THE RAILROAD WEEK IN REVIEW
JANUARY 16, 2009

"Milk the cash cow and kill the sacred cow." Anon.

Shares of all four of the major US Class I railroads hit new 52-weel lows on Thursday as investor concerns over a weakening economy and deteriorating performance metrics (see below) put improved 2009 earnings further out of reach. Shares of Bunge, ADM and Potash Corporation of Saskatchewan also drifted lower because of economic conditions. March corn shed four cents to $3.66 while December corn remains north of $4.00 thanks in part to ethanol-derived demand, according to an item on tradingcharts.com. Could it be farmers are holding back pending higher prices in the next quarter, depressing railroad grain volumes for the present quarter? The Jan 12 WSJ ("Double Whammy for Ethanol") says they might be.

Art Cashin, UBS Financial Services Director of Floor Operations, is one of my favorite stock market observers. His daily *Market Commentary* not only tracks the previous day's market moves but also gives insights as to why traders trade as they do and what that says about the trends fore and aft. Typical were his recent comments following the December Federal Open Market Committee (FOMC) minutes.

He writes, in part, "The staff revised down sharply its outlook for economic activity in 2009 but continued to project a moderate recovery in 2010... All told, real GDP was expected to fall much more sharply in the first half of 2009 than previously anticipated, before slowly recovering over the remainder of the year as the stimulus from monetary and assumed fiscal policy actions gained traction and the turmoil in the financial system began to recede.

"Real GDP was projected to decline for 2009 as a whole and to rise at a pace slightly above the rate of potential growth in 2010. Amid the weaker outlook for economic activity over the next year, the unemployment rate was likely to rise significantly into 2010, to a level higher than projected at the time of the October 28-29 FOMC meeting... Core inflation was projected to slow considerably in 2009 and then to edge down further in 2010."

Echoing the same theme, Jon Langenfeld at RW Baird said in a note to clients that "2009 is likely another tough year for freight, particularly 1Q09. Domestic and international freight trends continue to deteriorate across modes; pricing pressure is mounting (notably in trucking and ocean). Bleak 1H09 prospects and no expectations for 2009 freight recovery put consensus estimates at risk. Given the first quarter is the seasonally weakest quarter of the year and given the extremely challenging environment, 1Q09 could be weakest transport quarter since deregulation."

Ed Wolfe of Wolfe Research in NY sees wakening volume trends so "we recently reduced our 4Q08 EPS estimates by about 4% for the large-cap rails, and we are now about 1% below consensus, with a downward bias. We also reduced our C09 EPS estimates by 9% for the large-cap rails, and we are now about 10% below consensus. We still expect US Class I railroad earnings to be down only about 4% and to materially outperform the broader market next year as visibility to pricing and productivity remains better than any other industry we can think of. We also expect a gradual rebound in rail volumes at some point in 2H09, into easy weather comps, an eventual inventory rebuild and a likely infrastructure-based stimulus package with plenty of steel and cement moving on the rails. Our C09 estimates assume a 6% average decline in volumes during 1H09 with a 2% average decline during 2H09.

And Morgan Stanley's William Green sums it up thusly: "Key themes are 1) Volume declines will finally overwhelm pricing; 2) Railroad pricing story could slow, but will still be strong in 2009; 3) Rails have less operating leverage than perceived, and won't lose money; 4) Volumes declines are unlikely to trough before 3Q09, except at UNP; 5) Cycling export gains will be a headwind for every railroad except UNP."

A parallel M-S thread has to do with intermodal, with good news for the Class Is and a potential warning for the short lines. "Intermodal remains a cost-saving solution [for transportation buyers] during tough times. After the rapid surge in fuel this summer, more shippers expressed an interest in rail alternatives in our semi-annual shipper survey. However, we've seen continued share gains even with falling fuel prices, which is partly due to legacy decisions but also strategic decisions to incorporate intermodal.

"The most often cited reasons for intermodal growth today are: 1) intermodal is still a more cost-effective solution than truck; 2) intermodal service has improved substantially over the past few years; 3) rail carriers are more stable than TL carriers who may shrink capacity or close without warning; 4) intermodal offers diversification benefits and a hedge against any future rise in fuel."

