THE RAILROAD WEEK IN REVIEW
SEPTEMBER 19, 2008

"'Strains in financial markets have increased significantly'. Ya think?!?!" Schwab Chief Investment Strategist Liz Ann Sonders on this week's FOMC statement on why no rate cut

Sonders continues, "The cost of borrowing in dollars overnight more than doubled to the highest since 2001. The overnight London Interbank Offered Rate (LIBOR) soared by more than three percentage points to nearly 6.5%, the biggest single-day increase in history. And the longer-term LIBOR has been trending higher relative to the fed funds rate since the beginning of the year."

Elsewhere, the Federal Reserve says output in American factories dropped 1.1% in August, mostly due to cutbacks in the auto industry, according to the Federal Reserve. Ex-autos factory output has been off for five consecutive months. The *Wall Street Journal* suggests that the worst may still be ahead. A third of the economists surveyed see further contraction in the fourth quarter with a growth rate of less than one percent, not enough to stem the job-loss rate. Moreover, the contraction in oil prices is more a function of "waning global demand" than of economic strength in the US.

Highly-leveraged short lines with high operating ratios and shrinking car-counts ought to be particularly concerned. Columnist David Wessel writes in Tuesday's *Journal,* "Mortgage credit losses deplete the equity capital of leveraged institutions and persuade them to reduce their financial leverage." Thus smaller companies are likely to see tougher requirements from their banks and those firms with less-than-stellar credit histories will have trouble finding more "Blanche money" (see WIR for 9/12) to keep the wheels turning. Worse, when credit lines come up for review and the bank learns the railroad is using car hire money for payroll, they may find the window closed.

I have before me a short line balance sheet with $1.58 in current liabilities for every dollar in current assets. On the asset side, accounts receivable increased 50% in the past year indicating a slowdown in collections. And prepaid expenses were up a third, which makes one wonder why prepay expenses at all? (Accounts payable are really interest-free loans; it's not uncommon to see a short line paying in sixty or even ninety days.) On the debit side of the ledger, notes payable and current long-term debt account for 29% of the current liabilities. LTD including current portion is 1.16 times equity.

A quick look at my list of some 500 short lines (excluding the big S&Ts but including individual names under holding companies from Genesee & Wyoming to the Pinsley group) reveals roughly a hundred names that may be at risk for want of adequate revenues or capital or both. It may well be some of these names are worth more dead than alive. For example, a ten-mile railroad with 90-pound rail has about sixteen hundred tons of steel on the ground, ex OTM. At a nominal $400 a ton FOB scrap merchant, that's something north of $600,000.

Giving the short line credit for 100 carloads a mile per year or a thousand carloads at $300 per is $300,000 total revenues. If the operating ratio were just 90, it would take the short line 20 years to generate enough operating income to equal the scrap value of the rail. That's what I mean by worth more dead than alive. (Of course, you could put the rail up as collateral but then if you go bust you lose the railroad. But what banker will let you prolong the agony?)

Rather than hang out the funeral wreaths during this downdraft, one might be better served by a little bottom-fishing. In my humble opinion, the smart money is finding companies that have come back to earth after some astounding run-ups. And that includes our favorite railroad names. They're all trading at discounts to their intrinsic value and the dividend yields at these prices look rather tempting.

Take Union Pacific, for example. The forward cash flow-based intrinsic value is $84; the drop to $70 meant one could pick up UNP at 83 cents on the dollar. Or look at Canadian Pacific. The company's shares are worth a nominal $72 each; with a ticker price of 54 smackers CP is going for 75 cents on the dollar. The car builders are a real steal --- less than 50 cents on the dollar for TRN, GBX, ARII, RAIL and even GMT. Alas, GWR, KSU and WAB remain at or above their intrinsic values.

As it happens, just last week CFOs from five of the Big Six Class Is (CP passed as they had just tapped Kathryn McQuade CFO the week before) gathered in New York for the Dahlman-Rose conference. They talked up their railroads and what they are doing for shippers and shareholders. Naturally, I was particularly attuned to the merchandise carload sector, critical to the health of the short line industry. Please see individual railroad websites for the power-points.

The Gang of Five did not disappoint. In alphabetical order, BNSF has kept the grain fleet right about 30,000 cars but annual carloads will be up 20% to more than 600,000 for the years 2005-2008 (e). The greatest growth has been in the shuttle trains (37% of total cars in 2005 to 46% projected for 2008) however that still leaves some 335,000 annual units in non-shuttle service.

