THE RAILROAD WEEK IN REVIEW

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"I do not expect to get the money, and I do not expect any for the foreseeable future." —Short Line COO on state funding already promised

Continuing the thread on wobbly state finances and short line infrastructure assistance, a friend who runs a sizable short line operation with a sizable chunk of state assistance in years past writes, "In April, [the state] announced grants of $500k each to [our two properties]. Not a dollar has been released and now I don't even get returns of my calls when I try to find their status; the only purpose of my call is to see if I should be budgeting to do it ourselves.

"I do not expect to get the money, and I do not expect any for the foreseeable future. Any railroad that has built its business model on the premise that state grants would provide their track and bridge maintenance, rehab, and/or upgrades is destined for disappointment, and perhaps failure. I'd say a similar fate awaits short lines in [the adjoining states], and probably in any state that has had a strong rail grants program. Freight railroads are NOT the focus when times get tight."

And tight they are. Tuesday's *Wall Street Journal* ran a story on the plights of many states where in "years of flush budgets" they added so many programs that today they must "prune spending because of falling sales-tax receipts and other revenue." There was a link to a table ranking budget gaps by state as a percent of the 2009 General Fund topped by California (31.4%) and Arizona (25.9%). Not surprisingly, the biggest gaps are in the biggest Blue States (see WIR 11/14) where there are no "right to work" laws. Only two red states (Virginia and Georgia) had good *Harvard Business Review* business success scores in spite of their budget gaps relative to the others.

Virginia, I hasten to add, is in the vanguard of states that appreciate what aggressive railroad investments can mean to its competitive advantage vis a vis the other states. Speaking at last September's Eastern Region ASLRRA meeting in Williamsburg, Kevin Page, Chief of Rail Transportation for the state's Department of Rail and Public Transportation, said Virginia hosts ten short lines, two class Is, three Amtrak Routes and two commuter routes. There are three separate funding programs that run more than $40 million a year in rail-related projects in addition to Virginia's pioneering work in Public-Private-Partnerships. Let's cross our fingers that the rail programs survive to keep the Commonwealth wealthy enough to keep up its rail programs.

Larry Kaufman's Red State-Blue State commentary [WIR 11/21] brought this note from a Midwestern short line president who's been in the thick of this one way or another the nearly twenty years I've known him. "Having spent almost four years now in [this] heavily-unionized area, I have to say that the organized labor environment here is detrimental to industrial development.

"Every significant initiative I have been involved with, particularly for large, high potential employment, industrial properties we own or have access to, has a union labor component to work around or with. A couple of potential businesses have surveyed the activities of the [various unions active] in the area and just walked away to the south. Others factor in strategies for an inevitable organizing drive into their prospective business models and wind up in the south for many of the reasons mentioned in the HBR article.

"Right to work and union work rules are not insurmountable issues but add significant negative elements to prospective development business plans. Union wages and benefits are usually not the issues, driving decisions but rather uncertain and onerous work rules that might be imposed once an operation is up and running." Card Check, anyone? (For a fine bit of hypocrisy, note Waxman got Dingell's job by secret ballot.)

UBS rail analyst Rick Paterson got it exactly right in this note: "Any rail suggesting 2009 volumes will be 'OK' or 'flat' is in fantasy land, and this should be a red flag to investors. All rails should be preparing for the worst (hoping for best optional). Railroads have posted stellar EPS growth since 2003 by riding the secular pricing wave and improving productivity where they're able to offset rising fuel and the imploding housing and auto industries.

"We think that game is over and 2009 presents a new set of challenges, specifically: material, rather than modest, volume declines, and a likely deceleration in pricing (albeit probably still > cost inflation). Fuel is now a tailwind, but by itself it won't likely be enough. Productivity is still critical, but we think the other key differentiator will be which companies can most quickly i) recognize and accept the extent of likely volume declines; and ii) most rapidly cut variable and semi-variable costs to right-size to their shrinking businesses. Railroads that refuse to accept and act will likely see bloated labor and equipment inventories – and cost structures. Our view: Get the knives out."

We might also see the convergence of two shortline trends: tougher economics and the original ex-Staggers short line buyers figuring it's time to get out while the getting is good. One thing the class Is have done very well is take points out of the operating ratio. When you're a Class I and your OR is in the high eighties (or worse) short-lining marginal branch lines can look very attractive, even if you have to spend a few bucks setting up a handling allowance accounting office and a marketing support team.

