THE RAILROAD WEEK IN REVIEW
APRIL 3, 2009

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Cherylyn Radbourne of Toronto's Scotia Capital recently held court with Canadian Pacific CFO Kathryn McQuade. Radbourne writes, "Ms. McQuade made a credible and persuasive case that CP has considerable opportunity to reduce its operating ratio over time through process improvement and standardization and better coordination between sales and marketing and operations and network planning.

"In the short term [however], CP's ability to improve productivity is being frustrated by unprecedented volume declines and traffic volatility. We have reduced our Q1/09 EPS estimate to reflect CP's disclosure at a conference earlier this week that potash volumes are down >70% YOY, and long-haul Canadian coal volumes are down >20%. The volume declines in those two higher-margin businesses are not evident in CP's weekly carload data, which shows overall sulphur & fertilizer volumes are down 54% QTD, pro forma the DM&E, and flat coal volumes.

"Furthermore, CP's customers have limited visibility to their as possible own business volumes and are waiting until the last minute to communicate their plans to CP, which limits CP's ability to schedule appropriately. CP continues to adjust train operations to match volumes as closely as possible while maintaining the flexibility to react when business improves." The downside of scheduling train ops to match volumes is getting power and crews out of place. Happily, CP uses much the same planning tools as NS giving the Calgary Crowd to keep the assets one step ahead of the carloads - as long as the customers know what they are about.

Union Pacific has asked the STB to "determine the extent of the common carrier obligation to quote rates for new, lengthy movements of chlorine averaging 1,900 miles in distance and traveling through two High Threat Urban Areas and several other large cities." While the STB is awaiting public comment, I thought it might be instructive to find out what percent of shortline revenue moves are hazmat. Are there financial implications for a short line that has a TIH incident? And, if moving hazmat means betting the farm, is there any way for the short line to refuse the car -- an embargo, for example.

I put the question to Dave Mears at the ASLRRA. He writes, "Concerning the first question, there is a significant number of short lines and regional rails that are moving TIH. Concerning the second question, a significant TIH accident could indeed be economically catastrophic to a company not sufficiently self- or externally insured; you will recall that the settlements out of Graniteville came to total in the hundreds of millions of dollars. Concerning embargoes, that would likely not be an option, as embargoes are only for use as a temporary measure. We are watching the STB review of the UP case with interest." So am I, along with the "significant number of short lines and regionals" David refers to, I'm sure.

The STB has determined that the Class I railroad average rate of return on net investment increased to 11.2% in 2008 from 10.1% in 2007. Among individual railroads, Norfolk Southern was the ROI leader in 2008, with a return of 15.2%, compared with 13.4% in 2007. CP/Soo Line had a return of 14.8%, down from 16.2%. BNSF earned a return in 2008 of 11.1% vs. 10.4% in 2008. Union Pacific earned 10.6% vs. 8.8%. CSX Transportation had a return of 9.6%, up from 7.2%. CN/Grand Trunk Corp. earned 9.8%, up from 10.8%. Kansas City Southern's ROI was 8.3%, compared with 10.1%.

The STB uses return on net investment and an annual industry cost of capital figure in evaluating the adequacy of individual railroads' revenues each year, as well as in various types of regulatory proceedings (such as determining the reasonableness of a challenged rail rate, considering a proposal to abandon a rail line, or valuing a particular railroad operation in certain other types of cases). STB, using the Capital Asset Pricing Method to calculate the cost of equity (a key component of the cost of capital), found that the rail industry's after-tax cost of capital for 2007 was 11.33%. In 2007, only NS and Soo Line were determined revenue adequate.

But what's the company really worth, especially if you're concerned with per-share yield compared with fixed-income paper? The yield of the stock is easily calculated. It's the trailing-twelve months earnings per share divided by the current stock price (essentially the inverse of the PE). To get total yield add the annual dividend yield (annual dividend over price) to the earning yield. The result is what you as a shareholder can expect your shares to earn for the next twelve months assuming no change in earnings. Based on 2008's actual earnings, NS scores best with a total yield of a whopping 17.7% with CSX second at 16.8% and so on down to 12% for CNI, lowest of the dividend payers. Include GWR and KSU and the former comes in last at 6.1% and KSU at 13.8%.

Now to double up. KCS recently issued new paper to wipe out some debt that was coming due later this year. To do so they put on a coupon rate of 13% due 12/15/2013. It was first issued at less than par, yielding 16%. However since then the price has risen to $104 so the effective yield dipped to just under 12%, still not too shabby. It's callable paper, however taking a little risk on the bond (it's Moody's B2) and buying the stock should give you a nice ride assuming the earnings hold.

