# THE RAILROAD WEEK IN REVIEW
## SEPTEMBER 5, 2008

*"The best time for acquisitions or creating value by stripping out and selling embedded assets is, for now, past." – breakingviews.com, 8/29*

**Rich Timmons provided some sobering thoughts** about the economy in his remarks at the UP short line meeting late last month. As President of the ASLRRA, Rich stays ahead of the economic curve. His remarks showed why it's important to look at what's going on in the world beyond one's service area.

He notes that in five of six developing regions around the world annual GDP growth 2000-2006 ran well north of five percent per year. The folks in these places are now beginning to sample the benefits of prosperity and free (er) enterprise and want their cars, washing machines and flat screen TVs like everybody else.

Rich has a point, and it was amplified by a comment on seekingalpha.com just yesterday. Speaking of the recent decline in gasoline consumption in the US, blogger Mike Fitzsimmons opines, "It is true there is some decent demand destruction in the US. However, I am not convinced that US demand is not being sucked up by increasing demand in [the BRIC countries] – all of which are showing brisk sales of automobiles and light trucks."

And today a scrap steel shipper said they can't move enough product to meet the demand for sheet steel in China for stoves and refrigerators. He said that even though there are some *eighty* (that's eight-zero) steel mills in China, they haven't been producing steel long enough to have built up a scrap stream of their own.

We also know that every country in the civilized world is spending jillions of dollars, euros, marks, rubles – you name it -- on rail transportation infrastructure for both freight and passenger including light rail. Russian President Vladimir Putin told the First Railway Congress a year ago, "[Our] strategy... calls for the construction of thousands of kilometers of new railway lines, overhaul of the existing network and modernization of the rolling stock. All of this will help to make our country more competitive and strengthen its geopolitical position…This is why we say that infrastructure development in general, and development of the railways in particular, is such a priority."

Moreover, Russian Railways is, according to a press release, "providing rolling stock to transport refugees from South Ossetia to Russia's Southern Federal District and giving them medical care at all railway hospitals in the North Caucasus region. In addition, hospitals belonging to Moscow Railways, a regional division of Russian Railways, have begun collecting blood to treat those wounded and injured during the conflict. Moscow Railways expects to about 350 liters of blood to be donated this week."

Elsewhere, says Timmons, by 2020 China will have built forty thousand miles of new highways and *sixty* thousand miles of new railroads. Europe is looking at ten thousand miles of new road and rail in the same timeframe and India plans on expanding its rail network by more than six thousand miles in the next *two* years and by the same amount in the next ten. And what are *we* doing? Adding eleven hundred new miles of Interstate plus two thousand miles of new rail.

Economically, road congestion costs the US nearly eighty billion dollars in lost productivity and burns up three billion dollars worth of fuel annually. Truckers report some two hundred freight

bottlenecks across the US and these together result in eight billion dollars of economic losses and two hundred forty-three thousand hours of delay. And truck traffic is expected to double in the next twenty-five years.

Clearly, the rails can be part of the solution. But they have to get their own houses in order first. For example, at this very moment I'm looking at a thousand-mile rail move that takes nine days from the time the Class I gets the load until it's placed at the destination dock. (The originating short line interchanges the car to the Class I within hours of loaded release.) There are three nodes with dwell times in excess of more than thirty hours each, two of which are within a hundred miles of the receiver.

This Class I reported 2Q08 average speed per the AAR performance measure of twenty-three miles per hour yet this move, interchange-on from the originating short line to destination place averages *five* miles an hour. And the irony of it is the Class I wants to exit the service due to poor equipment cycle times. Well, maybe they should. Google says highway travel time for the OD pair is 13 hours.

I'm reminded of a line from *Bye Bye Birdie*, an old musical from the cold war days, where the father of a teenage daughter sings, "What's the matter with kids too-daaay" and asks, "How will we ever beat the Russians?" Well, at five miles an hour we're not going to beat anybody anywhere.

**So what's this got to do** with short lines? Just this: It was a short line that brought the sorry situation above to my attention because their customer was looking to their local rail server for a solution. Finding one meant going beyond the local ops guys and finding out how the Class I works. In this case, we're suggesting stopping the car at a transload 100 miles short of the receiver, trucking the goods the last miles, and saving six days in car time. Will the Class I buy it?