As inventories shrink to meet lowered sales expectations, so do shipment lots. The rail-direct customer who would normally take a carload of material at once now takes a truckload -- a third of the inventory to have on the floor eating into working capital. The question thus becomes on of whether short line owners know and understand their customers' changing supply chain management practices. I'll be looking for answers as I interview shortliners for my June 2009 *TRAINS* feature, "The Short Lines of CSX."

Speaking of which, CSX has opened the fourth quarter earnings season with a note warning that results are likely to disappoint. CSX said in a press release that preliminary fourth quarter earnings would be 63 cents a share including "a non-cash impairment charge of approximately 27 cents per share related to the write-down of its investment in The Greenbrier resort."

Excluding the charge CSX expects to earn 90 cents, up six percent over the 2008 fourth quarter. Revenues are up some four percent to $2.7 billon and operating income is expected to come in at $692 million, up 16 percent, indicating that revenue was up more than ops expense, and the Operating Ratio improved 2.6 points to 74.1 from 76.7 a year ago. The earnings call is Jan 21 at 0830.

I suspect CSX will not be alone in reporting less than spectacular results. A short line operator who works mainly with the western roads told me the other day he was up six percent for the year through October however volumes dropped precipitously over the last two months of the year that he finished down oh-point-two percent. And CSX lives in the same neighborhood as NS so how can it be that much different for the Thoroughbred?

The quirks of the calendar motivated the AAR to call the week ending January 2 "Week 53" of 2008 and it was not pretty. The last week of the year saw a carload decline of 16 percent, a modest improvement over Week 52's drop of 23 percent, the latter perhaps exacerbated by severe winter weather across much of the northern part of the country. Every commodity but coal ("heat and eat" again) posted double-digit year-over-year declines. The primary drivers of the week's volume shortfall were motor vehicles and equipment (-50.3%), non-metallic minerals (-35.5%), and intermodal (-11.4%). Declines by rail for the week were as follows: CP (-30.6%); CSX (-19.7%); CN (-18.8%); BNSF (-14.8%); NS (-14.7%); and UP (-13.8%). Taking mix into account, our volume/mix score shows that NS was the best performer in 4Q08 and UP was the worst.

RMI's weekly RailConnect chart of weekly short line carloads is a useful guide to shortline revenue-unit trends. There is a tendency to try to square it with AAR weekly traffic figures however without taking due care this can be an apples-to-oranges exercise. I asked RMI's Paul Pascutti to help me understand their process and how to use it for trend analysis.

He writes, "While we generally follow the categories reported by the AAR for Class Is, it is not our goal to square up exactly with the way that they report, nor is this data used for any sort of official industry statistical data the way the AAR is. You asked specifically about "same railroad" data, how we count intermodal units, and how we handle local moves that originate and terminate on the same short line.

"As for 'same railroad,' we do indeed show 2008 Week 1 with 310 short lines reporting and 344 roads in Week 53, for example. The way the index works is that a railroad must have been reporting data for at least 53 weeks before we include them in the index. So while the number of roads may change, the year-over-year trends should be accurate. Certainly with short lines you are going to get roads that handle different commodity mixes, which might skew the percentage of commodities that are reported, but overall, the trends should be legitimate.

"We recognize that not all short lines count intermodal the same way as the Class Is or the AAR where the unit of measure is the intermodal container. Some of our member roads count platforms whereas others count containers or trailers. Moreover, there is no unit count where the short line works on a switch fee as do certain port roads. But since we are looking for trends we count units the same way the reporting short line does. This is an example where the numbers aren't going to necessarily square up with Class I/AAR reporting.

"RMI short lines report all moves regardless of origin-destinations pairs. However, if both origin and destination are on the reporting short line that counts as one load. This is another area where we differ from Class I reporting, which, if I'm not mistaken, only counts originating traffic for official reporting purposes." Thanks, Paul.

