursue external growth opportunities.” – John Giles, President, RailAmerica*

**RailAmerica reported fourth quarter** and full year 2009 results Thursday. Looking first at the quarter, freight sales dipped ten percent to \$86.1 million on four percent fewer revenue units and as a result revenue per unit skidded six percent from last year’s fourth quarter. Sequentially, revenues, revenue units and revenue per unit slid four percent, two percent and a third of a percent respectively. Other revenue – car storage, car repair, demurrage, property leases, etc. -- was down five percent to \$19.3 million and total revenue dropped nine percent year-over-year to \$105.4 million.

Operating expenses came down six percent for a 26 percent operating income drop to 14.2 million (\$22.8 million before \$6.3 million in IPO fees and \$2.3 million for Ottawa Valley Railway discontinued operations) and a three-point degradation in the operating ratio to 86.6 from 83.5 a year ago. My sense though is that low revenue-unit volumes are behind a lot of the negatives on this line.

With more than half RA’s railroads living off handling fees, there is less opportunity to cover revenue carload declines with higher rates as the Class Is are wont to do. There *is* opportunity, however, to follow the Class Is’ lead by making more fixed costs variable. Look at Giles’ slide 10 in the presentation PowerPoint and see how reductions in fuel, car hire, labor and purchased services all had volume components. Writ large in this trend is that when volumes start coming back much of the incremental revenue will drop quickly to the bottom line.

Speaking of which, the bottom line net income was a negative \$6.9 million vs. a positive \$8.9 million a year ago. The \$9 million negative delta in freight revenues didn’t help, nor did the \$24 million interest hit or the \$8 million decrease in tax credits, mostly from the federal ‘45G’ tax credit program for shortline track rehab spending. The problem here is the tax credit has a built in lag – spend the money first, get the credit later.

Full year revenues from all sources came in at \$410.6 million, down 16 percent though operating expenses dropped 19 percent for a three-point operating ratio improvement, 80.3 from 83.6. Freight revenues were down 20 percent for the year but the operating expense improvements produced operating income of \$80.9 million, up one percent year-over-year. The full year net was down four percent largely on the 40 percent interest expense jump.

That RailAmerica was down in revenues as it was down in carloads is neither surprising nor unique – it’s the same story we’ve heard from all the rails this earnings season. Setting aside for the moment the accounting noise of the initial public offering and the OVR discontinuance, my friends in Jacksonville now have a cash hoard of \$190 million on the balance sheet and the acquisition theme was heard throughout the call. The shortline community as a whole has seen revenue units drop more than 20 percent in two years and it’s going to take a lot of organic growth at an optimistic four percent per year to get it back. Acquisitions are the only route back.

During the Q&A Giles gave us a glimpse of what he sees as the best acquisition opportunities. He talked about “more activity in the small independent short lines” than in Class I spin-offs or in taking out railroads owned by companies whose business is other than running a railroad. It’s surely the direction I would take if I had that much cash. One could set up many a first-generation shortline

entrepreneur with a nice retirement package with a pot that size. A handful of modest properties contiguous to current RA holdings will do wonders for that bottom line.

**Jim Giblin's TranSystems team** has been working on creating new lanes for boxcar traffic. He writes, "With concerns about rising fuel costs and environmental impacts, more and more companies are going 'back to the future' and looking at boxcar shipping as an option. But it takes not only a keen understanding of the sophisticated world of supply chain management but also the complex and sometimes arcane world of freight railroading.

"It's no secret that over the last few decades many companies stopped using rail carload service altogether. In the process these companies lost whatever in-house rail shipping competency and experience they once had." This is where Giblin's group comes in. Rail carload freight service is clearly a niche business and it's definitely not for everyone. But where it works it can work very well. And I think the Giblin model is well suited to short lines where local presence is key to new business development.

TranSystems has been working with clients to identify those specific markets and lanes where it seems to work and in some cases works very well. Giblin tells about one company where rail carload service turned out to be one of the best supply chain solutions the client ever tried. He also cites Whirlpool's shift to boxcar from intermodal where in 2009 more than 2,000 railcars were part of their supply chain mix. His PowerPoint tells the story eloquently and is a worthwhile read for any short line looking to build a boxcar franchise for its customers. See [www.railshippers.com/regional/midwest/vanderboegh\\_presentation.pdf](http://www.railshippers.com/regional/midwest/vanderboegh_presentation.pdf).

