THE RAILROAD WEEK IN REVIEW
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"When too many people borrow, it's a threat to all of us." -- Eric Kades, Vice Dean and Professor of Law, William & mary Law School.

We have received some very helpful trucking industry intelligence from Jon Langenfeld at RW Baird. He writes, "Truckload dynamics are firming and demand outlook remains modest. The October demand trends are generally below expectations, but early November trends have improved and provided some optimism for the remainder of the peak season.

'The impact of CSA 2010[1] is a large source of uncertainty for both shippers and carriers into 2011. Carriers estimate five to ten percent of industry drivers will be disqualified under more stringent safety criteria; given the structure of the program, smaller carriers could well be hit harder than the majors. There will be additional expense pressure to materialize from higher equipment costs and driver pay, which should be more than offset by rate increases."

Jon suggests "higher costs will raise industry barriers to entry," which I take to mean barriers to the hydra-like growth of small owner-operators who "will drive for fuel," to coin a phrase. Yes, oil is now $80 and change with the pundits predicting more ups than downs. While in Maine this week I saw diesel prices north of $3. Last time fuel prices got this high a shortline marketeer told me local operators park their trucks as fuel nears four bucks a gallon.

But I digress. Langenfeld concludes, "Intermodal share gains continue given shippers' desire to reduce transportation expense combined with intermodal's improving service standards. We expect upper-single-digit domestic intermodal demand gains for 2011, with one carrier expecting year-over-year expansion at an annual rate exceeding ten percent. The outlook for international is a more modest rate of increase."

Further on domestic intermodal, Tony Hatch writes from the recent Intermodal Expo, "Intermodal will continue to do better than the economy – from continuing globalization and through market share gains; nearly nine out of ten shippers at the Expo say they expect to increase intermodal spend in 2011. Domestic intermodal should truly come of age next year with growth levels of ten percent or more [*there's that number again -- rhb*] regardless of GDP deltas.

"Shippers remain terrified about 2011 truck capacity and at the same time are increasingly comfortable with rail/intermodal service (as well as its green aspects, lane development and, of course, total delivered costs savings). Easing of capacity bottlenecks, particularly in containers and well-cars, for the domestic intermodal supply chain will lead to a release of pent-up demand, exacerbated by the trucking situation.

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[1] Comprehensive Safety Analysis 2010 (CSA 2010) is a Federal Motor Carrier Safety Administration (FMCSA) initiative to improve large truck and bus safety.

"This is a big deal for the rails. In the east, NS has been a leader and seems to have real momentum. In the west, we could see BNSF's two million domestic loads a year triple or more. Pricing will continue to favor carriers – 44 percent of shippers expect explosive truckload pricing growth, raising the floor for intermodal. Service is everything in intermodal – reliability, consistency, on-time percentages, velocity. It's also essential for keeping the regulators/ legislators at bay -- see STB 're-reg lite' that could seek to regulate intermodal -- and for pleasing shareholders with operating leverage that is producing heady incremental margins.

To which veteran rail observer Noel Perry, speaking at a Dahlman & Rose event, adds, "Driver shortage continues to loom over the truckload industry due to hours-of-service regulation, CSA 2010, and new proof of immigration status requirements for obtaining or renewing a driver license. These regulations, along with tighter in-house hiring standards and the recession-era closure of many driving schools, doubtless will exacerbate the driver shortage."

JP Morgan rail analyst Tom Wadewitz speculates whether implementation of CSA 2010 "will provide significant visibility to carrier safety performance. A result of this visibility is a likely increase in the potential liability risk to shippers who choose to use carriers with a poor safety score. [*The same could be said of shippers who use short lines with poor safety stats -- rhb*] We believe that increasing legal risk related to motor carrier safety could drive not only a move toward better quality carriers but it could also favor the larger transportation companies including intermediaries."

And again, "intermodal is a clear winner. Data points from the conference indicate that domestic intermodal demand trends have continued to be strong through the present time. In contrast to the lack of a truckload peak, the peak in domestic intermodal volumes appears to be lasting a bit longer than normal. Considering the current strong performance of intermodal volumes relative to truckload and given the tremendous potential pressures on truckload capacity in 2011, we believe that intermodal is likely to remain a clear winner in the medium term. We continue to believe that JBHT and HUBG are attractive names to own."

RailAmerica this week held its first Investors Day since completing its 2009 public offering. The usual cast of railroad analysts attended (I missed it because I was out touring yards and riding F-units on Pan Am Rail) and the reviews were generally good. Some excerpts follow.

Ed Wolfe and Scott Group for Wolfe Trahan: "Key senior managers presented an update on operations and financials, while delivering a clear message that RA was going on the offensive to try to improve growth, and leverage margins materially going forward. Management continues to see solid demand (four percent carload gain in October and five percent in the third quarter) driven by Industrial Products. It expects continued strong GDP and IP in the three to four percent range for 2011 and does not see a major slowdown in any of its businesses. Pricing expectations remain firm with revenue per carload net of fuel and foreign exchange up seven percent this year, accelerating from four percent in 2009."

JP Morgan's Tom Wadewitz: "The 70 operating ratio target for 2012 appears somewhat aggressive. In 2010 year-to-date, RA has reported an 81 OR without 45G tax credits, while the 70 target assumes that the reinstatement of the 45G tax credits will benefit RA earnings by up to three percent. Assuming no 45G tax credit, management projects that over half of the 800 basis points of margin improvement over the next two years would come from productivity, with the rest split between volume and pricing gains. RailAmerica is targeting 400 bp to 600 bp of margin improvement that is driven by cost-side programs while the remaining productivity gains are the result of smaller cost projects such as tweaking RA's train plan. We believe that modest volume growth in industrial segments where RA has excess capacity can provide another driver of margin expansion."

Jason Seidl at Dahlman & Rose: "While railroad stocks have on average appreciated in excess of 25 percent thus far in 2010, RailAmerica is the only publicly-traded North American railroad to see its shares decline over the same period, albeit slightly. However, the stock has had a good run in the fall as productivity enhancement initiatives got underway and due to the company having reported two consecutive quarters of solid results after a lackluster post-IPO performance. We maintain our Hold rating as we monitor the productivity projects, the full benefit of which may not materialize until well into 2011, and we note that we would not be opposed to re-examining our opinion if shares were to pull back."

Meanwhile, a couple of weeks ago analyst Michael Olsen at *The Motley Fool* (where I began my financial writing career 16 years ago) posted this tidbit on RA: "Buy Buffett's Scraps -- RailAmerica." His argument is that Buffett "let the cat out of the bag," saying, "Railroads are a terrific business" when he bought BNSF. Olson adds, "Railroads haven't looked cheap since, and they never found a place on my watch-list.

"But today, that changes: RailAmerica's (NYSE: RA) our ticket, folks. A previously mismanaged business, the lingering and onerous debts from a leveraged buyout, and seemingly feeble profits mask a burgeoning cash machine with multiple means of value creation. And all of a sudden, I'm just a little less bitter that Buffett blew it for us. This is a classic value."

As Ed Wolfe remarked not so long ago, "RailAmerica, Act II" is still unfolding, though investors seem not to have discovered what *The Motley Fool* has -- trading volumes are on the cusp of insufficient liquidity, just over 200,000 shares a day. But I saw a number of RA folks at the recent BNSF shortline meeting and to a man (woman) they were all upbeat. There is no doubt Giles & Co. inherited a loose agglomeration of short lines, each with its own ideas, and they're working assiduously to tighten things up. The Act II curtain is still several scenes away. I'd stay seated if I were you.

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