THE RAILROAD WEEK IN REVIEW
OCTOBER 30, 2009

"We're certain that the economy will be in shambles throughout 2009 and probably well beyond." - Warren Buffett, Letter to Shareholders, February 27, 2009

Class I Rail stocks took a serious tumble the week before last and didn't find much recovery this week. A week ago, Oct 23 to be exact, the Big Six rails tanked on what appeared to be Wall Street disappointment that volumes are not roaring back supporting the investment community's desire to have some good news to start hyping stocks. It ain't happening, folks.

The view from the field is not encouraging. Henry Lampe reports that Mittal Steel, one his largest customers on the South Shore, has shut down two of three blast furnaces "indefinitely." A class I sales rep working the northeast tells me some short lines are staying alive solely by dint of car storage revenue. A friend touring the western roads on a series of business car trips reports seeing few trains vs. what he's accustomed to seeing out there. And today's *WSJ* notes that two thirds of the third quarter's GDP improvement was a result of "vehicle purchases and residential construction juiced by government support."

As Jason Seidl of Dahlman & Rose puts it, "While there appears to be a consensus that rail volumes and the economy as whole have stabilized, the railroads [in their calls have] expressed concern that they did not detect signs of a major upturn in traffic for the foreseeable future. The somewhat tougher pricing environment likely stems from pricing pressure being passed down by truckers." Maybe so. But in spite of railroad touts of "core pricing" in the six percent range, the fact is revenues are down and the only thing saving operating earnings is severe cost containment.

Let's start with Norfolk Southern. Third quarter sales were $2.1 billion, down 29 percent -- $831 million – year-over year. Chief Marketing Officer Don Seale showed how revenue unit count (down 20 percent) cost NS $570 million, how fuel surcharges came down $436 million as WTI oil prices dropped 50 percent, and how another $22 million dip came from coal-related adjustments. On the plus side, improved mix added $19 million and rate increases generated $178 million.

So even though NS can point to an average pricing gain of 6.2 percent, at the end of the day less revenue means less operating income and less money to spend on niceties like capex. System revenue per unit dipped 11 percent all-in. On the expense side of the ledger, ops expense came down only 25 percent, four points less than total revenue so ops income was leveraged down to a negative 37 percent delta. This is highly unusual for NS and boosted the operating ratio by 365 basis points to 72.8 from the sub-70 number reported a year ago.

It's also temporary. NS, like the others this quarter, shows significant improvements in operating metrics caused by sharper operating practices that will outlast the present slowdown. Take GTMs and fuel: GTMs down 17 percent, fuel burn down 19 percent, ops expense ex-fuel down 14 percent. Sequentially, third quarter GTMs were up nine percent over the second quarter yet road train crew starts were up four percent and no new yard assignments came on. Compared with third quarter 2008, road crew starts were down 16 percent and yard starts down 19 percent.

None of these operating efficiencies are coming at the cost of service. Seale said, "Service consistency is the number one priority for most of our customers and the magnitude of improvement here is significant for future price support." He had the numbers to back up the claim, noting a six percent improvement in transit time performance and a ten percent improvement in service consistency. But if folks aren't buying and inventories aren't moving, the best service in the world is not going to create demand where there is none.

[As an aside, the STB ran its cost of capital numbers and concluded only NS made the industry cost of capital (Railroad Cost of Capital — 2008, STB Ex Parte No. 558 (Sub-No. 12) (STB served Sept. 25, 2009), determined to be 11.75 percent. "By comparing this figure to the 2008 ROI data obtained from the carriers' Annual Report R-1 Schedule 250 filings, we have made revenue adequacy calculations for each of the Class I freight railroads that were in operation as of December 31, 2008." NS was at the top of the heap with 13.75 percent, the western roads were in the 10.5 range, CSX came in at 9.3 percent and KCS brought up the markers at 7.7 percent.]

Canadian Pacific's third quarter 2009 report is noisy. In order to show how the DME acquisition fits the total picture, CP had to adjust the results from 2008's third quarter to reflect an "as if" scenario. They also had to produce a set of GAAP numbers that I think are less meaningful to WIR readers than an accurate picture of year over year performance. I'm using the pro formas with DME here. Total sales fell 20 percent on 18 percent fewer revenue units and 15 fewer RTMs. Operating expense likewise came down 20 percent so operating income dipped 21 percent and the operating ratio was essentially unchanged at 76.