But now, with so many short lines under the aegis of larger holding companies run by folks with considerable high-level Class I experience, it begins to beg the question of who's doing whose work? I think that in the next few years we'll see more short lines going to ISS or junction-settlement formats where they can call on the resources of a Mother Ship and will rely less on Class I market managers for rate-making and hand-holding. The knives are out.

Elsewhere, RW Baird says, "We expect no material freight recovery until 2010. Freight trends continue to deteriorate across domestic and international freight modes as peak season demand failed to materialize; only domestic intermodal rail growth showed some signs of peak. Trucker pricing pressure is growing given the weak environment. Bleak first-half 2009 prospects and no expectations for 2009 turnaround place additional downward pressure on estimates across our group."

And Wolfe Research seconds the motion with a modicum of encouragement. " The government reported that we are in a recession since last December, the longest since the early 1980's, and many news agencies reported that as a surprise just this week. Yet the transport industry has been spot on in leading this downturn, and we should be early in leading out of it as well.

"A big drop in freight volumes has been related to working down inventory; at some point during C09 inventory will need to be replenished and our group will feel it before consumers...The transports have outperformed the S&P 500 during four of the past six major market corrections and during the twelve month period following all six of the past major corrections, since 1980. We remain bullish this trend should continue for the transports once the market senses a bottom.

"The transports should benefit on an absolute and relative basis to the market from (1) direct benefits from declining fuel costs and lagging surcharge revenue; (2) easy comparisons, low expectations, reduced capacity and early consolidation because of the past 2.5 year environment of negative volumes; (3) relatively little international exposure and few credit issues; and (4) early cyclical expectations for the stocks to rebound prior to the economy."

Lastly, an item in Wednesday's *Journal* suggests that we may be "hitting the limits of economies of scale in logistics," citing port bottlenecks and land transportation congestion. "One answer will be shorter, regional supply chains" In these tight times manufacturers have tightened up supply chains, meaning better inventory management and less of the stuff on the floor. Domestic intermodal is a solution and given the shift we've seen in the past few quarters, the total intermodal package is going to tilt more toward domestic and away from international. The effect on certain carload commodity businesses could be devastating.

From the Railway Age Newswire we learn that "Canadian National and Canadian Pacific say an adverse court ruling on grain rates and on the cost of maintaining a fleet of government-owned grain cars will cost each of them $C23 million ($US18.7 million) out of revenues from the 2007-08 crop year. CN says the ruling could affect its future investments in infrastructure and equipment related to hauling grain while CP said it will review its products and pricing as it is related to this decision and will communicate this to customers in the near future."

Neither Hunter Harrison nor Fred Green are known for sitting quietly by while outside forces play havoc with their asset management programs. CN inaugurated its guaranteed car order program a few years ago precisely because having cars sitting around for loads that a customer might generate was unacceptable. And Fred Green makes the point repeatedly that customers who don't use cars promptly and for the purpose they were requested may not get all the cars they want in the future. Said Harrison, "This railroad is not in a position to cross-subsidize its grain movements with profits generated from the movements of goods in other sectors of the Canadian economy."

Pan Am Rail's quarterly magazine, "The Pan Am Clipper," is one of the nicest such publications around. The Fall 2008 issue is particularly well done. To give a scale of the improvements that are part of the new Pan Am Southern joint venture with NS, we're told that there will be 24 track miles of new welded rail, 144,800 cross-ties replaced, 21 bridges upgraded to meet 286K requirements and some 181 miles of tamping and surfacing. Considering that just relay rail is going for north of $600 a ton, ties are $50 each (installed), T&S a dollar a foot and who knows what for bridges and clearances, we're not talking chump-change. But wait, there's more.

Pan Am Rail is putting in a new automobile facility in Ayer, Massachusetts sporting a pair of unloading tracks that can hold 20 auto racks each, a loading area for sixteen auto transport trucks, 828 auto bays and ten charging bays. Then there's the already-announced intermodal-auto-transload facility planned for Mechanicville, New York. And the east leg of the new wye connecting with the Vermont Rail System at Hoosick Junction ought to be in service in a few weeks, eliminating a reverse move for traffic like the Omya limestone slurry train serving the Maine paper mills.

Next week: How to use Charles Schwab & Co's "Sell Alerts For Individual Stocks" to measure any railroad's staying power in terms of cash flow and investor confidence. We look at the relationships between cash flow from operations and net income, capex and depreciation and the year-over-year changes in net debt and share count. And even though private companies do not have analyst ratings, short sales or share price changes in the stock tables, they retain accountants who can tell them what their companies are worth and that can be tracked on a periodic basis. The tools presented provide a means to an evaluation and growth end. It's up to the short line investor to pick the right data and read the tea leaves accordingly.

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