RAILROAD WEEK IN REVIEW
AUGUST 17, 2007

“During the six months ended June 30, 2006 the Company issued 13,011 shares of its common stock with an aggregate fair market value of $211,000 to fund its 2005 profit-sharing plan contribution.” – P&W 10-Q for the quarter ending 6/30/2007

Providence & Worcester’s net income for 2Q07 increased 34% or $347,000 from $259,000 a year ago, helped along by a near doubling of “other income” from asset sales. Operating income actually declined 52% to $79,000 from $163,000 in 2Q06. Total rail-related revenues slipped 3.7% yoy to $6.972 mm from $7.243 mm while ops expense of $6.893 mm, down 3% yoy, ate up most of the revenue gain. Revenue per conventional carload increased 7% to $698 and intermodal boxes generated $56 each, up 6%.

Comp and benefits, at P&W always a higher percentage of railroad ops revenue – 61% -- than any other railroad by a factor of nearly two, was unchanged though car hire and purchased services were down double-digits. But then, carload units dropped by 8% and intermodal units were off 29%. Fuel was down 7% so that about fits. The OR remains stubbornly close to the 100 mark: the quarter’s 96.8 was 110 basis points worse than 2Q06 and for the first six months it was 115.1 vs. 103.0 yoy.

Cash flow remains problematic as well. For 2007 YTD ops cash flow was $205,000 against a net loss of $817,000. But they had a $2.2 mm capex line and paid out $376,000 in dividends. There is no LTD on the balance sheet however they did borrow $1.2 mm from a line of credit and posted *another* $275,000 in asset sales to the Cash Flow Statement.

Even with that P&W burned through $855,000 in cash and equivalents. And in a footnote to the financials, we learn than in 1H06 P&W issued some 13,000 shares netting $211,000 “to fund its 2005 profit-sharing plan contribution.” With a market cap of just under $90 mm P&W is trading at 29 times the FY 2006 ebitda of $3.1 mm. I’m still scratching my head at how a company burning nearly a $million a quarter can command that high a multiple. Any ideas?

The continuing pressure on mortgages and liquidity are having a decidedly negative effect on rail stocks. The view from here is that rails are seen as tightly beholden to the general economy and are still viewed as cyclical stocks in spite of all the evidence we’ve seen to the contrary of late. Shortline loadings are down (see attached for week 30) and that’s particularly bad news for short lines that are paid handling fees rather than divisions – when vols go down, their revs go down and there’s no chance to participate in the 6% or so rate hikes Class Is are getting.

One saving grace, as we saw from the GWR discussion with CEO Hellman and CFO Gallagher, is the flat-fee switching contract work. A short line with a switching contract worth say $500,000 a year can bank on that and the lower the ops expense – no track maint, no car hire, etc. – the greater the return. The Rule of 100 says you need 100 revenue carloads per year per route-mile of track. If the connecting Class I’s merch carloads are down, the short line’s most likely will be too, and in a marginal operation every carload lost is one step closer to shut-down. I mention this because a flat-fee contract switching contract can add significantly to the value of any short line property.

The STB on Tuesday issued Decision EP-664 in which the Board announced that it intends to revise its railroad cost of capital calculations “by computing the cost of equity using a capital asset pricing model.” The ramifications could be serious especially if the revised formula shows the cost of capital lower than it is by the present method. Morgan Stanley's William Green puts it this way: "Changing the industry's method for computing its cost of capital could result in greater regulatory scrutiny on railroad customer pricing. A switch to a CAPM framework for computing the railroads' cost of equity could make it appear as though the industry is generating more acceptable returns than under the current single stage DCF method."

The Decision notes that "each year the Board determines the railroad industry's cost of capital. The Board then uses this cost of capital figure for a variety of regulatory purposes. It is used to evaluate the adequacy of individual railroads' revenues each year. It is also employed in maximum rate cases, feeder line applications, rail line abandonments, and trackage rights cases."

But then, "the Western Coal Traffic League (WCTL) argued that there is a mismatch between the 5-year growth rate supplied to the Board by the AAR and the long run growth potential of the economy as a whole." Accordingly, the STB concluded that "the concerns raised by WCTL should be explored in more depth with broader public input," which brings us to EP-664. (The decision is on the STB website in excruciating detail, down to the most esoteric of mathematical formulae and tables.)