Watco once again shows how to expand the franchise without adding any more miles. As of January 1, 2009, subsidiaries Millennium Rail, Inc. (MRI) and Fitzgerald Railcar Services, Inc. (FRSI) began operating under the name of Watco Mechanical Services. Unifying all railcar shops under one name provides the opportunity to make customers more aware of the vast services the different shops can provide and allow the shops to follow Watco's guiding principle of improved customer service. Watco acquired MRI on May 1, 2007 and FRSI on June 3, 2008. With the acquisition of these two companies Watco Mechanical Services is now the largest car repair company in the United States. Watco's first car repair shop was opened in Coffeyville, Kans. in 1985 to repair coal cars running from Wyoming coal fields to southern power plants and now operates14 car repair shops, 18 mobile mechanical shops and four locomotive shops at facilities located in 14 states.

George Woodward, a Philadelphia investor and railroad professional writes, "I enjoyed your last newsletter and especially the comment about government aid to the Fallen Flag and Easterns and to General Motors. I agree that government aid is warranted in those situations where the government, through regulation or earlier public policy, has contributed to the financial problems of an industry and particularly if current government assistance is tied to correcting the earlier public policy distortions.

"The ICC (government) price controls contributed to the Penn Central bankruptcy and then to the government-sponsored creation of Conrail creation. Then came price deregulation under the Staggers Act, the successful Conrail initial public offering and ultimately the CSX/NS joint acquisition of Conrail. The end result is a stable, successful and self-sustaining rail industry; it is a good example of government support to correct earlier policy problems with a government exit strategy and a resulting market oriented public policy. (As a former Conrail executive I'm always pleased to cite this successful example of how it should work in practice.)

"In the case of the automobile industry, government wage price controls dating from the 1940-50s (when the Federal government was trying to artificially control inflation and overall wages in the face of labor shortages (due to manpower being off in WWII and the Korean War and high demand for U.S. goods from the rest of the world which was rebuilding from WWII) encouraged the automobile industry (and other domestic industries like steel and railroads) to hold the line on current wages and instead unrealistically increase the future pension and health benefits of the automotive work force. With a declining market share and active workforce for the domestic automobile industry this was a long-term recipe for financial non-competitiveness.

"The domestic automobile industry has been struggling with this legacy of earlier government-imposed wage and price controls for over fifty years to the point where the current wages and productivity of the automobile industry (even General Motors) are reasonably competitive, but the enormous pension and health benefit overhang of previous generations (something like over $1500 per automobile for just the pension and retiree health care benefits) is a huge fixed cost that makes them non-competitive on the world market.

"If proposed government aid were tied to using some of the TARP money to support the attenuating cost of these retiree pension and health benefit plans it might be a good investment but only if the automotive industry workforce could be weaned off industry specific pension and retiree health benefits in the future. In other words, it's appropriate aid if government could help solve the instant problems and make a positive contribution to correcting future economic problems and preserve a domestic manufacturing capability and work force at a perilous time for the entire U.S. economy." Amen, George.

Larry Kaufman has also weighed in on previous WIRs. He writes, "I have to take issue with the so-called conventional wisdom (neither conventional nor necessarily wise) that because of a Democrat majority it would be easier to pass re-regulation legislation. The re-regulation debate is a fight between big railroads and even bigger customers over how the money shall be divided.

"There is no partisan issue here, and certainly no fundamental principles involved. The 4R and Staggers Acts were passed by Democrat-majority Congresses. Personally, I don't see Congress really choosing to take sides in a pure commercial dispute, as there is nothing in it for a member of congress to do so. But, keeping the issue alive results in more campaign contributions from both sides. Cynical? I sure hope so."

And "The homilies about debt, cheap money, etc., apply to virtually any business and not just railroads. That FRA declined to fund DM&E's coal line venture is proof that they look at investments and the likelihood that the government will be repaid more than they try to play 'choo-choo.' As you know, Cliff Eby was brought in as Deputy Administrator specifically to manage the RRIF program. Now he's acting FRA Administrator and who knows how long the new Administration will keep him around."

Part II of our How to do a RRIF Loan screed, begun last week courtesy of Chris Rooney, will resume next week with observations on eligibility and what the FRS is looking for.

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