THE RAILROAD WEEK IN REVIEW
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Are shortlines missing the boat on track rehab? The lofty-sounding "American Jobs Creation Act of 2004" created a tax credit for track rehab (WIR 10/15/2004) and there are those who wonder if its value is fully appreciated. I was reminded of this fact by Carl Vercollone's excellent piece in the May 2005 *Railway Age* and by the remarks of some banker friends at the recent Watco Lenders' Meeting (WIR 5/27/2005).

By way of review, the Act lets Class II and Class III railroads use actual track rehab and maintenance expenditures to earn credits against their federal tax bill. And if your tax bill is minuscule or non-existent there are still ways to use it. There's a cap of $3,500 per *track*-mile so fixing up a mile of yard tracks or runners still counts. The $3,500 is a good number, too, since most shortlines ought to be spending around $5,000 a mile to keep their FRA class 2 track up to spec. And if you've got ten miles of excepted track that need $100,000 of work to get to class 2, there's $35,000 down.

A shortline client has 60 miles of mostly class 2 track. Say he puts down $5,000 a mile for 50 miles and $10,000 a mile for ten miles, total $350,000. The tax credit is capped at 50% of the total expense or $3,500 a mile, whichever is less, so this project earns $210,000 in credits. He also has a matching-grant program from his state's DOT that pays out $3 in state money for every local dollar. The counties plunk down $35,000 among themselves, the state picks up $105,000 and – voila – the track is fixed.

But wait, you say. This shortline never breaks even so it has no tax bill. Maybe not, but three big shippers that depend on the railroad sure do. Vercollone writes, "The Act recognizes that customers, contractors and suppliers are potential Eligible Taxpayers" and so can work down their own tax liability by working on the railroad. He continues, "An Eligible Taxpayer [customer, contractor, supplier] may borrow the funds with repayment effectively coming from the railroad" on whose behalf the money was spent.

Jim Bowers, one of the best shortline tax guys in the business, writes, "In your example, it's possible the credit will apply only to the money spent, net of grants, since grants are not taxable and as a result, there is no tax basis in the asset purchased with them. However, there may be ways around that. We're looking into the possibility of recording grants as taxable to create income and, hence, create tax with which to shelter with the tax credit." In the above example, Jim adds there are many considerations and what may work with A may not work with B. Check with your tax man first.

In short, it's a great time for shortlines to jump on the scheduled RR bandwagon and get their track up to snuff. There are more than 300 shortlines not associated with the top 20 operating groups and half of them are *very* small potatoes. As we've written before, 10 MPH and a cloud of dust doesn't work any more. What a great opportunity to play with the big kids.

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The recent BNSF Regional Shortline meeting provides some interesting links to the foregoing. The railroad expects to increase train-length and to extend passing tracks another 2000 feet to a total of 8,000 feet to accommodate the bigger trains. The goal is to get division cars-on-line below 23,000 because more than that clogs the system and harms velocity. Though not said in so many words, cars on shortlines must count toward that total and miles of excepted track on shortlines similarly harms division velocity.

The common thread throughout both operating and commercial remarks is velocity. Bigger trains, longer passing tracks, fewer yards, more BNSF road jobs, fewer BNSF local jobs, faster turns of bigger freight cars, and elimination of fleets that don't earn their way. Shortline participation comes in the form of good track, frequent service, and faster equipment turns.

Why the shortlines are not breaking down the doors for this tax credit program is a mystery. For openers, I think I'll ask around at next week's NS shortline meeting.

Norfolk Southern's Southern Hospitality will be in full bloom starting Sunday with the inaugural reception for the 2005 Shortline Workshop. Shortline manager John Kraemer has a few surprises up his sleeve in terms of new additions to the shortline toolbox. And once again he's created a matrix with more than 200 simultaneous one-on-one meetings between shortline managers and their NS counterparts. What must be particularly gratifying is the level of response from and participation of the 250 or so shortline connections with NS.

One of the most important aspects of any Class I shortline meeting is the opportunity it affords to compare notes with other shortlines. All the Class Is have their shortline caucus groups, and typically there is a shortlines-only caucus session early in the proceedings. The idea goes back to the "Sandhouse Sessions" hosted by Walter Rich at the ASLRRA Northeastern Region meetings. But there's a down-side.