GTMs were down 15 percent and fuel burn dropped 19 percent. During the call, Brock Winter, SVP Operations, said increased use of distributed power generated five percent more GTMs per gallon of fuel while improving train speeds by eight percent and train weights nine percent. Train miles fell by 21 percent resulting in 23 percent fewer train starts. Running a safer railroad was another contributor to improved operating efficiency as FRA reportable incidents dropped 60 percent. Casualty expense on the income statement dropped $9 million, showing once again that a safer railroad costs less.

CP, like NS, shows how running a faster, smarter railroad means that, as CP President Fred Green said in his concluding remarks, you don't have to "bring back resources on a one-to-one basis as volumes return." Part of this is the continuing industry initiative to make formerly fixed costs variable. CFO Kathryn McQuade said CP was able "to save 57 cents of expense for every revenue dollar lost, net of inflation, fuel hedges and foreign exchange."

As for what's down the pike, CP sounded like everybody else: we really don't know. During the Q&A Ray Foot, Group VP for Sales, was asked how shippers feel about the prospects for recovery. Said he, "We just don't know where inventories stand and where their volumes are going to go." Which pretty well sums up the comments at the beginning of this letter.

Kansas City Southern put on as good a face as one can expect under the circumstances. Total third quarter revenues came to $386 million, down 21 percent or $105 million year-over-year, of which more than 40 percent was due to the drop in fuel prices. However, third quarter sales increased 13 percent over the second with Mexico sequential volume growth outpacing the US. Revenue units dipped nine percent, one of the smallest declines we've seen this quarter. Bright spots were chemicals and petroleum, up eight percent, and coal up half a percent. System revenue per unit came down 14 percent anyway.

Operating expense came in 21 percent below the third quarter oh-eight number so operating income showed a 24 percent dip; the operating ratio added 72 basis points to 78.1. As usual, KCS made no mention of fuel consumption on the call, and only referred to RTMs and GTMs obliquely, showing a slide with sequential improvements in the ratio of RTMs to GTMs, the lesson being the higher the ratio the fewer the empty ton-miles.

All in all, KCS seemed pretty upbeat, citing more positives than negatives in business opportunities, one of the things KCS has always done well. Positive factors are seen in six areas: Mexico, ag and minerals, US intermodal, core pricing, auto production and new business. Coal and chemicals are neutral and the only negative aside from inflation in Mexico is housing-related and that's no surprise.

Jason Seidl again: "KCS voiced a good deal of optimism about the outlook of its business indicating that it expects volume to improve in 4Q and grow sequentially in the mid single digits. The company expects to see improvement in Mexico, which has done well in the last month. Such improvement is likely to continue into 2010 as management noted they would expect about the same pricing for the railroad in the coming year."

There has been more than passing interest among WIR readers about the RailAmerica IPO, especially in view of the stock's initial decline in price. To see what might be causing these concerns I ran the second quarter 2009 year-to-date numbers from the revised S-1 to compare RailAmerica with others in the same space, mainly KCS and GWR. Conclusion? Good results though perhaps a bit pricey at 15 smackers.

First, RA's results. Revenue decreased 19 percent to $207 million and operating expense came down 25 percent, leveraging a ten percent gain for operating income, pushing the operating ratio down 577 basis points to a respectable 78.2 from a not-so-spiffy 83.8. By comparison, six-month figures show KCS revenues down 27 percent and GWR down nine percent. Operating income for KCS and GWR came down 51 percent and 20 percent respectively to RA's plus ten percent. Operating ratios were 87 and 85 respectively to RA's 78.

Looking at the adjusted balance sheet post-IPO, we see net debt/equity at 84 percent, down from 143 percent, and net debt/capitalization at 46 percent from 60 percent, both as of 12/31/2008. Interest coverage is a scant 1.3x. Reported six months EPS of 15 cents on $19.2 million of net income implies 128 mm shares. Annualized EPS 30 cents at $15 a share gives a PE of 50, which seems rather rich. With the "normal" rail multiple around 15, RA may perhaps be a better value at $4.50.

One of my more analytical long-time readers writes, "I agree that they have made some progress with the basic business, however the first value [put to the market] was *toooo* much. The economy won't turn on a dime so things will be stretched a bit. While the shortline roll-up makes great sense it still costs a bit more to run myriad operations. I posit that any turn in the economy will be quickly obvious for the Class Is but a longer pull for the Class IIs and IIIs. I think they run a great operation but they still serve the Big Picture God."

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