THE RAILROAD WEEK IN REVIEW

August 19, 2011

Atlas Shrugged Dept: "Almost four in ten millionaires vanished in two years and the taxes millionaires paid declined by $131 billion, a drop of 42 percent." -- WSJ, Aug 17, 2011

At Thursday's stock market close every single railroad stock was down double-digit percentages from its 200-day moving average, save two: Canadian National and Norfolk Southern. And to show how steep the sell-off has been, declines from the 50-day averages are just as bad or worse, again excepting CN, down only nine percent, and CSX by a like amount.

Suppliers are getting hit even harder. Among freight car builders, American Railcar Industries is off 29 percent from its 200-day moving average, Greenbrier is down 42 percent, Freightcar America is down 39 percent, Trinity is down 31 percent and Wabco 16 percent. Infrastructure suppliers were not immune, either: L. B. Foster's off 40 percent, Koppers is off 26 percent.

Adding insult to injury, the AAR weekly carload report has Week 32 (Aug 13) US carloads down one percent with particular weakness in coal, non-metallic minerals and waste/scrap. Intermodal was up only eight-tenths of a point for the week, taking the total revenue-unit count down three-tenths of a point. Add in Canadian carloads and the total revenue-unit count is up a measly oh-point-five percent with the carload sector down four-tenths of a point.

Peter Nesvold, who toils over at Jefferies & Co tracking all these numbers, sums it up thus: "In Week 32, industry-wide volumes posted their weakest YoY reading in five weeks (-0.3% YoY), amid tough year-earlier comparisons, decelerating economic trends, and sporadic weather-related disruptions. Looking ahead, volumes are likely to remain muted into a fading macro backdrop. We view the rails as core holdings, although it is important to resize the positions from time to time. We have argued that investors should buy the group up to 14x earnings, but then sit tight for a period."

Short lines, it appears, are holding their own, up eight percent for the week; back out intermodal, the particular province of such players as Anacostia's Pacific Harbor Lines, and the increase slips to just under six percent. Grain, 13 percent of shortline carloads, slipped 13 percent while ores, STCC 24 forest products, waste, chems, metals and even coal were up by small double-digits.

Earlier this week, Nesvold published a well-researched 53-page note about how and why they are "reducing earnings estimates and price targets across our Transportation & Logistics coverage." He notes that they're now "assuming 2012 U.S. GDP growth of 1.5 to 2.0 percent and $85 oil." As for the rails, Nesvold et al are basing their revised earnings estimates on a three percent decline in vols with average RPUs ex-fuel surcharge up three to four percent.

The lower vols will hit handling lines and switch carriers on flat FAK fees and allowances the hardest, especially where there is little or no "heat and eat" component. Deeper in the report, Nesvold continues: "The combined impacts of continued high unemployment, recent national

budgetary and debt issues, a stagnant housing market and consumer confidence at 30-year lows... lead us to revise our GDP estimate for 2012 and thus our earnings projections. Directionally, we are assuming the low-end of the 1.5 to 2.0 percent range during the first half of 2012 and the high-end of the range during the second half."

The note concludes, "We expect the railroads on average to see a 3.0 percent decline in total rail volumes in 2012 as freight demand decelerates. The specific carload assumption will differ from name to name due to commodity mix and other factors. Still, we expect the positive rail pricing story to continue, with rail inflation-plus (we're assuming rail inflation of 2.5 percent) gains in 2012 as capacity, improved service, and comparative costs vs. other modes drive higher yields." As one pages through the note, one can see how the Jefferies team drills more deeply into companies and trends. If you'd like a copy, drop me a note.

The Gartman Letter of Aug 16 supports the Jefferies thesis.

> There' a bull market in savings that began when the savings rate fell too and for a very short while below 0% back in late '05 and early '06. The savings rate fell that low because Americans were investing in stocks and were "speculating" in housing, cutting their savings while buying ridiculously expensive houses intent upon selling them to the next speculator along the line. When the stock market tumbled, and when housing prices fell the savings rate rose from 0% to 8% in swift order. It has since settled back down and according to the Bureau of Economic Analysis it has fallen toward 5%. We consider this a correction in what is a bull market in savings.
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> Savings rise and fall with consumer confidence, rising as confidence falls, falling as confidence rises. The most recent University of Michigan confidence figures have fallen to new multi-decade lows and we suspect that consumer savings will therefore rise to multi-decade highs.

And as long as savings are up, there will be less excess cash flow to send on stuff. Stuff that has to move in boxcars, containers or over-the-road, and stuff that you need to make the stuff that folks aren't buying. Ergo I think Nesvold has got it right. Attention must be paid.

Providence & Worcester's second quarter freight revenue increased six percent year-over-year to $7.4 million even though revenue units were essentially unchanged, up less than two percent. The intermodal side of the house saved the day, up 28 percent to 3,125 units, as the carload side dipped five percent to 9,420 units over the past year. A shame that, since P&W averages a respectable $765 per carload and a mere $68 per intermodal container. Total revenue, including "freight related" and "other operating" came in at $7.8 million, up six percent year-over-year.

Operating expense less capitalized costs dropped four percent and operating income jumped seven-fold to $550,000, yielding a 92.9 operating ratio, low for P&W, and six points better than it was a year ago. Still, if they could manage to get comp and benefits down from the present 50 percent of revenues to something closer to their Class II peers, say 30 percent-plus... Net income more than tripled to $833,000 thanks part to a $100,000 reduction in taxes. Not bad.

(P&W also availed itself of the 45G tax credit to the tune of nearly a million dollars. It's a very good story and an excellent how-to for short lines, but there are some details I'd like to flesh out and was not able to do so by press time. The good folks at P&W have promised to walk me through the details for as full report here next week.)

RailAmerica has been busy. In the first six months of 2011, thirty-four customers have announced plans to build, expand or re-open facilities on RailAmerica railroads. When completed over the next 12 to 18 months and operating at full production, these projects are expected to generate over 25,000 annual freight carloads for RailAmerica lines.

Moreover, RailAmerica offers one-stop shopping. Not only does RA offer a full gamut of site selection across 7,400 route miles of railroad but also can design and build the railroad infrastructure to support new on-line industries. Recall that just a year ago RailAmerica bought Atlas Railroad Construction, a Pennsylvania-based railroad engineering and construction firm, specifically for this kind of support.

Said RA President JohnGiles at the time, "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. Acquiring Atlas, a quality company with established relationships in the transit and freight rail sectors, positions RailAmerica to benefit directly from this spending."

And how. RailAmerica VP for Industrial Development, puts it this way: "Our clients and the communities that host them benefit from a number of advantages that arise when raw materials and finished products move by rail versus other modes of transportation. The environmental benefits, energy-cost savings and overall efficiency of rail transportation are all compelling drivers of continued development on our railroads." And to do it all in-house adds further value.

Union Pacific hosts its shortline partners in Omaha Aug 28-30 starting with a train ride on UP's "Heritage Fleet" Sunday afternoon. The seven-car of 1950s era varnish will head south 33 miles on the KC line out of Omaha, destination Union, where the train will wye for the return trip. I'm going out Saturday to rent a car and chase trains over at Mo Valley or maybe even scope out the line to Union and back. Or both. Some company would be welcome.

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