THE RAILROAD WEEK IN REVIEW
June 15, 2012

"Negative sentiment regarding coal has more or less peaked and is overshadowing the strong results the railroads have achieved despite these headwinds." Peter Nesvold, Jefferies & Co.

RailAmerica's May 2012 car count increased eight percent year-over-year to 75,384 units. Acquisitions added 2,194 cars to the count, so -- even absent these -- same-store vols were up five percent, not too shabby in this shaky economy. Coal recovered by nearly 2,000 units -- up 22 percent -- thanks mainly to flood recovery on RA's Missouri & Northern Arkansas property.

Forest products units were up a third with strength across the board; automotive more than doubled on Honda's extra shift in Greensburg, Indiana on the CIND. Paper was off a bit in the PNW; non-metallic minerals slipped a bit in the Northeast. However, if we back out the significant coal and auto increases, both one-time events in my opinion, we begin to see the kind of merchandise freight staying-power RA's diversified commodity franchise can present.

May same-railroad carloads ex-coal increased 2.3 percent; same-railroad carloads ex-auto rose 3.2 percent in the quarter. Same-railroad ex-both was essentially flat, up 0.4 percent year-over-year. In other words, RA -- like the class Is - is bringing on new business in less-volatile commodities -- lumber and ag products, e.g. And that's to be rewarded.

Genesee & Wyoming's North American carloads for May 2012 (we exclude Australian results to provide a better gauge of how GWR fares vis a vis other North American Class II and III roads) drifted south by 7.2 percent year-over-year. Like RA above, there were aberrations. On-line coal was off 13.8 percent and overhead coal (NS moved nothing overhead in May) came down by more than 4,000 cars, taking the Other category down by more than half. Grain dropped 25.7 percent year-over-year as last year's number included barge traffic diverted to the GWR Illinois region due to Mississippi River Flooding.

Backing out Coal and Other for both years puts GWR North American vols actually up 3.9 percent, once again supporting the notion that even though coal by itself has been a huge downer, there is in fact life after coal. For example, these decreases were partially offset by a 1,092 carload increase (18.8 percent) in metals traffic primarily due to increased steel and scrap shipments in GWI's Southern Region.

It's not been a good year for GWR in North America. May vols were off 1.7 percent from April, April was flat from March, March was up 5.7 percent over February, but Feb and Jan were down 4.4 percent and 9.0 percent respectively from their prior months. Quarter-to-date NA loads are down 8.2 percent and year-to-date down 9.5 percent.

One last tweak: same-railroad results. Excluding 1,327 carloads from the Arizona Eastern Railway acquisition starting September 1, 2011 and 155 carloads from the Hilton & Albany Railroad, starting January 1, 2012, same-railroad traffic in May 2012 decreased 5,265 carloads, or 6.4 percent, compared with May 2011. But it's only 3.0 percent ex-Coal and ex-Other.

The ***BIG*** news from GWR is the hiring of David Brown as Chief Operating Officer to succeed Jim Benz who retires in early 2013. I've known Dave for a good many years, going back to his days with NS out of Harrisburg. In addition to being one of the sharpest operating guys in the country, he understands the shortline-Class I dynamic exceptionally well.

Over the last two weeks I spent some time here in the northeast looking at the results of three major regional railroads' new business development efforts. Without getting into the specifics of who's doing what, I can say the common thread is transload services and the selling point to customers track-side land with good highway access. I saw -- among other things -- carloads of lumber, plastics, propane, crude oil, frack sand, export grain and DDGs, re-bar, and finished vehicles made elsewhere in the US brought in by the trainload for local distribution.

Precisely because these railroads can put new businesses practically next door to each other, the switching density is incredible, such that it takes several local train starts a day to cover all the moves for all the customers. Best of all, the Class I interchange tracks are often within the confines of these "Transportation Villages," to coin a phrase.

Long-time readers of WIR may recall my visiting CN's Tascherau Yard east of Montreal where they were filling every inch with transloads. And I've written several times about how Pennsylvania's North Shore Rail Group has filled up Williamsport's Newberry Yard by offering these same strategic advantages -- and that was before the Marcellus Shale boom began.

Recent conversations with marketing managers at all the Class Is have been encouraging about their support of shortline-sponsored Transportation Villages. They recognize the value of the shortline business development teams' local presence and ability to take a customer from a vacant field to an active transload. All you gotta do is ask, says one short line guy who's been doing this for nearly thirty years and who has increased his road's vols ten-fold in ten years.

Week 23 (through June 9) Shortline carloads per RMI's RailConnect Index, 418 roads reporting, increased 1.2 percent all-in. Vols increased 2.2 percent if you take out coal, intermodal and auto. Grain's off 11.9 percent YTD, representing 11.9 percent of total shortline loads. Lumber, at only 4.2 percent of vols, increased 10.7 percent. The volume leader, chemicals at 17.3 percent of YTD loads, was up a scant 2.9 percent, but that's still 15,000 more high-rated loads.

The Class Is finished Week 23 with 15.2 million units, up 0.7 percent -- hardly enough to write home about. The 6.7 million intermodal boxes represented 43.8 percent of the total and a gain of 4.0 percent year-over-year. Carloads including coal and auto were off 1.8 percent. For apples-to-apples shortline comps, back out coal and auto. Now you get a Class I increase of 3.0 percent to 11.8 million units, adding further proof that the rails are holding their own absent coal.

It's no secret that rail stocks have of late been pretty badly beaten up over coal. Peter Nesvold at Jefferey's & Co. sums it up thus:

> Rail equities in 2012 have been driven by the soft coal trends that have plagued overall rail volumes thus far this year. While we understand the importance of coal to many of the North American railroads, we believe negative sentiment regarding coal has more or less peaked and is overshadowing the strong results these companies have achieved despite these headwinds.

Just how badly beaten up and what are the shares' prospects? Two measures come to mind -- the Graham Number and the price-earnings-growth ratio. Each is a measure of a share's price vs. a "fair value" given the company's earnings outlook. The Graham Number was developed by Buffett mentor Benjamin Graham who believed that the price-earnings ratio should be no more than 15 and the price-book value per share ought not to exceed 1.5, ergo the product of the two should not exceed 22.5. A stock is under-valued when the Graham number is greater than the share price.

Thus (Price/eps)*(price/bvps = 22.5, price-squared = 22.5*eps*bvps and price = square root of (22.5*eps*bvps). I then take this number as a percent of share price to see by how much shares are over- or under-valued. By this measure, the fair value of CSX is $18.37, 1.15 times the recent price of $21. Similarly, the Graham Number for NSC is 1.09 times the current price, UNP 1.42 times and so on.

I then put that number in the context of the price-earnings-growth ratio. The PEG ratio holds that a stock is fairly priced when the PE ratio is equal to or slightly above the anticipated five-year growth potential; underpriced with a PEG less than 1.00, and overpriced north of 1.5 -- KO has a PEG of 2.38 and JNJ is 2.17, for example. The rails run the other way, most particularly NS and CSX -- the very ones where stock prices suffered the most over coal.

NSC at $69 is trading at a PE of 11.64 with a five-year outlook of 14.50 and a 0.80 PEG ratio. CSX at $21 has a PEG of 0.89. GWR, RA and UNP also sport PEGs under 1.0 while CNI and CP are 1.31 and 1.49 respectively. NS and CSX are both right at the fair-value Graham Number and sport under-value PEG numbers. A happy combination, I'd say.

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