THE RAILROAD WEEK IN REVIEW
NOVEMBER 14, 2008

"Performance of buyouts in 'red' states is likely to be above average, while buyout performance in 'blue" states is likely to fall below the mean." -- Harvard Business Review, November, 2008

As GWR's Jack Hellman said on last week's third-quarter earnings call, they are trolling for "good investment opportunities at attractive valuations" (WIR 11/7/2008). The two most recent of which are Georgia Southwestern (Georgia) Ohio Central (Ohio). As it happens, both of these are (or were, at least when the HBR story was written) "red" in the *HBR* piece cited above. This is important for shortline owners wishing to expand their franchises because successful companies present the best odds for a freight-favorable environment.

The *HBR* authors say "value-creation strategies such as outsourcing labor, shutting down less-efficient units, a lower commitment to social responsibility and de-unionization" are more at home in the red states. As a result, the average ROI in the red states ran three to seventeen percent above the mean (Oklahoma scored best) while the average blue-state return as six to twenty-one percent below the mean (Michigan bringing up the markers). The authors went a step further and created two hypothetical funds. One invested only in red-state forms and the other fund bought only blue-state firms. The former beat the latter by nine percent in annual net internal rate of return.

People tend to vote with their feet, moving from Michigan to Georgia and from Pennsylvania to Oklahoma, for example, following the jobs and better odds for personal value creation. The *Wall Street Journal* says the 2010 census could show population shifts adding congressional districts in a number of red states including Texas, Arizona and Florida. New York, Pennsylvania, Michigan and others in that orb -- plus, believe it or not California -- could lose districts.

Thus if I were looking at short lines I'd be looking at the map accompanying the *HBR* piece and then going to the members page at www.aslrra.com to see what short lines are in those states. Moreover, I'd be wary of any short line that does one foot solidly in the "heat and eat" category (WIR 10/17/2008, page 1, paragraph 4) and does not have at lease two Class I connections. To be sure, many of the red-state short lines are small mom-and pop shops, however these might be excellent tuck-in acquisitions for existing near-by or contiguous profitable short lines.

Finally somebody's saying it. Chris Ceraso at Credit-Suisse writes, "Our proprietary freight forecasting model is now calling for tonnage to decline by about 7% in 2009 vs. 2008. This marks a serious deterioration versus our prior outlook, which had tonnage down about 3% in 2009." He adds the last time volumes were off more than seven percent was in 1982, down twelve percent). This time around, however, auto sales are much worse, exacerbating the situation. The operating income picture is not all that bleak as the lag in fuel surcharge rates and the decrease in fuel expense and -- thanks to collapsing fuel prices -- the operating income hit from fewer revenue units is less than it might otherwise have been.

Ed Wolfe of Wolfe Research takes much the same view: "Overall, conditions in the freight environment are not favorable. Carloads have declined each week so far in 4Q (the pace of which accelerated in week 44; marking the worst week so far in the fourth quarter), which in our view more than offsets year-over-year gains in operating metrics. This deterioration supports our thesis that the freight environment is likely to contract further over the next several quarters. Our composite volume and service scoring analysis suggests that every Class I is slated for a net negative impact on operating profits. We once again highlight CNI and UNP as having the greatest risk in 4Q08 (though we note that we are just 1/3rd of the way through the quarter) as both rails once again posted the lowest composite scores."

To which UBS' Rick Paterson eloquently adds, "Every year we conduct a small customer survey and this year's results suggest pricing momentum will be maintained, with 7.9% nominated as the average expected price increase in 2009, ex-fuel surcharges, by 28 customers. This is higher than expected and no doubt reflects some sampling error, but customers clearly expect the rails to stay aggressive on rates. This, however, contrasts sharply with the reality of deteriorating volumes. Can the rails maintain strong pricing growth when fundamentals are getting worse? Well, they've successfully done just that in 2007 and 2008, although 2009 could be a different kettle of fish with potentially bigger load declines and growing customer rate fatigue."

As for the short lines, RMI's RailConnect Index for Week 44 once again shows how Class I merchandise carload declines affect the short lines. Revenue units declined eight percent for the week, the steepest drop this far with waste and scrap, ore, coal and grain double digits. Sharply lower scrap steel prices (see below) and the drop-off in building construction, lower steel production, and farmers holding grain in anticipation of a price rebound are thee root causes.

Happily, there are bright spots where short lines have teamed up with customers to offer supply chain solutions. John Cockle, Operations Superintendent for California's Richmond Pacific Railroad serving Levin Terminal (ten miles east of the Golden Gate Bridge), writes, "We have heard from our on-line steel scrap customer that the value of steel scrap has plunged from $600/ton aboard a vessel to $150. They have cancelled two vessel shipments between now and the end of the year and have begun laying-off workers. This is the same customer whom we nearly embargoed in July because they had 120+ cars waiting to unload. They couldn't export the stuff fast enough. Amazing -- I'd say anyone wanting to scrap old rail or freight cars missed their window of opportunity.

