The Railroad Week in Review, May 29, 2009

"The whole de-leveraging of this economy [by consumers] will depress the growth rate out of this recession." – Daniel Meckstroth, MAPI, as quoted in the Wall Street Journal*, May 27, 2009*

The economy is certainly Topic Number One wherever you go, or so it seems. It sure was at NARS this week, as evidenced by a trio of notes from reliable observers. Tony Hatch reports neither the railroads nor their customers see any signs of economic recovery. He writes, "The current environment can be best summed up by a headline from a coal publication distributed at the conference: 'Markets Weak – Rates Firm.'

"Several rails expressed surprise at how coal had turned cyclical and thus weak – historically electricity demand grows between 0.5-2 percent year in and year out but is down 4 percent or so this year in the face of the industrial debacles in aluminum, autos, cement, etc. Even the stimulus package hasn't helped, yet anyway; UP noted that states may even be delaying projects to try to get stimulus dollars. But the rails expressed a common theme that this will pass, capacity will tighten up sharply (and pull up rates) and that they are prepared for the comeback, whenever that occurs.

From JPM's Tom Wadewitz we get the sense that a "stable rail-competitive environment" is in the offing. "Based on our conversations with a variety of shippers, we believe the railroads are generally asking for moderate rate increases and in some cases shippers can achieve lower rates, but rail rates are still going up on a broad basis and the railroads remain disciplined.

On the NARS legislative front Morgan Stanley's Bill Greene and Adam Longson write that maneuvers in the Senate could delay new rail legislation. "A Washington publication, the *Congressional Quarterly* (*CQ*), is reporting on its website that four senators on the Commerce Committee sent a 'Dear Colleague' letter to fellow senators [urging them] to vote against cloture (which ends a potential filibuster)." The letter warns, 'Premature passage of the proposed railroad antitrust bill could undermine future STB reauthorization (expected later this year).' According to *CQ*, Sen. Rockefeller, who is a key driver in any potential rail legislation, signed the letter, which urges consideration of the more expansive bill (S 146), rather than the narrow aspects addressed in the anti-trust bill.

"The prospect for compromise legislation should temper risks, but negative headlines focusing on unfavorable outcomes for rails are possible, especially if rhetoric from shippers intensifies. A long, heated debate increases the likelihood pro-shipper legislation will move to the floor for a vote. Even so, we maintain that compromise remains the most likely outcome in the current debate. While hardly bullish for shares, this is more favorable than Anti-trust legislation or Re-regulation, which have the potential to affect the rail pricing story in a materially negative way."

The data points are not encouraging. Housing starts lag and prices for existing houses continue to slip. Lumber has dropped to under $200 a thousand board feet whereas in September 2007 it would have set you back $320, a 38% drop due no doubt to falling demand. Shares of lumber-producer Weyerhaeuser (WY) have nose-dived to $33 a ticket from $80 in the same period. You can buy October $40 calls for a buck-seventy, though, indicating there may be some upward momentum on shares after everybody goes back to school.

With unemployment hovering in the eights and some talking it hitting ten percent before we're done,

consumers are in no mood to storm the stores looking for new refrigerators or riding lawn mowers. The thinking seems to go along the lines of "my neighbor just got laid off; am I next?" No wonder spending slows as folks try to regain the paper wealth lost in their homes and 401-Ks. And it is no wonder appliance store owners are keeping the lid on inventories, meaning less steel and plastic going to the appliance factories in mill gons and covered hoppers.

The afore-mentioned Mr. Meckstroth says in his report (see www.mapi.net) that manufacturing production will drop by twelve percent this year followed by two percent growth next year. He doubts there will be any consumer-driven snap back if only because of de-leveraging and wealth rebuilding. How long will it take before this newfound thriftiness wears off? The National Association for Business Economics (www.nabe.com) says, "The key downside risks remain continued large job losses, no improvement in credit conditions, and further sharp declines in home values. More thrifty behavior is here to stay, at least for the next five years."

The duration of consumer thrift bears directly on short lines that are paid fixed "handling allowances" that do not change with any increase in the underlying freight rate the Class I collects from the beneficial owner. Short lines report total revenue unit counts down 26 percent through April against the Class Is' drop of 18 percent. As noted before, AAR car counts are stabilizing in the minus 20-25 percent range and short lines are following suit, only five to eight points worse off. Consider what will happen to marginal short lines if volumes remain at these levels for three to five years.

