THE RAILROAD WEEK IN REVIEW
AUGUST 28, 2009

"Our program for home-grown distributed power retrofits works so well it is almost scary." – Gary Lee, General Road Foreman, Paducah & Louisville Railroad

JPM's Tom Wadewitz sees "a trend of modest improvement in absolute volumes." He writes, "Week 33's volumes were up 8.2 percent in total vs. the second quarter average. Intermodal was up 5.6 percent and coal was up 9.3 percent over the second quarter. Metals and ores increased 41.5 percent, waste and scrap grew 36.5 percent while stone, clay, and glass increased 14.7 percent. Chemicals and petroleum products were up 9.6 percent from the average weekly carload rate in the second quarter.

"Motor vehicle shipments were also strong, up 21.0 percent vs. the second quarter average run rate. Industrial products as a whole increased 14.7 percent against the second quarter average. On a year-over-year basis, the industrial products group was down 22.1 percent, slightly better than the four-week moving average of -25.8 percent and better than the second quarter average decline of 33.8 percent."

North of the border, Scotia Capita's Cherilyn Radbourne writes, "Average weekly carloads thus far in the third quarter have… essentially just returned to first quarter levels. Traffic categories showing sequential improvement, some of which is likely attributable to seasonality, include intermodal, coke and coal, chemicals, metallic ores, grain, waste and scrap materials, and the metals group. We note that shipments of chemicals and waste and scrap are traditionally seen as leading indicators."

She adds the truckers' rate of decline may have slowed but they're not turning cartwheels just yet. "The American Trucking Association's Monthly Truck Tonnage Report increased two percent in July compared to June, bringing the seasonally-adjusted index to 101.9 (2000=100). Compared with the prior year, the index was down ten percent, the smallest year-over-year decline posted since February 2009. ATA Chief Economist Bob Costello commented that while he is optimistic that the worst is behind us, he doesn't see anything on the economic horizon that suggests freight tonnage is about to rise significantly or consistently."

The rail outlook may bode a bit better for short lines. However, there is a caveat. In the east particularly we see the distances between intermodal ramps and transloads shrinking to accommodate shorter drays as the cost of driving a truck increases. It's not likely to go down again, so more ramps with shorter drays make for increased service reliability and customer satisfaction. One eastern short line I spoke with this week says year-to-date car counts are down double digits year-over- year but revenues are less worse thanks to a changing traffic mix. Without that new traffic he'd be way down, as are many of his peers.

Taken as a whole, RMI's "RailConnect Index of Short Line Traffic" shows the group down 27.1 percent for the year and for the week. The six-week trend is holding in the neighborhood of minus 27 percent plus or minus a few tenths of a point. Meanwhile, the Class Is are doing about ten points better in the weeklies and year-to-date. I'm including coal and intermodal here because the continuing domestic intermodal expansion is surely taking share from the single-carload franchises where the short lines live. Coal is important to many eastern short lines and needs to be included in this discussion.

On the investment side, UBS' Rick Paterson writes, ""Stock picking in recoveries is often difficult because it's a balancing act between improving fundamentals vs. the degree to which they're already priced in. One exercise we find useful is to compare the current price to the prior cycle's peak EPS, deriving a P/E on prior peak (PPP), then trying to forecast how long it will take earnings to re-peak.

"The optimum mix of low PPP and the shortest re-peaking time potentially highlights future out-performers. Two stand out to us: CSX with a lower than average PPP (12.2x vs. 12.5x) and the fastest recovery time (six quarters) and NSC with the lowest PPP of only 10.2x-a 21% discount to the average of the other rails, albeit with a slower expected recovery given a deeper volume hole to dig out of. This analysis also supports our two top US picks: CSX and NSC."

Supports my short-call strategy, too. Because we're in an iffy market, I don't expect any quick moves either way. Thus I am hedging my bets by selling calls with strike prices two dollars or more out of the money a month or so out. I don't sell the calls for less than a dollar so I'm at least three dollars ahead if called away. If not called away, it's rinse, lather, repeat -- sell another call for a buck a month out with a strike price at least two dollars out of the money. At the moment I have positions like that in CSX, NSC and UNP.

Ed Wolfe sees "catalysts" in Kansas City Southern and Genesee & Wyoming. He writes, "We favor GWR and KSU for their high-end industrial exposure and catalysts outside of a U.S. economic recovery: impending acquisitions for GWR and above market operating leverage from Mexico plus a cash flow inflection for KSU. Currently these are our only two Outperform rated rail stocks.

