THE RAILROAD WEEK IN REVIEW

April 2, 2010

"NEW CROP DECEMBER CORN: A Bear In Full Regalia. The USDA's inventory figure yesterday sent corn fleeing to the downside. Any small rallies are to be sold into." Gartman Letter, April 1, 2010

Grain prices continue their southerly drift. A note from UBS on Thursday says the continued pressures on corn and soybean prices "cloud the outlook for fertilizer." Softening demand has pushed the prices of May 2010, Dec 2010 and May 2011 corn down 21 percent, 16 percent and 15 percent from their Jan 2010 highs. Says UBS, "Another record-size corn crop in 2010 could further weaken corn prices." [This week's USDA Grain Stocks report has corn and wheat inventory levels up 11 percent and 30 percent year-over-year, respectively. On-farm inventories were also up 11 percent for corn and 24 percent for wheat, which suggest farmers are continuing to sit on inventory. --rhb]

The UBS note says this growing season will see fertilizer demands up somewhat but still the second lowest level in 20 years. "While US fertilizer demand should rebound from the 2008/09 trough, lower corn prices limit growers' ability to pay higher fertilizer prices. Potash price rises are lagging expectations and nitrogen and phosphate prices appear to have plateaued. CSX and CP are the biggest players here and each has a sizable shortline network serving country elevators in the plains and the broiler markets in the southeast.

UBS concludes, "Weekly crop progress reports commence April 5 and corn planting starts in earnest by mid- April. Corn prices will ebb and flow with the rate of planting progress through early June when corn planting is completed. The USDA issues its first yield forecast on May 11 and updates planted acreage on June 30."

The Health Care Law promises further mischief for short lines. I've been reading up on the provisions and as near as I can figure out payrolls of 49 or fewer names are safe from government mandates for employees' health care packages. Add that 50th name and you open yourself for massive fines of $40 grand for the company plus $2,000 per employee number 50 and up. And even if the short line itself can stay safely under 50 employees, what about the customers? Will the plastics extruder want to add that third shift or the transload warehouse want to add a new commodity line? I think not.

The fact of the matter is that smaller companies will now enjoy labor efficiencies no longer available to their larger competitors. And who's to say the 50+ employee companies will not try go get below 50 by downsizing, outsourcing or shifting production to non-US locations? Is is indeed unfortunate that the Members of the world's greatest deliberative body did not consider these ramifications. Atlas will shrug and the short lines will be the worse for it.

Signs of downsizing are already in place. The RailConnect Index from RMI shows shortline carloads up 2.6 percent year-to-date thanks mainly to the surge in ores and metals yet big carload moves like paper remain in the negative column. It's indicative of what's wrong with the single-carload shipment franchise and it's going to get worse as rail customers shrink inventories of both finished goods and raw materials.

Two factors are at work here. In the first place, you don't want to build up a stockpile of finished goods if you don't know you can sell them in a reasonable time. And if you don't think you can sell as many goods as you did before, you're certainly not going to be buying great gobs of raw materials. In the second place, higher labor costs mean less money to spend on other stuff, like manufacturing machinery and raw materials. Smaller inbound needs mandate less time lag between arrival of material and use in finished goods, ergo smaller shipments closer together. Ditto on the outbound side. Good for the trucks -- or domestic intermodal.

Local trains come by once a day and if you miss that switch you're done for the day. How big a pain is that? A friend who's been in this business since before Staggers uses the airport taxi vs. bus example. You fly in and you learn there's one bus a day that makes the rounds of all the hotels and that your destination is last in the queue. Moreover, you just missed the *bus du jour*. Do you sit around for a day or grab a cab? The single-carload shipper/receiver does not have that option.

Happily, short lines are morphing into distribution experts, using their locations close to many businesses to serve them in cahoots with local truckers. To see how much of this is happening, grab a copy of the April 2010 *Railpace* magazine and count the short lines -- even so-called "tourist roads" -- with transloads: liquids and grain on the Strasburg (with the ex-N&W 4-8-0 No. 475 providing the steam heat), Davisville auto park expansion for the P&W and the Wellsboro & Corning transload cited here hast week.

But where short lines can be incredibly valuable is in assembling all the pieces of the supply chain in a transload project. I just got a note describing a terrific example but because this is still a work in progress, I'm not at liberty to give names and specifics here -- just the elements of the services provided by the short line.

The customer expects to receive his first cars in June and is contracting with current railroad customers to provide track materials and grading for the transload point. Inbound car types can vary by vendor of raw materials and the customer has told the short line what to watch out for with each car type. The customer is narrowing down his selection for a local GM and once chosen the new GM will establish communication protocols with the short line for this 24/7 operation. Finally, the short line has lined up the new customer with local truckers that have worked with the railroad in the past. This is the kind of proactive customer management that wins new customers and -- more important -- enhances the short line's reputation for value-added performance.

