THE RAILROAD WEEK IN REVIEW

July 2, 2010

"Housing is a vital part of the economy, representing about one-sixth of all activity, yet it's being held together right now by the financial equivalent of duct tape." US News on line, June 30

Railroad share prices Tuesday dropped across the board in line with the Dow Jones index shedding 268 points (3 percent) to close below 10,000 once again, continuing a sideways pattern going back to early May. Said the S&P, "Some analysts see a major pullback underway as double-dip recession fears revive. NYSE breadth 28-2 negative, NASDAQ breadth 24-2 negative. All 30 DJIA stocks, all 10 S&P sectors lower. Trading fairly active. Treasuries, gold futures rose in flight to safety amid heightened concerns Friday's Jobs report will be weak."

NS and RailAmerica both dropped six percent, CSX and CP came down five percent, KCS, UP and CN shed four percent while GWR escaped with a two percent loss and Providence & Worcester was unchanged. The Big Six Class I CEOs are generally pooh-poohing the idea of a double-dip recession; however, there remains a lot of chatter on the boards about this. Tuesday's downdraft did not do much to allay those double-dip fears.

I for one do not think the double-dip idea is all that far-fetched. *US News*, in an on-line story Wednesday, posits that the Fed's funneling $1.2 trillion into mortgage-backed securities starting in March, 2009 was the start. Investors who sold these instruments had to park all that cash someplace and the stock market was one obvious answer. "The Fed stopped buying those securities in April of this year, the same month that the bull market ended." The paper concludes, "If it was the Fed's activity that stoked the market rally -- and not an inherent improvement in the underlying economy -- then sooner or later the markets will fall back to their 'natural' levels and stay there until the real economy picks up steam." Ergo this week's sell-off.

We're in what you might call a "90-percent economy" where 90 percent of us still have jobs. We're buying less "stuff" and the savings rate is now pushing four percent of disposable income, up from less than one percent in early 2008 before railroad revenue units tanked. In a note on UP, Zacks points out "The current state of the U.S. and world economy is expected to keep Union Pacific's top-line growth under pressure in the near future. It will not be feasible for the majority of sectors to escape this downturn unscathed. Volumes, as measured by total carloads, were down 16% for full year 2009, compared with a decline of 5% in 2008 and 1% in 2007."

This -- 2006-2008 -- was a time when people who shouldn't have been getting mortgages were indeed getting them, sometimes several. Houses had to be built to go with those mortgages, using up bricks, lumber, cement, roofing material and water pipes, much of which doubtless touched a railroad at some point between manufacture and installation.

One report says, "The Sun Belt states of Nevada, Arizona, Florida, and California continued to lead in foreclosure rates. In Nevada, more than 10 percent of all housing units were in the process of foreclosure in 2009." In other words, housing was overbuilt by 10 percent. If 10 percent of units were in foreclosure, then 90 percent were not, giving you an idea of what I'm talking about when I call this a "90-percent economy." Railroad loadings may be enjoying nice comps over 2009, but they're still down double-digits from 2006-7 when we were building ten percent too many houses. Maybe today's revenue-unit volumes are all we need for the 90-percent economy.

Rail stocks have had a nice run on the 2009-2010 comps with earnings gains coming largely on the heels of better operating practices and double-digit gains in operating income. Let's see the vols return to where they were two-three years ago and then think about whether continued share price increases are warranted.

Week 25 reports are now coming in; the proof of the comps pudding will be when we get a look at Week 26 results. JPM's Tom Wadewitz is particularly encouraging on the eastern roads. He writes, "CSX and Norfolk Southern experienced the sharpest sequential improvement in volumes in 2Q, and our unchanged 2Q10 EPS estimates for CSX and NS are 13% and 11% above Consensus. We note that both of these railroads should also benefit from an increase in pricing as of April 1 on their transportation of export coal."

We don't want to make to much of this, though. In the grand scheme of things NS' Q1 export coal was just under 60,000 carloads, 17 percent of the total coal carloads. We do know, however, that export coal hauls tend to be longer and at better margins for NS. We also know that there are several NS short lines that are active in the export coal business, the Reading & Northern and its anthracite franchise for one. The company newsletter tells us they expect to triple the number of unit trains in 2010 from ten to 30 and more to come in 2011.

On the broader front, Jon Langenfeld at RW Baird writes, "Week 25 volumes grew 17% (vs. 2008 -5%), relatively in line with QTD trends. Non-intermodal carload volumes grew 13% yoy, with absolute non-intermodal volumes relatively stable in recent weeks. Overall volumes continue to benefit from intermodal volume strength."

The industrial products sector has been "relatively stable since Week 18, +30% yoy (vs. 2008 -13%), with modest improvement in week 25. Volume improvement from 2009 levels owe largely to metal- and gravel-based carload growth, while most housing-based inputs such as lumber and glass remain near depressed 2009 levels. Recent rail commentary reflects uncertainty over improvement in housing-related inputs."

In spite of lower than anticipated corn yields, agriculture loadings are "tracking roughly with USDA estimate of 6% yoy increases in combined corn, wheat, and soybeans this past harvest. A strong summer coal burn and increasing industrial electrical demand could suggest an improved 2H10 utility coal outlook. June's 5% decline from March/April was faster than the average 2% decline, but within historical ranges."

I've set up a table for weekly comps to see where short lines are *vis a vis* the Class Is for the first half. I'm comparing basis-point changes in year-over-year carloads ex-auto and intermodal. For Week 25, coal, 11.6 percent of total units, skidded the most, down 15.0 percent. Grain at 13.2 percent of total units was up 16.0 percent with aggregates, 11.5 percent of total loads, up 14.0

percent. The chemicals group at 16.2 percent of total loads was up 5.5 percent. Total carloads ex-auto and intermodal were 92.3 percent of total volumes and were up 10.3 percent. Look for Class I comps next week.

RailAmerica has reached an agreement to acquire Atlas Railroad Construction Company (Atlas) and related assets for $21.5 million in cash plus closing adjustments for working capital, which are estimated to be approximately $2.5 million. The transaction was to close on Thursday. Founded in 1954, Atlas is a railroad engineering, construction, maintenance and repair company operating primarily in the U.S. Midwest and Northeast. Atlas provides railroad construction services principally to public-transit agencies, industrial customers, and short line and regional railroads.

The acquisition should come as no surprise. RailAmerica President and CEO John Giles has repeatedly said there would be an acquisition and this is a perfect fit. There aren't that many short line owners of viable properties looking to cash out while those that ought to cash out have properties that are at best marginal. Atlas is a natural as it supports RA's core shortline business.

Says Giles, "We expect the next several years to see a dramatic increase in spending on railroad infrastructure driven by government stimulus programs and increased investments by North American railroads upgrading and improving their rail lines. RailAmerica will create new opportunities for Atlas to grow its business by expanding into regions where RailAmerica's railroads already have a presence and by providing new services. We also expect to realize cost savings from this combination by leveraging the best practices of each organization."

For the next twelve months, RailAmerica estimates Atlas will generate approximately $25 million in revenue, $3.5 million in operating income and $2.1 million in depreciation and amortization. RailAmerica intends to use cash on hand to finance the purchase. Wall Street approves, too. Says Wolfe Trahan in its note, "RA paid roughly five times trailing EV/EBITDA and expects to increase EBIT by roughly $500,000 immediately through the synergy of reducing prior owner expenses. We expect RA management to achieve its goals and believe the deal should be about $0.04 EPS accretive on a full year basis." Sounds good to me.

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