"GWR is currently trading a seven percent P/E premium to the Class Is, well below its historical 10 percent to 20 percent premium at a time (ahead of an acquisition cycle) when it should trade toward the high end or even above that premium range. We believe KSU should trade at 8x-9x forward EV/EBITDAR, above the large-cap rails' historical range of 6x-8x, due to its better growth prospects in Mexico and greater OR improvement still in front of it.

"GWR and KSU rank #1 and #2 of our 30 covered companies on greatest industrial/lowest exposure to the consumer-driven economy. We expect the industrial economy to improve much more quickly than the consumer, as unemployment lags inventory restocking back to recovery. GWR's collection of short line railroads provides operating leverage that allows it to add cars without adding train starts, adding very little incremental cost with incremental revenue."

Conversely, "KSU's Mexican operation has very high fixed labor costs that have hurt financial performance with weak volumes, but should position it very well now that volumes have begun to rebound. Thus we reiterate our Outperform ratings on GWR and KSU, as their consumer exposures are relatively benign, they have high-end potential operating leverage to an improving economy and their valuations are historically compelling relative to the large-cap rails. In addition, we see near-term potential catalysts for each outside of the US economy."

I like the part about "relatively benign consumer exposure." I wonder how many other short lines could successfully don that shoe.

Patriot Rail says now we are six. The Temple & Central Texas Railway, Patriot Rail's newest short line, will soon begin operations at the Temple Rail Park. The T&CT, Patriot's sixth railroad and its first in the Lone Star State, will operate 7.7 miles of track in a city-owned industrial area using a pair of leased GP-30s to run the trains. Say's Patriot's Wayne August, "Having our railroad on the property assures tenants daily service and on-call switching, something that is just not possible with a non-resident railroad service provider."

The arrangement calls for Patriot to be the exclusive manager and operator of the line for two years. Earlier this year, regional grocer H-E-B announced it would build a 400,000-square-foot distribution center in the park. That move followed a recent announcement by auto distributor Gulf States Toyota that it would construct a terminal to deliver Toyota vehicles to dealers that arrive via the nearby BNSF Railway connection.

Elsewhere, according to the *TRAINS* newswire, the Minnesota Valley Regional Rail Authority, owner of the 94-mile piece of railroad operated by the **Minnesota Prairie Line**, will use $2.5 million in stimulus funds to help repair the line, according to the Mankato (Minn.) *Free Press*. The money will be combined with $10 million from other sources to rehabilitate the route, possibly as far west as Winthrop, Minn.

The ex-Minneapolis & St. Louis route stretches from Hanley Falls to a connection with the Twin Cities & Western at Norwood, Minn. The track has suffered from deferred maintenance, however, and current track conditions have restricted trains to 10 mph. The line is gradually being upgraded to 25 mph standards, and lawmakers along the route are angling for $10 million in state funds next year. Final plans call for an improved connection to BNSF Railway at the line's west end.

Gary Lee, General Road Foreman at the Paducah & Louisville, writes, "I read in *Week in Review* about the UP's policy of acquiring new locomotives equipped with distributed power capability rather than using a re-fit program. I don't know about UP's situation, but here on the P&L we are almost finished with a program to equip our mother-slug fleet with DP. So far we have nine of eleven sets completed.

"This involves Knorr CCB II electronic air brakes as well as the Locotrol modules from GE. I can tell you from experience that it works so well it is almost scary. We have been able to increase our train size on the Louisville District from 75 263klb cars to 88 286klb cars using a three set by one set configuration. These units have software that allow them to link and work with the CEFX SD 9043 MAC's that we have on lease. We are totally sold on the concept." I picked up the phone and spoke at length with Gary and it's a great story; look for more on that topic here shortly.

Longtime WIR reader George Woodward writes, "Your Aug 22nd newsletter brought back fond memories of my time as a Southern Pacific assistant trainmaster at Stockton, CA in 1973-74. My territory, I believe, was from Elvas Tower just south of Sacramento to the north end of Fresno. However since I was part of SP's San Joaquin Division I'd occasionally get sent as far south as Bakersfield. In 1974 I was a junior officer and remember being dispatched to escort an ultra-sonic rail detector (at 4 miles per hour) to inspect all the track from El Paso, TX to Yuma, AZ including all branch lines. Only took seven weeks!!! I've probably stayed in every motel and eaten in every restaurant in southern New Mexico and Arizona." Thanks for the reminiscence, George.