For further proof that there's a link between inventory management and transportation, NY rail analyst Ed Wolfe writes that he's been discussing with shippers what drives long-term market share shifts from over-the-road truckload service to intermodal. He cites one shipper that is moving away from 100 percent truckload to intermodal in small increments until about a quarter of all his moves are on the rails.

The customer tells Wolfe, "Intermodal service levels overall continue to improve" as the rails get better technology to measure performance and can focus on customer perceived value. He adds, "Rates are roughly 30 percent less expensive and intermodal is more fuel-efficient." Wolfe concludes, "Generally, this shipper is looking to move all of his freight of 1,000+ mile lengths of haul to intermodal from truck, although shorter intermodal moves are increasingly becoming competitive as well." Wolfe cites the operational improvements in terms of transit times and connections in Chicago-land thanks to the CN's purchase and integration of the EJ&E Railroad in 2009.

Providence & Worcester's 10-K for 2009 is a good news, bad news story. The good news is the commodity mix is changing. Over three years -- 2007, 2008, 2009 -- chemical commodity revenues (ethanol included) have risen to 38 percent of operating revenues from 34 percent and "other" including autos is now 13 percent of revenues vs. five percent in 2007. Intermodal -- basically a low-RPU ($68 per container) local switching service for containers -- has dropped to three percent of the total from five percent in the same time frame.

The bad news is total operating revenues continue to slide. Calendar and fiscal year 2009 closed at $23.2 million, down 22 percent from 2008, 11 percent from 2007 and 18 percent from 2006. Every year the company logs about a $million in property sales and other income as revenue, though it's always "below the line" in other railroad income statements. P&W then subtracts operating expense from this inflated number and calculates the operating ratio from it. I put "other income" back where it belongs.

Operating expenses in 2009 were $26.4 million, down 13 percent, producing an operating ratio of 113.5 vs. 102.5 a year ago. Operating loss was $3.1 million against last year's $0.7 million loss. As usual, the comp and benefits line was the major culprit at 68 percent of operating revenues, up 15 percentage points from 2008. Comp and benefits for regional railroads of this size average 30-40 percent of revenues; cutting the P&W comp line to 40 percent would have yielded $3.3 million operating *income*.

The 45G tax credit program brought in $975,000 from assignment to a shipper and took down operating expenses accordingly. P&W owns just 163 route-miles of the 516 miles total operating authority and, according to the 10-K, "has the right to use the remaining 353 miles pursuant to perpetual easements and long-term trackage rights agreements. Under certain of these agreements, the Company pays fees based on usage." A big chunk of this is the rights on Amtrak and Metro North from east of New Haven to Fresh Pond Jct. on Long Island for the aggregates business. (The trackage rights fees chew up roughly 16 percent of the revenue stream from that OD pair.)

The 45G tax credit is allowed on miles owned or leased, not on trackage rights or other easements, so P&W gets about half a $million a year in tax credits. But P&W is a money loser so the law allows the railroad to "assign" these credits to other firms which it has a business relationship, typically contractors or customers. Being able to assign nearly a $million in 45G credits tells me they've been saving up.

A good thing, too, given the way P&W burns cash. Retained earnings dropped 5.3% from $37.6 mm in 2006 to $35.6 mm in 2009. "Cash and equivalents" as of 12/31/2008 was $876,000; a year later it was $157,000. The Cash Flow statement shows that in 2008 they sold $5.5 mm stock to GATX to support a $5 mm capex program. The $957,000 net loss in 2009 was covered by a $962,000 increase in accounts payable -- if you need cash don't pay your bills.

Market cap at year end was $52 million more or less with negative ebitda. If you could generate $3 mm in ops income the multiple would be close to eight, a tad rich in today's market. Still, it would be instructive to take the income statement apart, find where the revenue/cost ratios are most promising, where ops expense could be reduced and see what it might be worth. See cutting comp and benefits above.

The Men Who Loved Trains, Rush Loving's 2006 saga of the Conrail split between CSX and NS, was the subject once again Monday night for a Library Hour presentation at the historic Union League of Philadelphia. Rush had presented the story of how the book came to be written and his experiences in preparing it about two years ago in the same forum and the powers that be thought it might be fun to do it again, only this time inviting Jim McClellan. Jim, as readers will recall, was the lens through which Rush viewed the scene as he unrolled the story.

As the evening came together, we learned Dave LeVan, Conrail's CEO at the time, would also be available for our gathering. And so it was that each of the three talked for about five minutes on his reminiscences after which we opened it to a wide-ranging Q&A that went on for the better part of an hour. A common thread through the remarks of all three was the role Jim Hagen played in setting the stage for healthier railroads nation-wide and the number of firsts at Conrail from three-man crews to branch line rationalization. Thanks again to Rush, Dave and Jim for their insights and to the Union League for hosting the event.