Probably not because it shortens the revenue haul. But the end result is they will lose the move altogether, the short line will lose a major lane, and the customer will have one more word-of-mouth railroad horror story to share at cocktail hour.

**"Wild Cards" is what Rich Timmons** called such things as tax changes, the tax credit program (or lack thereof), federal regulation, the upcoming election, foreign conflicts and so on. All this uncertainty surely weighs on investors because of the volatility it brings to markets. *New Yorker* financial writer James Surowiecki writes in the September 1, 2008 issue, "Volatility is a very bad thing because it makes ordinary investors [that's you and me, pal] less inclined to trust markets. Too much risk aversion makes capital more expensive for everyone from businesses to homeowners and the economy less dynamic."

With the typical fifty-mile, five thousand cars-a-year short line running an operating ratio in the mid-nineties, access to capital is a big worry. Many are leveraged to the hilt and depend on the kindness of strangers in the form of track subsidies or maintenance grants to keep the wheels turning. Now comes the tightening of bank credit lines compounded by tightening discretionary budgets in the state capitals.

Take New York State. *Barron's* Editor Thomas G. Donlan writes in this week's issue, "The golden goose of Wall Street has stopped laying eggs the state can tax. Wall Street bonuses and investment profits are so heavily taxed that the revenues make up 20% of the whole state-tax take." But everybody knows bonuses have been taking mega-hits due to the credit crunch – no credit, no deals.

"Faced with a six-billion dollar shortfall in the current hundred-twenty-one billion dollar budget, Governor Paterson called the legislature back into session and presided over victory celebrations

when the legislators agreed to somewhat more than four hundred twenty-five million dollars of reductions in planned spending increases." It ain't getting any better, either. One-time *Fast Money* panelist Jon Najarian writes in a promo letter, "Wall Street's backing McCain of course [because of its] fear of a 'tax and spend' Obama policy." To be fair I have to add that Najarian admits to his jibes being "all tongue in cheek." But the idea had to some from somewhere.

Point is, New York's short lines have enjoyed millions of dollars worth of track grants and other subsidies, dollars that could never have come from the short lines' own coffers because there just isn't enough operating cash flow. So the best way to deal with the wild cards is to make sure one's own railroad has a sustainable business case in case the legislature shuts off the tap. Don't spend the money if you don't have it and don't try to run a hundred-mile railroad on crumbs. There's a reason the *Rule of One Hundred* works.

**How do you know** if your financial house is in order? Consider the "firm value" cash flow model in which company stock (everybody has this, publicly traded or not) is really a call option on the assets from cash to receivables to PPE. The strike price is the company's debt. As long as the asset value exceeds the debt, the option is valuable and is a keeper: call it at will and own the company.

But let debt get ahead of asset value and the call expires worthless; the lenders take over the company and liquidate it to satisfy their debts. Which leads me back to the quote below the masthead. Short line railroads have long kept themselves going through acquisitions to add assets and cash flow. Yet the primary facilitator of expansion has been – you guessed it – debt. And with lenders getting increasingly picky, few are going to want a short line railroad that needs five thousand dollars a mile a year in maintenance just to keep the doors open.

The watchword of the day is then, hold what you got and increase sales with existing customers first and new customers second. As for tax credits, RRIF loans and grants? Forget they ever existed. If your short line, line Blanche in *Streetcar*, can't get by without the kindness of strangers, then it's time to fold. Here endeth the lesson.

**Continuing the thread of car counts** vs. tonnage, Rick Paterson at UBS writes, "What we find bizarre is that most of the media focus seems to be on volumes. The U.S. rails averaged twenty-three percent EPS growth in the first half. Was this driven by the minus oh-point-seven percent change in volumes? We don't think so. Granted, there has been a great ag and export coal story in the rails, but these gains have been more than wiped out by the demise of autos, building materials, paper, and international intermodal.

"Total volume growth has been terrible across the board with no end in sight. In order of materiality, we think the things that drive earnings are: i) pricing – gains fall straight to the EBIT line; ii) productivity/operating efficiency – ditto; and iii) volumes – which have an associated cost to haul them, growth increases network complexity and erodes efficiency, and too much can trigger congestion or a meltdown." The short lines, being close to the customer, can help. More on this anon.

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