THE RAILROAD WEEK IN REVIEW

August 27, 2010

"Today's credit markets are a miracle drug that allows weak companies to cheat dearth." -- Wall Street Journal, August 27, 2010

There are two kinds of short lines. There are those that keep reinventing themselves to broaden the franchise and make their properties pay their own way. Then there are those that were established as one-trick ponies -- serving one or two industries, e.g. -- and never reached out any further. It is this latter group that lives settlement check to settlement check and on the kindness of bankers and state largesse. It is this latter group that concerns me most because they are a drag on the first group, sopping up funds that might be put to better use on strong franchises.

Recently I spent a day with a short line that's been in business for 26 years and is an object lesson in making the franchise work. It's a truth universally acknowledged that of every ten customer on the line today one will be gone in ten years. Asked how many of their original customers are still in business today my host told me they can be counted on the fingers of one hand. The business lost has been more that replaced with new business that pays its own way.

This is also a railroad that has been handsomely supported by state and local government infrastructure money over the years. Asked whether they could continue their excellent track program if that money dried up, the answer was unhesitatingly in the affirmative. Finally, the railroad has had extraordinary success in building a franchise around a couple of key industries. Asked whether they could continue to operate at a profit if one or both went away, my host again said yes, though "it would be tough."

This short line's track record is something to keep in mind as you read Wall Street analysts' stream of negatives on the economy and thus the railroads because -- if the economy is in trouble -- there will be less money to buy stuff. Hogwash. As you have read recently in these pages, I posit we're in a 90 percent economy and there's still a lot of stuff on the move to support the majority of the population that remains gainfully employed.

To try on my thesis, I sent this note out last week to a number of industry observers representing short lines, regional railroads and class Is. "A leading Wall Street rail analyst writes that shares of railroad operating companies 'rose 2.7 percent over the past month, on the heels of a 4.2 percent increase from July 1 – July 12. During the month, rail relative outperformance gained steam as earnings season progressed, but after earnings, as more subdued economic statistics, suggestive of a *less robust economy*, were released, the rails gave up their gains.' [*emphasis added -- rhb*]

"I've been out on the D&H, CP over the rockies, the RF&P portion of CSX and to the NS in Virginia's Shenandoah valley (twice) since June. Everybody looks busy and seems to be running well. Dispatching is crisp as evidenced by tight headways and -- on CSX -- effective use of Rule 261 ops for run-arounds in double-track territory.

“The Street seems to be saying volumes can't hold up. But my thesis is that with 90 percent of the populace still employed, they all gotta heat, eat and replace durable goods from lawn mowers to refrigerators as they wear out. As long as the rails offer a superior value proposition to supply chain managers they will do well, even at the 90 percent level, as managers look to keep stuff moving at lower unit cost than a year ago. What do *you* think?”

Responses were overwhelmingly in support of the idea. A sampling:

** Freight rails have learned to adjust and will do OK as the economy simply chugs alongs with a high unemployment rate. My take is that unemployment has really been at 9-10 percent level for over a decade; it was just masked over with folks buying houses they could not afford and maxing out their home equity loans to buy more stuff (SUVs, etc.) that they could not afford either. In a consumer-driven economy, a consumer now deeply in debt means a long, slow recovery. Anyone expect to see 17 million in vehicle sales again anytime soon? Hey, the old car will last for a decade now.

** I was at three different stores at three different malls yesterday. They weren't mobbed - but they were busy, and it appeared to me as I waited in the line to check-out that the 90 percent of folks with jobs are still buying.

** Intermodal numbers show the strength more than carload numbers. The big boxes [Wal-Mart, Target, Cosco, e.g.] use intemodal.

** I generally agree with your thesis and would add that most economists and most macro thinkers appear to be cautiously optimistic even as unemployment remains very high.”

** Wall Street analysts help rig the game by pretending that they understand what is really going on outside of lower Manhattan, even though most have never worked in the industry in which they're "experts.” How can sitting in an office possibly rival your latest adventures on the rail? The answer is, it can't.

** Your observation that the railroads will continue to handle the nation's freight is correct in my view. The problem is that by continuing to poke their customers in the eye with a very sharp, hot stick by pushing prices up and using fuel surcharges as a profit center, the railroads will lower their worth and chase away high-value business to truck (or worse, offshore). Or, in biz school speak, their value proposition will be downgraded.

** The game will be about shifts off the highway, albeit at relatively low margins compared to coal and chemicals. The question for the short lines is whether they can develop transload services that allow them to tap into the truck market.

** Anyone depending on the public sector for funding ought simply to turn off the lights and find something else to do. Debt repayment, "meds for Grandma" and education will consume public spending at all levels of government. If folks are selling their zoos to raise money, how much does that leave for passenger rail? But this is good news long term for [healthy] freight rails which, though they do take some public funding, can do just fine without it.

Summing up, my correspondents are out there looking at things and generally liking what they see in terms of long-term outlook for the rails. The program and institutional traders are taking an exceedingly short-term view, in my opinion. The MarketEdge daily newsletter that watches technical trends has now downgraded all but CN and UP to “Avoid” and the latter two rated “Long” with “strongly deteriorating conditions” -- an indiction that a further downgrade is imminent.

