THE RAILROAD WEEK IN REVIEW

April 15, 2011

"Signs indicating future increases in traffic volume have been mixed and, therefore, management cannot definitely predict when economic conditions will improve enough to enable the Company to return to operating profitability." -- Providence & Worcester 10-K for 2010

Providence & Worcester's 2010 results are in. Total freight revenues increased 25.8 percent to $27.3 million. Revenue units gained 21.8 percent to 46,419, with ethanol (largely from CP origins in the US Midwest) accounting for half the increase. The chemicals commodity group was the largest single revenue producer -- $11.8 million, up 41.7 percent. Intermodal units remained minuscule at roughly 700 units and less than $70 a box. As a result, P&W is now a 97 percent carload railroad by revenue units.

Below the line, operating expense was held to a 13 percent increase but all that did was reduce the operating loss to $1.2 million from $3.1 million in FY 2009. The big drag is comp and benefits at 54 percent of revenues -- railroads of this size are rarely more than 35 percent labor. Still, it's an improvement because in 2009 comp and benefits represented a hair under 60 percent of revenues. The operating ratio "improved" 9.5 points to 104; if payroll were 35 percent of revenue the OR would have been a more respectable 85.2 -- still high but a lot better than 104.

The net loss was reduced to $267,000 from $1.8 million for 2009 thanks to another healthy dose of "other" income, $1.1 million vs. $1.7 million a year ago, from the sale of assets. The 2010 EBITDA was a positive $1.9 million *vs*. a negative $28,000 a year ago. But with a share price of $16.75 at year's end and a market cap of $80.7 million, we're still looking at a 42 price/cash flow multiple. A more rational approach suggests a multiple of eight times cash flow and a share price of three dollars.

Alabama is a beehive of shortline activity this week as RailAmerica buys a three-line cluster from Gulf & Ohio and Watco picks up a 20-year lease from NS near Montgomery. Searching station lists at usraildesktop.com, photos at railpictures.net, and histories at trainorders.com and Wikipedia, one can garner useful intelligence about what's really being bought and sold.

RailAmerica is paying G&O $12.7 million total for the Three Notch Railroad (THNR, 35 miles), the Wiregrass Central Railroad (WGCR, 20 miles), and the Conecuh Valley Railroad (COEH, 15 miles). In a press release RailAmerica says the three lines handle some 6,000 cars a year among them for a traffic density right at 100 cars per mile per year. Operating income is reckoned to be $1.2 million for an operating ratio of 68; EBITDA is $1.9 million, indicating a purchase price multiple of 6.7 times.

Average revenue per car is north of $600, which seems high for this ag/industrial commodity mix. If ARC were $500 per car, we'd have $3 million in freight revenue plus $700,000 in something else. RA says in their analyst presentations that "non-freight" revenue includes car storage fees; storing 500 cars for a year at $1.50 a day is worth nearly $300,000.

This is a nice buy for RA as it gives them three properties that are close together (the three operations bases are less than 100 miles from each other) and the nearest one (THNR) is less than 100 miles from Monroeville, ops base for RA's Alabama & Gulf Coast Railway. It's also a good deal for Knoxville-based Gulf & Ohio. Alabama has always seemed an outlier for them as their other four properties are pretty much along an imaginary line between Knoxville and the North Carolina coast. The transaction is expected to close in the second quarter of 2011 and is subject to customary closing conditions including regulatory approvals.

The other Alabama play is Watco's 20-year lease for Norfolk Southern's ex-GM&O 46-mile line between Maplesville and Prattville, operating as the Autauga Northern Railroad. It's Watco's third Alabama railroad, having started operations April 9, and is a logical extension for Watco as they have had the switching contract for International Paper's Prattville facility since 1990 or so.

