THE RAILROAD WEEK IN REVIEW
NOVEMBER 20, 2009

"If we get a reasonable return on the added capital investment - -because it <u>*will*</u> *take added capital investment -- we'll do OK." Warren Buffett on the capital-intensive nature of railroads*

Railroad volumes are not going to grow very fast for the next two years, if I'm reading the tea leaves right. During the third quarter earnings calls everybody talked about prices going up in the four to six percent range with not much change in operating expense as assets are brought of storage to handle any traffic gains, so operating income deltas will most likely remain in single digits. Flat to slightly positive volume deltas, however, are not good for short lines paid flat per-car allowances.

AAR carloadings YTD for the week ending November 7 were down 18 percent compared with where they were at this time last year with the worst comps in the industrial products (IP) sectors that move mainly in single-carload lots. As corroboration, RMI's RailConnect Index of short line and regional railroad volumes (attached) puts IP loads down from 17 to 38 percent, depending on what STCC you're looking at. These trends closely mirror the class I trends yet the declines are deeper so it'll take longer to get back to 2007-2008 levels.

The consumer remains in a funk and the market is responding accordingly. The S&P continued its slide this week as consumer discretionary names like Home Depot issue less than encouraging words about upcoming earnings. In a speech Monday Fed Chairman Ben Bernanke offered what the *Wall Street Journal* called a "dreary assessment" for economic recovery and how the dollar's decline vs. other currency helps push up commodity prices, squeezing producer margins.

Ah, you say, but you're reporting shortline successes in WIR. How can this be? The biggest gains have been energy-related as in the Marcellus Shale plays for Penna and NY short lines. The three roads winning prizes at the recent BNSF shortline meeting were recognized for doing the basics better, for an energy play and for franchise expansion in number of operating properties and for opening transloads. It's not like new companies are rushing to open new factories.

Plainsman Switching Company (PSC) in Lubbock, Texas, is a new railroad created when the town's biggest business took over operations from an operator whose performance appeared to be lacking. BNSF says PSC did 8,000 plus cars in 2008 yet my short line database has the previous owner at 14,000 cars in 2006. Looks like they're getting back what was already there.

Watco's Yellowstone Valley Railroad (YSVR) is finding new, energy-related customers in the natural gas, crude oil, and frac sand markets. This 170-mile property went to YSVR in 2005 and has been running some 8,000 carloads a year, about half what it needs to satisfy the Rule of 100 (100 cars per route-mile per year) for successful shortline operations. Watco is no stranger to the energy business; see my "Energy Rides the Rails" in the June, 2009, *Trains* featuring YSVR.

The Burlington Junction Railway (BJRY), based in the Quad Cities of Iowa and Illinois, is a franchise-expansion story. Started 25 years ago as a single branch line it now has six properties (total under 20 miles) and has enjoyed 12-percent volume increases year over year. The BNSF award cites BJRY's success in attracting eight new customers to its transload facilities -- of which it has seven -- to which it can direct carloads to reach truck-served customers.

In times like these, one looks for good news where one can. Dahlman Rose rail analyst Jason Seidl writes, “The pace of improvement in rail traffic picked up last week with the first single-digit volume decline reported since 2009’s Week 35. That week’s decline of only 5.6 percent was primarily due to easy comparisons with a shortened Labor Day holiday week in 2008. Excluding the [short] week that created an enhanced recovery illusion, one would have to go back to Week 47 of 2008 (nearly a full year) to find the last-single digit weekly decline in rail traffic. For volume growth, one must travel back even further to Week 36 of 2008 with its 6.4 percent gain in rail traffic.

“Week 44’s decline of 9.9 percent year-over-year represents a continuation of improving volume trends, which, we believe, is primarily due to favorable year over year comparisons with the historic collapse of markets in 4Q08 as well as a modest improvement in economic fundamentals. The relatively low percentage drop [combined with the rate of decline decelerating] in nine out of the last ten weeks are likely indicative of the ongoing stabilization referenced by the railroads in their 3Q earnings calls.