Industrial Products were up 10.5% in revenues in 1H08 on essentially unchanged revenue units carrying chemicals, building and construction products, petroleum products and STCC 20 foods. They're taking a page from the unit train book to increase car and loco miles per day and take waste out of the gathering and distribution network. This tells me there are great shortline opportunities in non-unit grain and streamlining their merchandise carload offerings to fit the BNSF model.

Canadian National's slide 9 is most instructive. It's a map showing locations of the new business initiatives and covers the entire property east-west and north-south. In no particular order, commodities include coal, coke, corn, ethanol, steel plate and slabs, iron ore, machinery, potash, sulfur and grain. Then flip to slide 10 to see productivity initiatives in yard ops, network capacity, and asset management -- a sure shortline recipe for success with CN.

As usual, CSX' Oscar Munoz gave good account of what they're up to in the carload side of the house. Slide 10 shows why CSX gives better commodity transparency than any other Class I and with that kind of clarity it's easy for short lines to see where they need to look for increased carloads. Yes, the CSX pie-chart is in revenue, but in CSX' case that's OK because as revenues go up so does shortline compensation thanks to their unique junction settlement arrangement.

One can have a certain measure of comfort with CSX growth targets because they have increased the 2010 estimates for operating income, the operating ratio (would you believe the high *sixties*?) and earnings per share. A key driver is CSX' ability to maintain revenue ton-miles even as volume shrinks. The charge to CSX short lines thus becomes increasing ton-miles while keeping a lid on revenue units: more money for less work means better yields.

Norfolk Southern took the longer view, ranking volume gains by commodity 2001 through 2007. Starting with municipal solid waste and construction and demolition debris (+278%) one goes down the list in descending order through machinery (+81%), corn sweeteners and ethanol (+53%) and printing paper (+36.8%) before hitting domestic intermodal (+31%). The commodity list kicks in again reaching down to iron and steel (+21%) before finishing with the other intermodal segments.

Union Pacific stressed its dominance in the fastest growing western states plus the agriculture, energy (other than coal) and industrial products coverage in those states. June YTD freight revenues are up double-digits across the board (ex-auto – no surprise there) with significant growth projected in the energy and agriculture carload segments (UP has the largest ag franchise in revenue).

On the energy side ex-coal UP sees “diverse opportunities” including ethanol, petroleum and LPG, wind (unit trains of parts, would you believe), oil shale and sands, pipe frac sand (some of which is coming east to the Marcellus Shale fields), pipe and related materials. The energy-related opportunities make up 30% of the 2008 estimated revenue pie.

In sum, then, there are new shortline revenue streams to be had regardless of the Class I connection’s name. All you have to do is read the tea leaves clearly laid out in presentations such as these. With oil closing above $100 again on Thursday the rails’ fuel advantage over truck continues. Now all we have to do is turn the cars and provide truck-competitive service.

Rick Paterson’s September 10 note goes precisely to the matter of fuel. He writes, “The investor fuel survey results are in. Last week we invited investors to nominate whether they think falling fuel prices are good or bad for rail stocks in terms of how they’ll trade through year end. As expected, it wasn’t black and white, with 62% of you saying ‘good.’

“In support of the positive, comments included ‘Near-term impact positive as the fuel surcharge lags yet diesel costs drop immediately, stocks react favorably, but longer term it probably makes it tougher to raise base rates in a declining environment.’ Bears cited: ‘Bad! Rails are toast at these valuations.’ And my personal favorite: ‘My response is I listen to you Rick.’ Ladies and gentlemen, we have a strong favorite for our Investor of the Year award.”

Anacostia & Pacific’s Pacific Harbor Lines has completed renewal of its locomotive fleet, becoming the first all low-emission railroad in the nation. All PHL locomotives now meet or exceed U.S. Environmental Protection Agency’s stringent Tier 2 standards to reduce air pollutants. In addition to consuming less fuel, particulate and nitrogen oxide emissions have been cut by at least 70 and 46 percent, respectively, according to PHL President Andrew Fox.

The $30 mm project enabled PHL to replace its fleet with 22 low-emission locomotives, beginning in May 2007. The costs were shared by PHL, the ports of Los Angeles and Long Beach and California’s Carl Moyer Program, which is administered by the South Coast Air Quality Management District.

Save the Dates! RailTrends 2008 runs September 30-October 1 in NYC. A note from Tony Hatch says they will touch on a variety of issues from the changing makeup of the railroad investor base to the impact of the present credit crunch on the railroads. The legislative panel will cover a gamut of legislative matters including the re-regulation threat. We’ll have a collection of top commercial guys from the Class Is and RailAmerica President John Giles tells me he is going provide some color on their results to date. Tony writes that *RailTrends 2008* “will provide a timely and varied agenda beyond that of the typical investment bank event.” See you there.

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