

THE RAILROAD WEEK IN REVIEW

June 25, 2010

“Charging so much for transportation that the grain doesn’t move at all doesn’t help the grain dealer, the grower, or the railroad.” -- Larry Kaufman in Argus Rail Business

Kaufman writes, “A recent US Department of Agriculture (USDA) report claims that high rail rates have damaged the economic health of the farming sector, but officials seem to have forgotten that farmers also benefitted from railroad service. Rail’s share of the grain market has been decreasing. Grain growers and railroads have an increasingly symbiotic relationship.

“Both are participating in a logistical supply chain that demands operational efficiency. Farm productivity drove railroads to develop highly efficient shuttle train networks. For growers, yield is the name of the game as they increasingly operate like industries. Mom-and-pop family farms rapidly are disappearing, especially in the Midwest where grain production is concentrated.”

Railroads are batch processes and they do big lots of the same stuff very well; what they do not do well is the customized service where each shipment moves at the whim of the shipper. That’s the truckload market and the intermodal market. Moreover, the shuttle terminal concept is intermodal applied to grain. Super-trucks on super highways take the harvested grain from super-sized fields to super elevators to be loaded on super shuttles for movement to super elevators for processing into super-market products or loading into super-sized ship bottoms for export.

The day of the country elevator is over. I’m reminded of one short line that told its five-car-a-year country elevator to use the railroad or lose it. They did not use it, they lost it, their truck rates went up, the country elevator went out of business and the town dried up. And not long ago I was doing the due diligence for a client looking to buy a grain road from a short line that was for sale. There were three parallel rail lines within 15 miles of each other serving the same markets. There was barely enough grain to support one line. We passed.

Art Ivins, a former Conrail marketing exec and long-time WIR contributor writes, “Your trip through the ruins of Connecticut can be duplicated in PA, NY, NJ, MA, and the rest of New England. Those industries have been gone for years and just didn’t disappear in the most recent downturn. When I was a transportation supervisor with the PC at Morrisville in 1970, Trenton teemed with industry; now it is all gone.

“The same can be said for my days at Greenwich Yard in South Philly and my trips up Delaware and across Washington Avenues. [Freight drags ran down the middle of both streets. The rails are mostly gone but on Washington Avenue the area south of the east-west street is still called “across the tracks.”]. Sorry to say, but carload freight in the East is almost a thing of the past.”

Carload freight as we knew it, with many industry tracks off runners adjacent to the mains and myriad local freights on branch lines, is surely gone. However, much of what single-carload industry remains now uses domestic intermodal or transloads. Look at how the bulk-transfer

business has grown for everything from plastic resins to corn sweeteners. Moreover, the individual carloads are 25 percent bigger -- 100 tons payload vs 80 tons.

The tea leaves are pointing to smaller inventory carries of both raw materials and finished goods, particularly in the manufactured-goods sector. Yet many shortline contacts are telling me the carloads lost in the manufacturing and building supply sectors have been more than offset by gains in food- and energy-related commodities.

Interesting. But how wide-spread is it? I dug back in the files to 2006 for week 22 and found that 2010 revenue units on Class II and Class III roads as reported by RMI's Rail Connect Index are down 27.6 percent compared to what they were for the same period in 2006. What's most interesting is the change in mix: it's not as big a swing as I had thought it would be.

Take a look at the table below. You can see the lumber and forest products line has declined the most, down 230 basis points while chemical moves increased 404 BP and grain increased 282 BP. The only real gainer in terms of absolute carloads was in the "ores" category, which the AAR defines as "overwhelmingly iron ore," chiefly driven by a handful of names and less than four percent of the total units.

| Shortline Week 22 comps 2006-2010 | | | | | | | |
|-----------------------------------|-----------|-----------|-----------|-----------|-----------|--------|--------|
| RMI RailConnect | | | | | | | |
| Commod | 2006 | | 2010 | | Units | Pct | BP Mix |
| | 2006 | pct total | 2010 | Pct total | Change | Change | Change |
| Coal | 323,835 | 11.7% | 235,182 | 11.7% | (88,653) | -27.4% | 0.04 |
| Grain | 295,313 | 10.7% | 270,274 | 13.5% | (25,039) | -8.5% | 2.82 |
| F&F | 102,977 | 3.7% | 97,110 | 4.8% | (5,867) | -5.7% | 1.13 |
| Ores | 63,526 | 2.3% | 72,325 | 3.6% | 8,799 | 13.9% | 1.31 |
| SCA | 239,232 | 8.6% | 225,780 | 11.3% | (13,452) | -5.6% | 2.62 |
| Lumber FP | 170,506 | 6.2% | 77,280 | 3.9% | (93,226) | -54.7% | (2.30) |
| Paper Prods | 193,646 | 7.0% | 124,047 | 6.2% | (69,599) | -35.9% | (0.80) |
| Waste, Scrp | 133,282 | 4.8% | 108,483 | 5.4% | (24,799) | -18.6% | 0.60 |
| Chems | 337,509 | 12.2% | 325,342 | 16.2% | (12,167) | -3.6% | 4.04 |
| Pet & Coke | 126,811 | 4.6% | 101,530 | 5.1% | (25,281) | -19.9% | 0.49 |
| Metals | 266,408 | 9.6% | 168,847 | 8.4% | (97,561) | -36.6% | (1.20) |
| Auto | 51,509 | 1.9% | 22,666 | 1.1% | (28,843) | -56.0% | (0.73) |
| Other | 73,428 | 2.7% | 45,609 | 2.3% | (27,819) | -37.9% | (0.38) |
| Carloads | 2,377,982 | 85.9% | 1,874,475 | 93.5% | (503,507) | -21.2% | 7.64 |
| Intermodal | 391,185 | 14.1% | 130,077 | 6.5% | (261,108) | -66.7% | (7.64) |
| Total | 2,769,167 | 100.0% | 2,004,552 | 100.0% | (764,615) | -27.6% | 0.000 |