Chop Hardenbergh's Atlantic Northeast Rails & Ports newsletter reports that the P&W has won a $150,000 grant from NESCAUM (Northeast States for Coordinated Air Use Management). The award was for reducing diesel locomotive emissions as part of a NESCAUM project. Chop reports that P&W was selected because their team had come forward three years ago with a commitment to upgrade its thirty units with a suite of emission reduction technologies, provided substantial funding support could be found. NESCAUM and several state agencies are working together to secure funding for a package that includes auxiliary power units (APUs), low-NOx rebuilds, and diesel oxidation catalysts (DOCs).

Also on P&W, Chop writes that the first cars of what will be a 200-unit fleet of auto racks are on their way from Trinity's plant in Cartersville, Georgia. The cars will be P&W's contribution to the Multilevel Reload Pool that used by all North American Class I roads. The STB authorized P&W's membership in the pool two years ago and is the natural next step in realizing the full potential of the Davisville auto facility and associated investments. The production of these cars was planned in January 2008 when GATX first invested in the company. GATX is leasing the autoracks to PW.

Vermont Rail President David Wulfson has, according to Chop, announced three track projects: $1.25 million for track replacement this summer south of Rutland; $500,000 of tie work north of Rutland to prepare for welded rail installation; and $4 million of welded rail between Rutland and Burlington. These projects are part of a five-year $35 million program for track improvement over the former Rutland Railroad between Rutland and Burlington.

Wulfson said some of that money has already been allocated in upcoming budgets, much of it is expected to come from the $13 million secured by former US Senator James Jeffords in an earmark for the western rail corridor, a project that envisions a redone line from Bennington to Essex Junction, along with a new Rutland rail yard, a new spur to Omya's quarry in Middlebury, and a redone Burlington rail tunnel.

An item in the Railroads of New York newsletter lays out eight requirements for short line projects to be funded with “federal economic stimulus funds.” The author? Why, the FWHA. of course. Here’s the short form. You have to get the fed’s OK and the funds lined up before you spend anything, meet MPO requirements and be in their plans and meet enviro provisions for water quality and endangered species. Be sure to meet “historic preservation” requirements.

In contracting, meet federal standards for equal opportunity, labor and payrolls, Buy American and use “a qualified base selection process in procurement/selection, negotiation and contracting with consultant firm for any program management, construction management, feasibility studies, preliminary engineering, design, engineering, surveying or architectural related services needed.” For dessert, “Designs must be in accordance with federal policies, standards and specifications” while complying with “environmental and uniform relocation assistance and real estate acquisition procedures if right-of-way is to be acquired.” And you gotta dot it all according to their rules.

The only good news is that track rehab projects on existing track and equipment purchases are “categorically excluded from the environmental and real estate related requirements.” Which seems to me it means everything else applies. To be sure, jumping through all these hoops ain’t cheap, and if you weren’t an “endangered species” at the outset you may be by the time the tamper comes through. (But then, it all may be moot as the 2009-2010 state budget reduces capital assistance for rail by a third -- to $5 million from $15 million. Worse, the Division of Budgets has yet to issue the requisite paperwork to let the grants made a year ago get under way.” Cheers.

GATX (ticker GMT) looks like it will be in no-growth mode for a while. This week’s Investment Summary from Jeffries & Co. cites “specific concerns [that have] have weighed on GMT’s stock YTD. While we think that these issues have been overblown and the stock was temporarily oversold, we do not see material upside at current levels until consensus estimates are rationalized. We recently hosted investor meetings with GMT and the interest level was high as investors revisited this well managed, cyclical company.” GMT earned $3.44 a share in 2008; the 2009 consensus stands at $2.10 and $2.40 for 2010 with Jeffries on the low ed of $1.80 and $2.20. Among others in the car-supply space, only FreightCar America (RAIL) shows an earnings upside 2008-2009 and into 2010.

Concerning the House action on AIG taxes and the implications thereof (WIR 3/27/2009), Larry Kaufman writes, “Members of the House and to a lesser extent, the Senate, often vote on bills without having the foggiest notion of what they are doing. [They may] vote on measures even when advised of the consequences (no law of unintended consequences here) on the theory that if the consequences do materialize the way they were warned, they will be able to rationalize a seemingly stupid vote and if it takes long enough, their successor in Congress will be saddled with cleaning up the mess they helped create.” Now consider the implications for the upcoming railroad legislation.

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