THE RAILROAD WEEK IN REVIEW
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"Stimulus plans that preserve failed business models could increase the likelihood of a worse calamity later." -- Wall Street Journal, January 2, 2009

Many readers have commented on the "kindness of strangers" theme begun on these pages over the past quarter. The reaction has been mixed, with some saying the state and federal infrastructure subsidies are only right -- the government pays for the truckers' roadways and the government should do the same for their short lines -- and others saying if the short line's business model cannot support its own infrastructure than it deserves to fail. I tend to side with the latter and here's why.

Recall the shortline owner who writes, "I do not expect to get the money and I do not expect any for the foreseeable future." (WIR 12/5/2008) This with respect to commitments made by his state's announcing a million-dollar grant in April, 2008. This is a property that relies on state-funded infrastructure subsidies and a seven-figure overhead traffic revenue stream. However, both these cash streams are at risk insofar as falling state revenues cut available dollars for rail subsidies and overhead moves can be curtailed by the user, though not as capriciously as the state grants.

Worse, this same operator tells me the new hours-of-service law mandates his adding six T&E personnel at a fully-loaded cost of a quarter of a million dollars. So in short order this operator is now exposed to three cash-flow threats that he cannot control. On the other hand, he also has a creative and energetic business-development team that has uncovered a huge untapped on-line demand for rail freight services that is turning opportunities into cash at a double-digit run rate going into 2009.

My sense is that this property, like so many independent short lines I see around the country, has tremendous potential but it's going to take a couple more years to get there. The cash infusion needed to offset the lost state funding isn't enough to get the attention of any investment banker (assuming you can even find one), however it might well be attractive to independent investors and even the FRA for a RRIF loan.

In any event, the cost of depending on the kindness of strangers is running out of strangers to provide the kindness -- government grants and tax breaks are great if you can get them and the cost is not too dear. Cash is king, and the more of it you can generate yourself the better. Look for WIR to continue to beat this drum in 2009.

Speaking of RRIF loans, the fact of the matter is the program is there specifically to finance investment in tracks and equipment, for the rehabilitation of tracks, bridges and equipment, or to refinance high cost bank or acquisition debt with funding tailored to its railroad purpose. My good friend Chris Rooney (with whom I have collaborated on RRIF work for the FRA) writes, "The RRIF program is perfectly suited to short lines that have sound businesses but have been unable to source financing in conventional ways. Unfortunately, the program has for too long been hiding under an OMB-induced 'bushel basket' and earning a bad rap.

"RRIF loans are typically available with long maturities (up to 35 years for track and infrastructure), with interest rates comparable to US Treasuries of the same maturity, and with amortization rates about the same as a conventional home mortgage." Rooney quickly notes, in a nod to previous conversations with me about the above thread, "The RRIF program is not a subsidy program by any stretch.

"The folks at FRA thoroughly analyze the borrower's situation either with their own staff or using an outside financial advisor. FRA is happy to sit down with prospective borrowers to discuss the program at no charge. It's when you decide to apply that the fees start to add up. There is a credit investigation fee, which normally amounts to one percent of the desired loan amount, payable when your application is presented. Then there is a credit risk fee assessed at the time the loan is drawn-down, to ensure repayment."

At this point it is imperative for me to note that the FRA takes the form and substance of the initial interview and the application itself very seriously. If you show up in a gimme-cap and jeans with a set of back-of-the-envelope books, the odds of success are greatly diminished. Or, as one applicant I know did, you're asking the FRA to refinance a previous loan that you could not pay off due to cash-flow problems, you won't get very far, either.

Rooney again: "Therefore, it makes sense to put your best foot forward with a little advance preparation and a top-notch application setting out all the required data in the most professional manner possible to make your case." It's not that difficult, either. The sample income statement, balance sheet and cash flow statement available on my website are a start. As for the business case, run your railroad through my Rule of One Hundred (available for download at www.rblanchard.com/resources) and see where you come out.

Look for more on this topic over the next few weeks in this space. We'll look at how to determine eligibility, what the FRA is looking for, how to prepare an expense analysis that shows how you compare with your peers and precisely how the RRIF loan will improve your standing among your peers. And of course -- as always -- drop me a note if you'd like to explore your RRIF options at any time.

Just be careful you're not piling debt on debt. If you're short of working capital, look at adding fresh equity first and never mind dilution. And if you can't attract new equity because nobody buys your business case, then the FRA isn't likely to bring you into the RRIF program either.

Too much leverage can create a false sense of health and lead to still further depredations. It was in this context that the December 20 Barron's cited -- at length -- the warnings of Elihu Root. The year was 1913 and establishing the Federal Reserve was under discussion in Washington. The idea was to let "the number of dollars in circulation expand or contract according to the needs of commerce and agriculture.

"Elihu Root, Republican senator from New York, thought he smelled a rat. Anticipating the credit inflations of the future and recalling the disturbances of the past, Mr. Root attacked the bill in this fashion: 'Little by little, business is enlarged with easy money. With the exhaustless reservoir of the Government of the United States furnishing easy money, the sales increase, the businesses enlarge, more new enterprises are started, the spirit of optimism pervades the community.'"

Sound familiar? But wait, it gets better. Continues Root, "Everyone is making money. Everyone is growing rich. It goes up and up, the margin between costs and sales continually growing smaller as a result of the operation of inevitable laws, until finally someone whose judgment was bad, someone whose capacity for business was small, breaks; and as he falls he hits the next brick in the row, and then another, and then another, and down comes the whole structure."