For me, the ratio of share price to book value (assets-liabilities) per-share is a pretty good measure of what a company is worth and what investors are willing to pay to own it. Railroads have traditionally traded right around two times book value. As of Friday morning CN was the high at 2.52 and RA was the low at 0.83. By comparison Apple (AAPL) is going for 5.09 times book, Amazon (AMZN) at a whopping 9.55 times with Coke (KO) and McDonald’s (MCD) at 5.00 and 5.93 respectively.

Yet each of these four non-railroad names sells “consumer discretionary” products -- i.e. you can live without them -- and see the kind of multiples they get. So why is The Street beating up on rail stocks even as they go ga-ga for AAPL and GOOG? I haven’t a clue and remain convinced that if more analysts went out and looked at the same railroads I’m looking at they might take a different view. Only time will tell.

Genesee & Western July 2010 carloads were up 7.4 percent year-over-year and up 6.0 percent year-to-date but down 2.4 percent compared to June, 2010. I’m hesitant to put too much emphasis on sequential numbers, however, due to the many variables one encounters month to month -- the swings thus far in 2010 are in the plus or minus 2.5 percent range. At least it’s consistent and that’s what we’re looking for in this business.

GWR’s monthly car-count is another excellent indicator of North American shortline health, with one caveat: Australian grain, where carload volumes for this franchise fluctuate annually according to the weather. The July count is a good example with total “farm & food” loads up 2,895 units, 46.4 percent, thanks to increased Australian grain shipments. The aggregates business is the other part of the Australian franchise; however, loadings are so consistent that any deltas in this group can safely be ascribed to North American operations. The group was up 16.5 percent and represents 18.4 percent of GWR’s traffic base year-to-date, down from 18.4 percent a year ago.

Elsewhere, the coal group -- including coke and ores and 22.7 percent of the franchise -- was off 6.0 percent (1,038 units) primarily due to decreased coal shipments in the Rocky Mountain and Illinois Regions. The “Other” group, 8.8 percent of the volumes, was up a whopping 41.7 percent thanks largely to increased overhead coal shipments over the Ohio Central, now part of the New York/Ohio/Pennsylvania Region.

It is important to add that GWR discontinued operations of its Huron Central Railway (HCRY) in the fourth quarter of 2009 and now operates HCRY under a temporary service contract through August 14, 2010. Starting in August 2009, HCRY carloads are no longer included in the monthly carloading report due to the structure of this temporary contract. To facilitate comparison to the prior year, GWR excluded 824 total HCRY carloads from July 2009 in the

July 2010 car count comps. However, carloads reported in the company's Form 10-Q will include HCRY traffic through July 2009.

Providence & Worcester's second quarter 2010 results showed carload commodity car-counts up 20.4 percent on a 25.4 percent increase in units, pushing average revenue per car south by 4.0 percent. In its 10-Q P&W states, "This was the result of an overall improvement in economic conditions, coupled with particular strength in the shipment of ethanol, specifically export product destined for the European Union, and construction aggregates for the New York Metropolitan and Long Island Markets.

P&W still has the most annoying habit of putting non-operating income above the line, seriously distorting one's view of how the railroad is actually performing. Put those numbers below operating income where every other railroad carries them and a picture emerges of a railroad operating on the extreme margins of profitability. The quarter's 99.0 operating ratio is actually a ten-point improvement year-over-year; part of the reason is comp and benefits as a percentage of operating revenues actually declined to 49.8 percent from 57.8 percent. It's still about 18 points above the place we find most regional railroads, but I'll have to give them credit for cutting the gulf in half.

Watco has joined the AAR, becoming the association's newest full member. Established in 1983, Watco Transportation Services (WTS) is the third largest short line operator in the U.S. with 22 railroads spanning 18 states and covering more than 3,700 track-miles. As a full member of AAR, WTS will have access to all association services and will be eligible to serve on AAR committees and the AAR Board.

Railroads operated by WTS include: the Alabama Southern, Alabama Warrior Railway, Arkansas Southern, Austin Western, Baton Rouge, Boise Valley, Eastern Idaho, Grand Elk, Great Northwest, Kansas & Oklahoma, Kaw River, Louisiana Southern, Mission Mountain, Mississippi Southern, Pacific Sun, Palouse River and Coulee City, Pennsylvania Southwestern, South Kansas and Oklahoma, Stillwater Central, Timber Rock, Vicksburg Southern and Yellowstone Valley Railroads. In March of 2008, the South Kansas and Oklahoma Railroad was named the *Railway Age* Regional Railroad of the Year.

WTS is owned by Watco Companies, Inc. (WCI) which also owns Watco Mechanical Services division, operating 14 railcar repair shops, four locomotive shops and 19 mobile mechanical shops. The Watco Transload and Intermodal Services division manages 12 transload facilities, seven warehouses and one intermodal location. Congratulations are in order.