Total traffic base is 9,000 cars per year, most of it relating to IP. Watco is budgeting some $2.4 million in the first year of operations to upgrade the track to FRA class 2 standards -- 90 percent for ties, ballast and surfacing, and the rest for bridge repairs. I'm glad they're doing it for two reasons: it lets them get over the road twice as fast (25 mph vs. 10 mph on class 1 or excepted track) and cuts down on casualty expense. (25 mph).

Two other short lines are in the news this week. In Chattanooga, the Tennessee Valley Railroad Authority has won the switching contract for the new Volkswagen *Passat* plant where the short line will interchange with both CSX and NS for distribution to 16 points in the US, three in Canada and one in Mexico. An appearance by Tennessee Valley Railroad Museum's Southern newly-restored 2-8-0 No. 630 marked the occasion of the opening of the new rail support yard.

The engine is proper for the location. The American Locomotive Company built her for the Southern in Richmond, Va., in 1904 and she was used in regular freight service until retired in 1952. She and sister, the 722, then went to the ET&WNC and were re-numbered 207 and 208 respectively.

In December 1967, both locomotives were traded back to the Southern for use in their steam excursion program. They were restored to their former identities and worked main line excursion trains over the entire Southern system until 1983 and leased to the Tennessee Valley Railroad Museum. Southern Railway successor Norfolk Southern loaned the 722 to the Asheville Chapter of the National Railway Historical Society while the 630 stayed at TVRM, where she remained in operation until being officially retired in 1989.

NS donated the 630 to TVRM in 1999. Over the next ten years the TVRM shop put the locomotive through one of the most thorough restorations performed on a US steam locomotive in recent years, including frame work and complete running gear overhaul. The 630 returned to regular service on TVRM in March 2011 and may participate in the upcoming “21st Century Steam” program being developed by Norfolk Southern. For the nonce, however, she’s happily steaming away at TVRM. Visitors are welcome.

Meanwhile, Ed Ellis’ Iowa Pacific Holdings will, according to a note on the *Trains* magazine *Newswire*, assume operation of New York’s Upper Hudson River Railroad as early as July 1. The Upper Hudson River’s main claim to fame was a tourist train operation for some 12 years on portions of a 16-mile ex-D&H branch between Saratoga Springs and Corinth, owned by the town of Corinth. When I talked with Ed on Tuesday about this, he said he plans to extend the service 30-plus miles to North Creek, paralleling the very upper reaches of the Hudson River.

Ellis plans to operate the railroad under the name Saratoga & North Creek Railway, LLC. The county will set up a public authority to oversee ownership of the tracks. Iowa Pacific has agreed to guarantee 100 tourist trains on the line plus 30 ski trains, some 50 dinner trains, a Polar Express train, and at least one “Thomas the Tank Engine” event.

Continuing the thread of rail pricing (Larry Kaufman, WIR 4/8/2011), a reader who watches these things *verrry* closely writes, “Railroad pricing is not an exact science. There is a subjective/artful side to it where everything from gut instincts to personalities come into play. For example, railroads sometimes utilize their leverage to capture competitive traffic they might otherwise lose to a competitor.” In other words, they may cut margins to increase traffic density and lower unit cost.

“The true proof of rate reasonableness in the customer’s eyes goes to such considerations as (1) is the railroad earning substantially more on my business than on my competitors’s and (2) how much of the cost of transportation can I pass on to my customer?” Does the shipper cut margins on Customer A to maintain production volumes thereby lowering unit cost? The conflict comes when the customer wants to protect margins by making the railroad eat its own increased costs.

Closing thoughts on the ethanol scam: Gasoline sales have fallen for five straight weeks, the first time that has happened since November, according to MasterCard SpendingPulse, which tracks spending at 140,000 service stations nationwide. Sales have dropped at about 70 percent of the nation’s gas station, according to a March survey by the Oil Price Information Service. More than half reported a drop of 3 percent or more -- the sharpest since the summer of 2008, when gas soared past $4 a gallon. Because gas is down so is ethanol and the special interests in DC now want to raise the blend to 15 percent to prop up ethanol production.

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