And that, dear reader, is, in a nutshell, why squandering tax dollars to subsidize failing businesses from the Fallen Flag & Eastern to General Motors is a bad idea. (Unless, of course, it was the meddling of the feds that contributed to the problem in the first case. See what the ICC did to Penn Central, e.g. But that's another rant I'll save for later.)

A few weeks ago David Fink, Pan Am Rail President, invited me along on a 137-mile business car trip from Waterville, Maine south to Durham, NH (MP 62 from Boston's North Station) with some of his senior staff members and other guests. What an eye-opener. I see a lot of railroads from the biggest Class Is to the smallest of regionals and this piece of railroad ranks right up there with the best of them.

We began with a brief tour of the Waterville shops, built by the old Maine Central more than seventy years ago and still in use as a 26-track heavy-repair facility fed by a transfer table. Though the place is showing its age, the house-keeping is impeccable and the safety record is enviable (not surprising – a clean workplace is a safe workplace). Moreover, there was power from other carriers in there – Boston's "T" and other regional carriers – something you would not see if the craftsmanship were less than first-rate.

Out on the railroad, I was particularly impressed with the state of track maintenance from Waterville to Portland (below Portland that's Amtrak and not all on David's nickel). My trip began with a ride in the cab (a pair of ex-CN GP40-2 units powered our special) on a section of rail I last saw more than fifty years ago visiting a school chum's Maine summer place.

The roadbed is a mixture of CWR and jointed rail with good wood, clean ballast with proper shoulders and ditching and the tree line cut way back for good visibility. A tie program is scheduled for the spring and they plan to replace the last of the jointed rail with CWR in 2010. Clearly PAR will benefit from the Pan Am Southern joint venture with NS exactly as KCS has – NS capital to speed up one part of the railroad frees up PAR funds to upgrade other parts of the system.

South of Portland we were on Amtrak's "Downeaster" route, essentially a single-track railroad with CWR, wayside home signals and frequent passing sidings with switch heaters and nice, gradual turnouts. It was on this segment we had meets with two huge freight trains, the EDWA (East Deerfield to Waterville and the MORI (Mohawk-Rigby), which shows there's good reason to keep the track in a high state of repair. Thanks, David, for the education.

Ed Wolfe, in a recent Friday Freight note, writes, "Over the past several years, since rail pricing has strengthened and truck pricing has weakened, a shipper told us, freight costs have now reached the point at which increases in rail pricing will force him to move his non-captive freight off the rails and on to trucks." Wanting to see how this translates into practice for short lines, I forwarded the note to a few key shortline contacts. I had heard stories of "any move, any price" being pushed by some Class I sales reps and this seemed a good time to see.

The first response, from a chap who runs a 300-mile system, pretty well sums it up. He writes, "What we're hearing is not quite there but it's that volume is more important than price right now, especially if it'll move in company cars in excess capacity lanes. Lots of cars stored." Equipment stored equates to smaller trains and fewer train-starts. Chris Ceraso at Credit Suisse correctly notes "Though volumes are getting worse each week, service metrics have generally improved (as they should since less freight is moving on rail networks)."

News You Can Use Department: Home builders face what the Wall Street Journal calls a "glut of foreclosed homes," some barely lived in. Priced to move off lenders' books, these properties will keep the pressure on listings and could slow the recover of home prices. This bodes ill for the home builders and thus dims the outlook for building materials shipments on the railroads. A Class I market manager tells me they are seeing smaller shipments from the lumber mills, preferring to use transloads to cover multiple customers as opposed to carload direct as in happier times.

Share prices of farm-machinery maker Deere ticked up on Thursday on a research report from Bernstein Research that predicts improved results on an agriculture products marker that will be "stronger than expected."

Amtrak's Paul Vilter writes that he has two openings on his Host Railroad staff. The first is a director-level position to negotiate and manage Amtrak relations with the Class I freight roads that handle 70% of all Amtrak train-miles. This involves everything from negotiating contracts to working with federal and state government agencies to working with Amtrak and host railroad operating personnel on subjects ranging from transportation economics to litigation to on-time performance. The position reports directly to Paul.

The second opening is for a Program Analyst reporting to the Director described above. This individual will prepare operational, contractual, and financial analyses of Amtrak trains operating on host railroads, to include identifying root causes of delay to Amtrak trains on host railroads and recommending cures. Paul asks that Week in Review readers wishing to be considered for these positions e-mail him directly at vilterp@amtrak.com.

To close on a sad note, the shortline industry has lost one of its pioneers, Kent Shoemaker, who passed away December 21 in Bloomington, Indiana. Kent helped launch the 514-mile Red River Valley & Western Railroad, based in Wahpeton, N.D., in 1987 and was one of the co-founders of the 229-mile Twin Cities & Western Railroad, which began operations in 1991 with headquarters in Glencoe, Minn.

Kent had a distinguished lifelong career of innovation and leadership in the American railroad industry. It was 1957 when Kent went to work for the Baltimore & Ohio and had assignments of increasing responsibility in operations, engineering and planning. He then moved to Minneapolis in 1965 to join the senior management team of the Soo Line, moving to the presidency of the Detroit, Toledo and Ironton Railroad in 1974. Four years later Kent took the reins to lead the D&H in its hour of need during the Penn Central meltdown.

After that Kent returned to Minnesota and took a leadership role in the emerging regional-railroad sector, helping to found and lead both the Red River Valley and Western and Twin Cities and Western railroads. Under Kent's direction, both railroads gained reputations as industry leaders, pioneering new operating and management practices and garnering national awards for excellence and innovation. He will be sorely missed.

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