So it's *not* as much a shift to "heat and eat" as some have suggested. Except for intermodal (a relatively small category for most short lines), the mix in 2010 is pretty much what it was in 2006. (The intermodal swing is so wide I've asked RMI to see what light they can shed on it.) The point of all this is not to take too much stock in the year-over-year gains you see in the weekly reports. Short lines are up nine percent in 2010 year-to-date and 24 percent for the week compared with 2009. Encouraging, yes. Recovery, yes. But a return to the heady days of 2006? Hardly.

Brian Holtz, a retired shortline manager, adds, “I loved your opening comment in the last newsletter about short lines being strictly variable cost to Class I’s. For my entire life I have felt railroads were too fixed-cost to be managed nimbly and responsively to changing business conditions. I have been amazed and delighted how Class I railroads have responded to changing conditions over the past five years, especially during downturns in business.

“In my opinion, the rail industry currently has the best top management since I started following the rails in the late 1950s. Short lines and contractors should continue to look at Class I’s and offer to take over more of the fixed cost items, and charge on a variable-cost basis.

“While you were visiting short lines, so was I. Johnnie Raab, the General Manager, and I hi-railed the 62-mile Louisiana & Northwest Arkansas Railroad of Patriot Rail. It caused me to rethink some previous benchmarks on business levels required for profitability and reminded me that each property needs to be looked at with understanding and creativity. Some services may be worth more than we have been thinking.

“I was also able to add another item to my “checklist” of possible revenue generators. Cell phone service was virtually non-existent along much of the rural route which parallels a busy highway used by trucks and locals. It struck me that most railroads own 50 to 100 feet from the track centerline and could provide properly zoned locations for cell phone towers. Railroads could provide improved cell phone service for communities and customers they serve, improve their own cell phone service and generate an on-going revenue stream with almost no cost.”

Pennsylvania not only is the eastern hub of the Marcellus Shale action but it now is in the ethanol business. BioEnergy International LLC has built an ethanol manufacturing facility on the that R.J. Corman Railroad Company/Pennsylvania Lines (RJCP) at Clearfield, Pennsylvania, in the historic heart of Pennsylvania coal country. The plant receives weekly deliveries of 90-car unit trains of corn via Norfolk Southern and RJCP. These deliveries allow the plant to produce 108 million gallons of ethanol and 350,000 tons of dried distiller’s grain yearly.

Concerning the outlook for the broader economy, Schwab Chief Investment Strategist Liz Ann Sonders writes in her June 14 note, *Life in the Fast Lane: Volatility and Uncertainty*, “A lot of focus has been on the latest jobs report, which showed a disappointing 41,000 private sector jobs created; the rest being temporary Census workers. It’s worth noting that in the past, the month in which Census hiring hit its peak, private sector hiring has weakened, after which the latter has rebounded smartly.

“I’m by no means sugar-coating the weak labor report, but I do want to highlight one bright spot in the release. Both the average workweek and hourly earnings increased in May, and have been increasing fairly steadily for months, which suggest that demand for employers’ products and services is going up. Companies are employing more labor in terms of hours, while also compelled to increase workers’ compensation. This is consistent with an expanding economy and bodes well for future jobs gains.

“But the hitch is the aforementioned uncertainty, and there’s a rash of it. To be frank, although there’ve been many US government policies aimed at job creation, it’s uncertainty about many government policies—including healthcare, regulation, taxes and trade—that’s likely putting the crimp in hiring.” And that, dear reader, is what’s causing our rail freight customers to work with smaller inventories of both goods in process and finished goods. And do it with smaller staffs.

Sound bites from The Street Department. Longbow Research is increasing 2Q10 EPS estimates for CSX, NSC, KCS, and UP on average by about 14 percent. “We continue to believe that the rail industry is well-positioned for further EPS outperformance in the coming quarter. As volumes bounce off their lows, the industry should continue to enjoy some operational leverage over the next 12 months as costs do not come back on a one-to-one basis with volumes.”

UBS on June 21 upgraded Vulcan Materials [*a major railroad user - rhb*] to Buy. “A long-awaited volume recovery should be apparent in Q2 results, with stimulus projects clearly starting to boost activity. Feb/March strong highway awards are a good leading indicator of demand recovery 2-4 months out. California and Florida markets remain challenged but should post strong recovery, with delayed benefit given slower processing of stimulus funds. We estimate public construction is >2/3 of demand. The now-smaller private sector construction segment likely has troughed, in our view.”

Also at UBS, rail analyst Rick Paterson “has a high conviction that CSX will surpass market expectations in both the near and longer term, likely pushing the stock materially higher.” He expects “big operating leverage and sustainable core pricing growth in excess of cost inflation that should deliver a nice Q2 earnings beat and lead to substantial upward revisions to future consensus.”

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