THE RAILROAD WEEK IN REVIEW

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"Competitive advantage enables the firm to create superior value for its customers and superior profits for itself." — Michael Porter, Harvard Business School

The Wall Street commentary from NARS has three themes: Infrastructure, service, and the regulatory scene. John Larkin at Stifel writes, "The North American railroads have entered a virtuous cycle. Most of the operating cash flow generated by railroads is now invested in the physical infrastructure, rolling stock, or systems. With the investment, service has improved. Improved service has attracted significant incremental amounts of freight traffic which, in turn, then requires additional investment in incremental capacity and improved system velocity. The cycle then repeats."

On the service front, he says the NIT League reciprocal switching proposal will, according to the AAR, mandate an additional 7.5 million more switching moves annually, putting a drain on capacity and harming service. Moreover, the so-called safety initiatives surrounding crude oil (crew size, speed, re-routes) "will boost the cost of transportation and sap valuable remaining capacity."

Allison Landry, Credit-Suisse, sees the rail industry as "entering a new phase of growth," which will be driven by continuing opportunities in intermodal and the growing energy markets, and increasing merchandise carload share gains from truck. She correctly predicts highway diversions to boxcar (covered hopper, center-beam, whatever), a happy development a number of shortlines are reporting. She underlines what Larkin says — continued capacity and equipment investments are necessary for increased vols. "Any regulatory disruptions to the cash flow generation that is required to make these investments would have severe consequences."

Cowan's Jason Seidl picks up the shortline thread from Jack Hellmann, GWR's CEO, the Day Two keynote speaker. Building on his Wolfe conference comments two weeks ago, Jack spoke mainly about his company's efforts to grow both organically and via acquisitions (the RCP&E opened for business last Sunday). Hellmann says what differentiates GWR from others in the space is its ability to accelerate core growth through its size in the marketplace, continuous improvement to former RailAmerica properties and more focused marketing efforts. My sense from reading Jason's take is that GWR is ready to use its considerable financial resources to the benefit of all stakeholders.

The output from NARS is, as one may expect, all about rail transportation users and what they want. It's going to be largely up to the Class Is to deliver it with the Class II and III roads making sure the first-mile/last-mile service adds value to the move. That's reactive: working with what the Class Is serve up. However, the local carriers can be proactive as well.

It starts, as Michael Ward is fond of saying, with the customer. That's why I track industry performance starting with sector ETFs such as the XLB (materials) and XLE (energy). These sectors dominate what I call the "stuff" group — those industries that have to move large volumes of raw and finished items to make their livings. I exclude sectors such as technology, health care, and financial, for example.

Then I look for the best-performing ETF in terms of positive share-price percent change above the 50-day moving average, XLB in this case. Next I drill down to industry performance within the materials sector. In order of share price appreciation over the last six months they are construction materials, chemicals, containers & packaging, metals & mining, and paper & forest products.

Let's say I have a short line in a growing southeast metro area like Charlotte or Greensboro. Customers include a building supply house, a paper mill, a steel fabrication shop and a plastics receiver. None of them are publicly traded companies but their suppliers and customers are. So I start looking for the leading publicly-traded names in these groups to get a read on how the business of each is holding up.

The big names in construction materials are Lafarge (cement), Vulcan (aggregates) and Eagle Materials (wallboard, etc.). All are up in the teens. On the other hand, shares of Louisiana Pacific, the biggest lumber name, are off 14 percent in six months. Paper is a mixed bag, with IP and Domtar down, while Neenah is up.

The steel business is in the doldrums, down double-digits everywhere, though specialty steel maker Allegheny Industries shares are up 20 percent. Of the five industries making up the chemicals sector, only the commodity chems group is up, and that's good for my plastics guy. Here we have suppliers such as LyondellBasell, Westlake and PetroLogistics LP. All are up nicely.

Armed with industry trends I'm ready to go calling, and my channel checks tell me a number of short lines are breaking new ground across a wide variety of sectors and industries: food, chemical, building products, grain and, of course, energy. RMI's RailConnect report for Week 21 (May 24) shows a trend is taking shape. Year-to-date — very close to my six-month stock performance period — numbers show carload gains in aggregates (construction materials), lumber (forest products), chemicals (plastics) and metals (steel). Only paper is down, and that by just two-tenths of one percent. Things are looking up for my Carolina short line.

Knowing your customers is a competitive advantage. The eponymous Fort Worth & Western, a not-so-short 276-mile short line operating in west-central Texas, not only lists customers on its website but also provides links to *their* websites. Two benefits accrue to FWWR. First, browsers can see the wide variety of industry sectors the railroad serves (ADM, consumer staples; Akzo

Nobel, chemicals; Domtar; Baker Hughes, energy, e.g.). Second, by showing its wide industry expertise, FWWR makes itself that much more attractive to other names in the specific sectors.

Volumes have been written about competitive advantage in manufacturing, yet a word must be said about how competitive advantage (CA) works in the shortline environment. By way of review, the two types of CA are the Cost Advantage and Differentiation Advantage. The Cost Advantage lets one deliver the same service as the competition but at a lower total expense.

Remember, cost is not just freight rate: it's everything that happens from the time goods are positioned for loading into the rail car until they are out of the car, positioned for use either as raw materials or goods for sale. Inventory value, transit time, demurrage, dunnage, even back office expense, are costs. To the extent that A can lower these costs to a number B can't meet, A has the cost advantage.

Differentiation Advantage accrues to the vendor who can deliver *better* servicer than the competition. But it has to be better in the eye of the customer, not just because the salesman says it's better. It's been proven repeatedly that buyers will pay up for quality today when it translates to better operating earnings and increased market share tomorrow — in the eye of the beholder. FWWR is saying on its website it can lower the cost of transportation because the systems are in place. And differentiation comes from having been there before so there's no learning curve. That's what gives FWWR a competitive advantage.

From the ASLRRA's Views & News for May 28 comes word that Watco is to assume operating responsibilities for three NS branches near Asheville, NC. The three line segments, to be operated as the Blue Ridge Southern Railroad and altogether totaling 92 miles in length, are from Murphy Jct. to Dillsboro; from Asheville to East Flat Rock; and from Hendersonville to Pisgah Forest. Like Watco's Autauga Northern near Montgomery, Ala., acquired from NS two years ago, these NC lines are light density branches where a nimble short line stands decent chance of making a buck and matching service to the need.

I've driven much of this area and can readily agree it's prime shortline territory. The Flat Rock line takes them to the top of the Southern's famed Saluda Grade while the other two lines serve light-density industries where Watco's business development strengths may be able to help these industries find new markets (see *competitive advantage*, above). NS retains the core high-density route from the Heartland Corridor at Roanoke through Winston Salem and Asheville to the Crescent Corridor just south of Knoxville. Suggests to me Watco's new feeder lines will feed the core directly. And that's a good thing.