“Looking forward, we believe that [sequential rate of] volume declines in Weeks 45 through 47 will improve further, while Weeks 48 through 52 should see an even more significant deceleration in declines with rail traffic possibly showing growth in Weeks 50 and 51.” Possibly. With so many commodity groups do far down from 2008 levels, it’s going to be a couple of years before we’re back to the traffic levels in late 2007 and through Oct or so last year. Take coal for example, perhaps the least affected commodity.

I reckon coal carloads will end 2009 ten percent below what they were at New Year’s Eve 2008. Even if coal comes back on a level with a respectable GNP expansion of four percent per year, absent any government meddling coal volumes won’t equal 2008 for sheer number of carloads until sometime in the first half of 2012.

Through Week 44 every commodity group but ag is down double-digits and there’s little reason to expect any significant reversal in the last six weeks of the year. If ag, the least bad-off of the lot, down nine percent now, recovers next year in the three-to-five percent range, it’s still not in the black until 2012. The railroads as an industry have done a spectacular job of cutting the fat and making more ton-miles with fewer assets and consumables and we’ve seen some nice earnings growth as a result. That game is definitely over and the only thing that will generate future earnings growth is top line growth. Absent that, I don’t see any significant earnings growth for the next two years.

And if I don’t see it on the Class Is, I surely don’t see it on the short lines, at least in terms of organic growth. We heard both John Giles of RailAmerica and Jack Hellman of Genesee & Wyoming talk about their growth-through-acquisition strategies during their third quarter calls. They had to because if the class Is are not growing the volumes, feeder lines dependent on class Is for their volumes aren’t going anywhere, either. Thus the only route to top line growth is with acquisitions that can add revenue faster than expense. There are three choices: buy, get bought, or face a slow death.

Morgan Stanley’s report on the US consumer and retail trends says mobile computing and e-commerce will have far-reaching effects on the way sellers sell and buyers buy. The term “disintermediation” shows up repeatedly and it appears to be in the context of eliminating the middle man. The message is that there is less reliance on bricks and mortar stores for reaching the consumer. And *Investors Business Daily* confirms this with an article on “pop-up stores,” temporary stores set up in vacant mall spaces where e-tailers can show their wares for a short time and then move on.

Actually, the lighter and more generic the product the greater the e-commerce attraction. Dell was a pioneer that helped kill the stand-alone computer stores. And look what Amazon is doing to the B.

Dalton's and others of that ilk. On the other hand, bulky and perishable items have some protection from eCommerce incursion. Think food and the Railex model (WIR 8/21/2009). Or the transload expansion at BJRY (above) where smaller inventory basic loads could be driving a shift to truckload shipments from a parked boxcar or covered hopper and where the receiver doesn't pay the supplier until the goods are in-house.

Just this week I saw several analyst reports naming names where the shift in supply chain emphasis is causing changes in operating results. Jeffries & Co maintains a Hold rating on BJ's "as core comp store sales remain challenging through April of next year." A note from Janney says "the consumer remains weak" thanks to "lack of available credit, higher unemployment (10.2 percent in Oct'09 versus 6.6 percent in Oct'08) and low consumer confidence." And UBS comes to essentially the same conclusion: "Our latest Consumer Mind Reader shows that consumers continue to worry about unemployment and their financial health."

Charles McSwain, recently retired from CSX and who has considerable knowledge of all of the above, writes, having seen the M-S report and my musings above, "The platform is changing and this is the perfect time for railroads to get into the mix of new products that will support the new economy. Railroaders can't just sit back and wish that things get better, they need to develop the new products that provide value for lots of companies that are desperate for a cost-competitive edge in a very tough marketplace. This does not mean cheapening the old [railroad] product, it means find new ways to insert yourself in much larger multi-modal platforms that create value and new market share." Anybody want to continue the thread?

The witty and inquisitive Rick Paterson, rail analyst at UBS in NY, can always be depended upon to find an intriguing angle to what's happening in our business. This week's note (Nov 19) enlightens us with the results of his shipper survey on the re-reg bill now sloshing around in Congress. He writes, "Among all respondents, 88 percent expect the bill to be immaterial, marginally impact earnings and leave the rail pricing and investment story essentially intact. Our sage participants were undecided, however, on the market's initial reaction to the bill, with about half expecting a sell-off in rail stocks the day the news breaks, and the other half expecting either a flat or an upward move. All of this is predicated, of course, on an assumption that something ultimately gets made into law, which is hardly a sure thing either." At least *that's* positive.