There is always that handful of shortline operators that wants to use these sessions to air their particular beefs. For questions to have value to the group, they have to focus on common concerns or topics that are likely to be of interest to all. For an example of what I mean, listen to a quarterly analyst conference. One analyst may ask about car supply. Another can be counted on to ask about capex and another will drill down into the STB Performance measures. Then after the formal Q&A everybody storms the podium to get their private questions answered. Why not here?

GWR redux. Earl Durden's Rail Management Corp (WIR 5/27/2005) reported EDBITDA of $32 mm on revenues of $65 mm. The sale price of $245 mm including debt represents a nice premium – four times revenue when we used to think two times was a big deal; eight times EBITDA when six was deemed to be rich. What this seems to say is if you have a shortline or two that's doing well now's a great time to generate some cash. In other words, it's a seller's market.

Paying up for the right property has benefits. GWR's $37 mm South Buffalo Railroad purchase in October, 2001 was a classic. Freight sales were $14 mm after closure of the Bethlehem Steel coke plant. Then in December GWR paid nearly seven times EBITDA for Emons Transportation. Like RMC, Emons was a nice fit to GWR's equating operations base so worthy of a premium. And let us not forget RRA's StatesRail acquisition in 4Q01, also at six times EBITDA.

I seem to recall a GWR presentation in which CFO Jack Hellman showed how an effective six-times-EBITDA deal can be worked back to four after the operations are brought under one existing roof. And that's the name of the game. Just this week I was looking at a stand-alone shortline that consumes twice the man-hours per revenue move than do similar operations elsewhere. Clearly the solution lies in more revenue moves and fewer man-hours per. And the fastest way to do that is to combine it with something else.

The demand for diesel fuel continues to grow even as refineries turn their attention summer driving demands for gasoline. The WSJ reports that diesel demand has increased four times as fast as gasoline demand, pushing diesel fuel prices up a a faster rate than diesel. July heating-oil futures, the pricing benchmark for most U.S. diesel, settled up 9.05 cents at $1.54 a gallon. July gasoline also settled at $1.54, up just seven cents, so you can see how the gap has closed.

Here in Phila regular is $2.25 or so and I paid $2.39 in Spokane last week. Diesel ditto, and if you're not NSC or BNI or LUV it's going to hurt. One shortline operator told me yesterday his Q1 results ops expenses are up 3-5% yoy due mainly to fuel. Revenues are up enough to cover so there's still EBITDA growth, but the run-rate is not where it needs to be for the ROA target he's set.

Rail stocks generally out-performed the DJIA this week, up a percent to the Dow's down a percent. The only bright spots were KCS and GWR with the former taking a pop up on Friday before the long weekend and GWR's bump clearly tied to the RMC transaction. From a technical view, there are fewer "avoid" signs flashing. We're not seeing any screaming buys yet, though RRA may be close.

The 10-day SMA crossed the 50-day curve on May 20 and the 20-day curve crossed the 50-day this week. There's beginning to be some positive stock-price divergence from the SMAs, though volumes are running below average. RRA gas been range-bound mostly between $11 and $13 for a year now and every time it looks like it's going to break out to the up side the stochastics flash "overbought" and it falls back through support. Today, though, the stock closed at $11.88, closing in on the $11.95 resistance level. Support is at $11.50 and it's not oversold – yet.

Week 21 (ending May 27) Performance Measures were an improvement on the quarter-to-date numbers. Train speeds were up less than one percentage point, not much perhaps but better than the 2.4% decline since April 1. Morgan Stanley's Jim Valentine thinks lighter volumes ahead of the Memorial Day weekend may have helped.

Over at Bear Stearns Ed Wolfe sees Week 21 yoy intermodal volume growth slackening somewhat, "up 2.3% against a difficult comp, which lagged the quarter-to-date and year-to-date averages of 4.5% and 6.0% growth, respectively." Mets were off 7% -- to be expected given the auto slump and aggies slid 2.4% yoy. YTD the honors go to BNSF and NS with revenue units up 7.8% and 5.7% respectively with commodity carloads (e-intermodal) up 2.9% and 2.4% respectively. However, if you're looking only at commodity carloads, KCS gets the brass ring: up a whopping 11%.

Wolfe concludes, "At the present time the Class I rails are trading at 13.1x on a one-year forward blend of our 05 and 06 EPS estimates. (Excluding UNP the Class I's are trading at 12.5x on our one-year forward estimates). The average historical forward P/E range for the major rail group is 11x-15x." Which may be one reason we see the tech signals turning long. A good way to end the week.

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