The response from Wall Street has been helpful putting it all in perspective. Greene continues, "Washington sources tell us the Board will still look for 5-10 years of sustained excess returns before changing its relatively pro-railroad stance, which won't occur before 2010. Even if the STB begins to take a more bearish stance in 2009 or 2010, the ruling would not be applied retroactively… Moreover, rebuilding the U.S. infrastructure and improving service remain at the forefront of regulators' minds, which should allow for continued pricing power over the long-term to support rail investment, in our view. Even if we were to interpret the STB ruling in the most negative way, it would likely mean more modest price increases going forward, not a collapse in pricing.

Over at JP Morgan, Tom Wadewitz writes, "The cost of capital decision adds to long-term risk. The STB decision to change its method for calculating the rail Cost of Capital was a drag on railroad stocks and we view it as driver of meaningful long term risk. The rail COC is essentially the allowable return used in customer rate cases and a lower COC would translate directly to a lower allowable price within the methodology used by the Board."

Tom concludes there will be little near-term impact because "the STB does not proactively set rail rates on any traffic but instead responds through a lengthy 2 -3 year rate case process to individual cases brought by shippers. As a result the earliest direct impact would not be until 2009 or 2010. Price-setting behavior of the rails could become more cautious earlier if there is an avalanche of cases (which we view as unlikely)."

And Rick Paterson at UBS takes a somewhat wider view: "Rail stocks have been taking a beating recently due to a confluence of events; specifically: i) the LBO premium coming out of valuations due to credit market turmoil (primarily impacting CSX & KSU); ii) Wal-Mart's more cautious outlook on growth and the low-income consumer; and iii) the proposed rulemaking by the STB to recalculate the rail weighted average cost of capital (WACC) lower – potentially diminishing pricing growth.

"Moving from a DCF to CAPM would reduce the WACC, therefore making it more likely that individual railroads are defined as 'revenue adequate,' hence more leverage for a captive shipper arguing a rate case against a railroad, limiting price increases… We think it's more likely incremental and will play out over years, not quarters. Our real concern here is that if it goes through it has political value for those on Capitol Hill that seek re-regulation. A fight is looming and the railroads may have to back up threats of curtailed capital spending growth to maintain pricing autonomy with action under a showdown scenario."

America Railcar Industries (ARII) posted record revenues and rail car shipments for the quarter. Total sales for new cars and railcar services came to $209 mm, up 38% yoy, on 2,286 cars out-shopped vs. 1,734 in 2Q2006. In a press release ARII said the increase "was a result of the recovery from low 2006 shipments, which resulted from the tank railcar facility shutdown for repair of tornado damages. This was partially offset by a reduction of covered hopper railcar shipments in the second quarter of 2007 compared to the same quarter of the prior year, reflecting a reduction in the number of covered hopper railcars ordered for delivery in the second quarter of 2007."

Net-net, manufacturing costs increased 37% however due to last year's relatively low sales figure ($152 mm), ops income rose 43%. Net income was $11mm, up 3%, though the 2Q06 figure includes a $5 mm insurance settlement so IMHO it's more accurate to say yoy net income effectively doubled. Reported eps was 52 cents, a penny ahead of last year, though deducting the insurance money eps becomes 27 cents for a yoy increase of 88%. Not too shabby.

Wall Street, however, zeroed in on the fact that manufacturing costs increased 37% yoy (never mind units produced increased 31%) and on the flat eps results. Shares had closed at $34 and change Monday. The numbers were released after the close and there was a conference call Tuesday morning. ARII opened at $30.74 on Tuesday and traded down to $28.20 before closing at $30.15, down 13% on the day.

Yet here is a company that generated $19 mm in FCF (ops cash less capex) for a 9% cash flow margin and where operating cash flow was nearly double net income. A 12.3% gross margin in the manufacturing business is laudable and a current ratio north of *six* is outstanding. First call estimates ARII can grow earnings at a rate of 23% a year for the next five years, indicating an intrinsic value closer to $51 and meaning that at Tuesday's close you could buy ARII for 59 cents on the dollar.