From the Warren Buffett Interview with Charlie Rose on PBS, on the railroad industry being capital-intensive and regulated: "You spend money in this business regularly every day. You're spending a lot of money to repair track, add rolling stock, whatever it may be. So it's capital-intensive, and it is regulated, and it will continue to be capital-intensive and regulated. The service provided by railroads is so important in many ways. It's the right way to move goods around the country to the extent that you can do it. And it's far, far more attractive in terms of global warming than using trucks, for example. So it will be here, and if we get a reasonable return on the added capital investment-because it will take added capital investment-we'll do OK."

There will be no *Week in Review* for November 27. The railroads will just have to get along without it until December 4. Have a great and family-filled Thanksgiving. And be safe out there.

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RailConnect Index of Short Line Traffic

Traffic Type: All

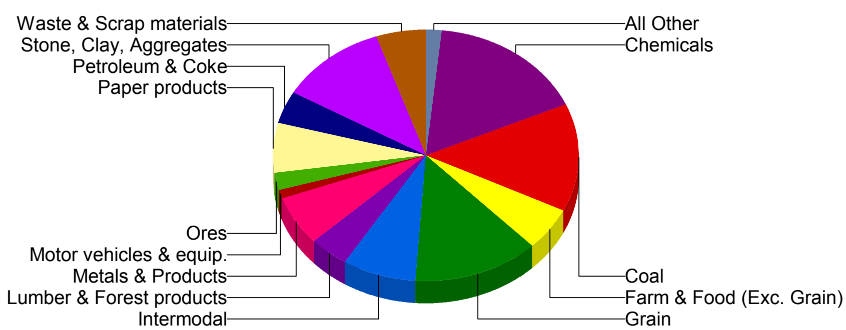
For the week ending: 11/07/2009

Week Number: 44

Carloads Handled	Current Week			Year-To-Date		
	2009	2008	% Change	2009	2008	% Change
Coal	11,169	15,662	-28.69%	518,676	640,700	-19.05%
Grain	13,284	12,552	5.83%	501,662	576,454	-12.97%
Farm & Food (Exc. Grain)	4,865	5,639	-13.73%	210,956	233,056	-9.48%
Ores	2,462	1,981	24.28%	78,619	121,207	-35.14%
Stone, Clay, Aggregates	10,053	12,359	-18.66%	430,473	522,529	-17.62%
Lumber & Forest products	3,666	4,979	-26.37%	154,979	217,248	-28.66%
Paper products	5,030	7,004	-28.18%	245,110	325,157	-24.62%
Waste & Scrap materials	4,635	4,995	-7.21%	193,728	268,547	-27.86%
Chemicals	14,927	15,727	-5.09%	624,157	723,349	-13.71%
Petroleum & Coke	3,229	5,086	-36.51%	154,426	249,660	-38.15%
Metals & Products	4,986	9,044	-44.87%	242,138	465,907	-48.03%
Motor vehicles & equip.	1,144	1,910	-40.10%	44,039	83,911	-47.52%
Intermodal	6,321	11,584	-45.43%	283,934	550,816	-48.45%
All Other	1,821	2,333	-21.95%	61,905	127,492	-51.44%
Total	**87,592**	**110,855**	**-20.99%**	**3,744,802**	**5,106,033**	**-26.66%**

RailConnect Index

Year-To-Date



All Other	1.7%
Chemicals	16.7%
Coal	13.9%
Farm & Food (Exc. Grain)	5.6%
Grain	13.4%
Intermodal	7.6%
Lumber & Forest products	4.1%
Metals & Products	6.5%
Motor vehicles & equip.	1.2%
Ores	2.1%
Paper products	6.5%
Petroleum & Coke	4.1%
Stone, Clay, Aggregates	11.5%
Waste & Scrap materials	5.2%
Total:	100.0%

This report is comprised from 337 roads.

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