Consider the plight of the St Croix Valley Railroad in northeastern Minnesota. Following up on a note by Andy Cummings on the *TRAINS Newswire*, I called SCV General Manager George LaPray to talk about the bridge outage that was the subject of Andy's note in which he writes, "A contract bridge inspection firm found an unsafe condition at the Snake River Bridge at Pine City, Minn., and the railroad followed its recommendation and embargoed the line."

Trouble is, SCV's largest customer is Horizon Milling's flourmill at Rush City, ten miles south of the washout and 25 miles south of Hinkley, where SCV has its only interchange with the outside world. LaPray told me that from the surface the bridge looks like it needs about $600,000 worth of repairs, but with much of the damaged area previously hidden view, one never knows until one starts digging. As for outside funding assistance, my sources say Minnesota DOT has been less than enthusiastic about helping with short line infrastructure projects. Applying for RRIF loans is "daunting," says LaPray.

In any event, the bridge will be out for an undetermined time and the longer it is out the longer Horizon Milling will have to get comfortable with more trucks on the highway. Do the math, Minnesota: If Horizon does 2,000 cars a year and there are four trucks per hundred-ton carload, that's 8,000 more trucks on the highways. Is that really what you want in this day and age of making everything leaner and greener?

Bottom line to short lines: your worst-case scenario is you have bridge failure or other infrastructure calamity and your car car-counts remain the same for five years. Revenues are unchanged; car supply gets tighter as lease fleets shrink and Class Is put more cars in storage. Fuel prices are heading back to the $70-80 barrel range – three smackers and up for a gallon of go-go juice for your faithful old GP-7s. Comp and benefits will increase as well, thanks to inflation and higher medical insurance costs. With fixed and variable costs on the rise and revenue flat, margins get squeezed. Now what?

Speaking of lean and green is what my good friend Jim McClellan has been doing on his latest rounds of the rubber chicken speaking circuit. Most recently Jim held forth at the Week Two session of Michigan State's "Certificate Program in Railway Management" held in Chicago May 10-15. The

topic for the week was "Railway Infrastructure, Rolling Sock, Command and Control" and I am told the short line community was well represented.

The McClellan message is that in spite of all the bad things we see today – revenue units down, a decade of growth gone, and a repeat of 2006 traffic levels may be years away – there is reason to believe the industry can emerge stronger, leaner and greener. By "lean," McClellan means "there is less stuff to move: the consumer is tapped out and the trend is toward less energy consumption, smaller houses, smaller cars" and less of everything that goes into consumer goods from plastics to metal to lumber to packaging.

In this constricting environment "the most likely scenario is slow growth. We cannot count on utility coal and international intermodal for growth so the rails need a new 'engine of growth' and that's domestic intermodal." But, Jim warns, margins here are modest; doing it right requires a lot of capacity and "precise, disciplined operations." To the extent the rails can become lean enough to shed excess routes, assets and operating shibboleths "they will have a bright future."

He then reiterates why the rails are the "greenest of transportation modes with their low carbon footprint, efficient land use, better fuel use and lower emissions." On the other hand, "green is not good for coal" as new coal-fired power plants are put on hold with renewable resources and cheap natural gas [from places like Pennsylvania's Marcellus Shale field which is only a hundred miles away from one of the world's biggest energy markets] replacing coal. Black diamonds as fuel for electricity isn't going away, says Jim, but "it is getting squeezed."

What about regional railroads and short lines where coal plays a much smaller part than it does for the Class Is and where intermodal is almost non-existent except for a few niche players? Lean and green means there will be some casualties as inventories shrink and domestic intermodal outperforms carload shipments by keeping supply chains shorter and smaller. Then there are the car supply and infrastructure questions [see the SCV above].

On the other hand the future looks good for corridor passenger service that will in turn help Class I track structure upgrades and add capacity. In the end, it all comes down to the availability of federal funds to support corridor and commuter rail for passengers while not impeding free movement of the Class Is' lean and green freight operations. The slide set is intriguing, challenging and thought provoking and Jim has graciously authorized me to share it with a select number of short line practitioners. Please drop me a note if you think it will help you get a handle on "lean and green" for your railroad.

Next week: The trend is your friend – how you can figure out where your customers, competitors and Class Is are heading by watching stock charts, options and short sales. Why Warren Buffett's "moat" analogy fits short lines so perfectly.

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