Elsewhere, Trinity CEO Timothy Wallace did a telephone interview on Jim Cramer's *Mad Money* on Tuesday. His message was that even though TRN shares have been taken down more than 20% from their recent highs, there's no sign the long-term need for rail cars is abating. Wallace said TRN serves the capital goods market and there's no softness in the balance sheets of *these* companies. What's more, TRN has a railcar backlog valued at $2.8 bn.

And Bear Stearns' rail equipment analyst Peter Nesvold writes that while there are some signs of a slowing non-intermodal railcar market the ag and ethanol markets remain in good shape and the brief slow-down in OT hoppers and rotary-gons for coal seems to have abated. That said, I think TRN's Wallace got it right: a freight car is a 40+ year asset and the time to be buying is when manufacturing capacity is available. Nobody wants to be waiting a year for deliveries as we saw in the earlier ethanol tank car crunch.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $125. Corporate subscriptions are $500 per year. A publication of the Blanchard Company, © 2007. Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned.

RailConnect Index of Short Line Traffic

Traffic Type: All

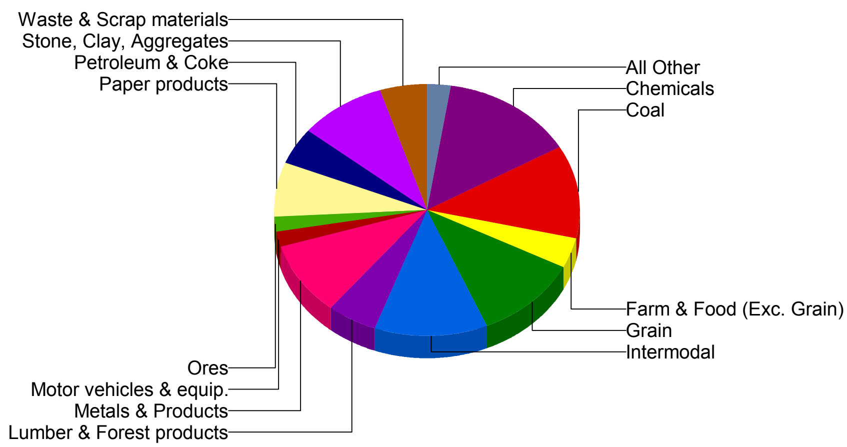
For the week ending: 7/28/2007

Week Number: 30

Carloads Handled	Current Week			Year-To-Date		
	2007	2006	% Change	2007	2006	% Change
Coal	15,302	15,131	1.13%	426,724	437,187	-2.39%
Grain	13,862	13,067	6.08%	392,402	401,320	-2.22%
Farm & Food (Exc. Grain)	4,437	4,368	1.58%	132,417	138,731	-4.55%
Ores	2,644	2,554	3.52%	77,898	87,839	-11.32%
Stone, Clay, Aggregates	12,324	12,151	1.42%	318,977	338,737	-5.83%
Lumber & Forest products	6,007	7,110	-15.51%	179,602	219,491	-18.17%
Paper products	8,023	8,686	-7.63%	243,165	264,131	-7.94%
Waste & Scrap materials	6,227	6,836	-8.91%	179,649	185,360	-3.08%
Chemicals	17,396	15,432	12.73%	496,016	458,396	8.21%
Petroleum & Coke	5,635	6,371	-11.55%	166,064	175,523	-5.39%
Metals & Products	11,412	11,580	-1.45%	336,893	362,141	-6.97%
Motor vehicles & equip.	1,865	2,036	-8.40%	63,816	68,392	-6.69%
Intermodal	15,253	18,515	-17.62%	429,244	532,301	-19.36%
All Other	3,360	3,379	-0.56%	89,136	101,776	-12.42%
Total	**123,747**	**127,216**	**-2.73%**	**3,532,003**	**3,771,325**	**-6.35%**

RailConnect Index

Year-To-Date



All Other	2.5%
Chemicals	14.0%
Coal	12.1%
Farm & Food (Exc. Grain)	3.7%
Grain	11.1%
Intermodal	12.2%
Lumber & Forest products	5.1%
Metals & Products	9.5%
Motor vehicles & equip.	1.8%
Ores	2.2%
Paper products	6.9%
Petroleum & Coke	4.7%
Stone, Clay, Aggregates	9.0%
Waste & Scrap materials	5.1%
Total:	100.0%

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