We also handle Utah coal to China. It arrives in older steel hopper cars that we bottom-dump into our conveyor system at what we call the Hopper Building. The material is stockpiled to await the vessel. We can handle at least 30,000 tons on the dock with another 10,000 tons in railcars to be dumped while the vessel is alongside. We have 38 feet of water at the dock, but due to berth restrictions and the size of the harbor we can realistically load only 40-45,000 tons in a vessel. This is the average load for what is called a 'handy-max' vessel, a five-hold ship.

"We have committed to UP that we will receive an entire 105 car unit train in interchange, unload it, perform a Class 1 extended-haul air-test, and interchange the entire train back to UP in under 60 hours. Last year we averaged about 54 hours. UP does not leave the power with us - it goes on in to Oakland after interchange of the train. This is not ideal, and UP would prefer 24 hours, but they understand our limitations and figure that we're the only game in town for coal exports in Northern California. Sacramento, Stockton, and Redwood City all have water draft restrictions that prevent them from loading even 40,000 tons on a vessel. The economics of the ocean freight in smaller cargoes do not support coal."

I asked John about other west-coast outlets for coal destined for Asia. He writes, "Utah coal is currently being exported through Long Beach, but impending iron ore exports from the Cedar City, UT area threaten to shut off this outlet for coal. Stockton unloads coal at the port for local power uses but I'm not sure that they have the ability to load this coal aboard vessels. Other than these CA ports, I know that PRB coal is moving to Roberts Bank, BC and that's about it on the West Coast. If I was at the Port of Coos Bay and was looking for a commodity to support a reopened line from Eugene I would certainly consider coal. Granted the Port of Coos Bay is in a rather out-of-the-way location but it is my impression that the UP corridor to Eugene carries unused capacity."

Thus it would appear that, despite the longish dwell times Richmond is about as good a point you'll get for loading coal into ships bound for Asia's Pacific Rim, short of getting in the queue at Roberts Bank in British Columbia (see below). Moreover, the Richmond Terminal being shortline-served, there is never any question of waiting around for the daily drill to show up, do its work and go home. For further information on how this facility works, go www.levinterminal.com . It's well-worth a visit.

Further down the California Coast, the Santa Maria Valley Railroad has found a niche for itself and under-used UP 50-foot reefers in the relatively short-haul (under 1500 mile) service. Rob Himoto, president of the SMVR, writes, “At some point prior to our 2006 purchase of the line (see www.smvrr.com for a great history tale) UP had raised the rates on the 50-foot cars to encourage use of the then-new 60-foot super-jumbo reefers. Our customer Pictsweet got a great rate, freed up the 50-footers, and found it could load twice the product at a discounted rate. But the SMVRR saw volumes drop because the larger cars meant fewer cars for the same tonnage.

“Fast forward to today and shippers love the 60-foot super jumbos so there is a shortage and there are plenty of 50-foot reefers, which is how UP suggested the 50-foot reefers to Pictsweet as deadhead and long transit times is less of a concern. In reality, Pictsweet's docks are designed around the 50-foot car and they can load and unload the cars faster. We can fill the dock with a car at every door, while with the 60-foot we could only fill every other door. Better for us because we will get twice the loadings.”

Rob also writes, that the Betteravia Industrial Park, site of a former Union Sugar Plant, is a boon for the railroad. “The owner wants to develop most of the site as a rail-served industrial park and has been very supportive. Just like that, we have forty acres we can market with covered storage, warehouse space, two huge food grade silos, and even a petroleum grade storage tank. The plant has been abandoned since 1994 and there is a lot of work ahead, but it can all be done in phases. Lots of potential here as the owner is very supportive, loves the railroad and he and his family are long time locals in Santa Maria.”

Meanwhile in north central Pennsylvania the North Shore Group’s Lycoming Valley Railroad is capitalizing on the energy situation with the developing Marcellus Shale natural gas field that runs along the New York-Pennsylvania state line before turning south toward Pittsburgh. Says Todd Hunter, VP for marketing and sales, “We took in our first three cars of casing pipe and have thirty more cars of frac sand [sand for mixing with water to fracture the shale strata to release the natural gas] en route” to the Bulk-Matic transload facility set up in Williamsport using a corner of the old NYC/Reading class yard.

Todd writes they will be firmly into tripe-digits of gas-related carloads within three months of getting the first car and commodities “have just scratched the surface.” He cites four specific well sites that the Lycoming will support starting this month with several more on the way. Annual carloads are expected to hit a four-digit run rate in short order, and, no, sixty-dollar oil isn’t slowing them down one whit. The present dip in oil prices notwithstanding, it appears that oil will settle in the $70-90 range when all is said and done, which positions the Lycoming Valley quite well.

Another place where the LVRR is well positioned is in scrap steel. With the sudden drop in prices Jersey Shore Steel (www.jssteel.com) “has gone on a buying spree.” Currently nearly two hundred loads of re-roll rail and OTM (other track material) scrap are en route. Todd concludes, “Since they normally keep several months of inventory on the ground, they did not buy rail all summer but sold lots of scrap. They ran yard inventory down to the dirt-something I have never seen before.”

Yes, the macro volume numbers are gloomy. Yet there still remain those market niches where access to the right information at the right time coupled with creativity and determination can result in new revenue streams. Look for more of these success stories -- and do send in your own -- in Week in Review. Enough of the gloom and doom already.

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