**TIGER grants** amounting to some \$1.5 billion were announced by the AAR this week. The acronym actually stands for 'Transportation Investment Generating Economic Recovery' and represents funds made available from the February 2009 economic stimulus legislation that included freight rail as eligible projects. In addition, Congress included \$600 million for TIGER-like grants that will be solicited and awarded later in FY 2010. Those grants will include an 80/20 federal/local match requirement.

A total of 1,380 projects were awarded to 41 states and the District of Columbia. Most of the money goes to class I projects like CREATE (\$100 million), the NS Crescent Corridor (\$105 million), CSX' National Gateway (\$98 million) and a \$49 million multi-modal bridge rebuild in Tulsa. There were only two non-Class I roads on the list: Pan Am Southern in Massachusetts (\$56 million) and RJ Corman to rehab five lines in Kentucky, West Virginia and Tennessee (\$18 million). The AAR says requests for more than \$57 billion came in for the mere \$1.5 billion up for grabs. As I watched the application process I got the idea some supplicants were just plain greedy and others had not thought their own requests through. Looks like I was not alone. Read on...

**George Betke of Farmrail fame** has been watching recent developments in New England surrounding the TIGER grants for railroad infrastructure improvement. He particularly takes aim at Connecticut for submitting 23 grant requests. Chop Hardenbergh ran Betke's letter in its entirety in his *Atlantic Northeast Rails & Ports* newsletter and has kindly given me leave to run it here as a cautionary tale for any short line in any state going out with its alms bowl.

Betke writes, "Instead of presenting a 'smorgasbord' to USDOT bureaucrats using vague selection criteria, might [it not] have been wiser to pick a couple of projects and make a strong advocacy case for them at the state level instead of allowing Washington to judge priorities? There is always a tendency to request something for everyone to satisfy a range of constituencies, often with the result

that (1) nothing is accomplished or (2) the funds are distributed too thinly to have a real impact for any of them.

“The biggest risk with the rifle-shot approach would seem to be funding limits, confirmed by the fact that applications for \$57 billion far exceeded the authorized \$1.5-billion program. New Hampshire’s more focused plan to request \$300-million to extend MBTA to Concord undoubtedly would have proved a delusion, even with Pan Am Railways’ participation.

Neither does Maine have much to crow about in terms of setting rail priorities and focusing political support for them.

“As I understand it, Eastport gets a conveyor, but not the accompanying rail connection; preserving the integrity of the MMA system was not deemed worthy; and USDOT at least had the wisdom to ignore the hopeless Mountain Division, which I consider a total waste of other people’s (our) money when more defensible needs exist.” Thanks, George and Chop. I’m hopeful the supplicants in DC this week for Railroad Day on the Hill keep this in mind as they go begging.

**UBS Rail Analyst Rick Paterson** has been making discoveries about what PTC is going to cost in both real dollars and network capacity. He writes, “Positive Train Control became a national transport priority in 2008 after a tragic collision involving a freight train and a Metrolink passenger service put rail safety under the Congressional microscope. The knee-jerk response mandated all Class I’s install PTC technology in an effort to provide an automated safety backstop for a train’s engineer.

“The economics and timing couldn’t be worse for an industry likely facing additional regulatory hurdles and only slowly recovering from the Great Recession. Rails must shoulder what could be a \$10 billion burden (installation plus NPV of ongoing maintenance) with a miniscule ROI of only \$1 for every \$22 spent, according to FRA estimates. What will happen to capex and free cash flow?

“With maintenance capex essentially non-negotiable and excess capacity negating the need for material growth capex, PTC will eat into free cash flow over the next couple of years. Our longer-term concern is busier networks will see a ramp-up PTC spending that displaces growth projects, at least up until the point the technology attains consciousness and turns on its human masters.”

I expect to hear at the CSX short line meeting in two weeks that many short lines, already strapped for cash by the double-whammy of shrunken carload volumes and less accommodating bankers, will be forced to ask their hazmat customers to find other delivery methods because the mandated cost of PTC is just too dear.

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