THE RAILROAD WEEK IN REVIEW
September 3, 2010

“Growth today is probably easier to buy than build for many CEOs.” -- Michael Santoli in Barron’s, August 23, 2010

New York’s Livonia, Avon & Lakeville is a short line that surely gets it. What they have done is position themselves as the Food Line Railroad, having brought in such household names as ADM, Corn Products, Kraft, Perdue and most recently the Barilla Pasta plant. According to a recent story in a local newspaper, “Barilla’s Avon plant accounts for more than 50 percent of the pasta maker’s U.S. sales. Kraft’s plant, also in Avon, is the only location where the company produces Cool Whip.”

The paper goes on, “Access to the locally-owned LAL as well as the area highway system allows Barilla to ship in Canadian wheat on day one, process it on day two and have it in U.S. and Canadian stores by day three.” Moreover, the LAL connects with two Class Is -- NS and CSX -- giving customers like Barilla inbound and outbound options -- a key consideration when origins and destinations are at points local to railroads beyond CSX and NS.

As I wrote in the June, 2009 *Trains*, “The success of the LAL may be directly attributed to three things: an intense focus on fulfilling customers’ supply-chain requirements, maintaining the infrastructure required to meet those requirements, and being a good citizen in both the railroad and non-railroad communities.” That’s what it takes to be a serious player in this business.

From Gulf & Ohio’s Pete Claussen comes word that they have announced the pending acquisition of the operating assets of the Lancaster & Chester Railway Company. The L&C opened for business in 1896 and operates 62 route-miles serving customers in Chester and Lancaster Counties, South Carolina. The commodity base is primarily agricultural products, building supplies, chemicals, minerals, and steel.

Gulf & Ohio Railways, Inc. is a family-owned holding company that owns and operates seven shortline railroads in Alabama, North Carolina and Tennessee . It also owns and operates two locomotive shops: Knoxville Locomotive Works, Inc., located in Knoxville, Tenn. and KLWX, Inc., located in Laurinburg , NC. The G&O’s rail properties operate 203 route miles and haul commodities including agricultural products, ethanol, chemicals and lumber products. The acquisition is expected to be finalized November of this year subject to STB approval.

The L&C gained a degree of notoriety nearly 60 years ago when the L&C's flamboyant Col. Elliott Springs took out full page ads in the *Official Guide* and listed half a page of vice presidents. Among them were Lucius Beebe, VP in Charge of the Internal Audit, W.F. Halsey, VP in Charge of White Horse Supply, and, most notable of all, Gypsy Rose Lee, VP in Charge of Unveiling. Claussen assures me Miss Lee (1911-1970) retains the position if only in spirit.

Last week's WIR remarks on shortline economics yielded some highly thoughtful and useful comments. A reader who was an early owner of a large post-Staggers regional railroad writes: "Agree there is a massive disconnect between 9.5% employment and freight volumes on the roads and rails. Agree the talking heads and WSJ don't leave their offices enough to see the rest of us coping. Agree the new normal is: 'Whatever you were doing in 2007-8 take off 10%.'

"Something to think about. How about a non-statistic, a black hole that pays taxes? There is no credible cross-tab between Dept. Labor and IRS stats, or so it would seem. There also appears to be none between secretaries of state for incorporations or Duns Numbers etc. Basically, ever since the loss of big-business' dominant status, the statisticians have been running to play catch-up with the micro economic aspect of things.

"Interesting to ponder whether the 'unemployed' electronics engineer in Cupertino doing odd jobs for Apple at twice his former salary is counted as unemployed or falls into the black hole, neither of which are 'economically true.' In other words, if news media unemployment is 9.5% -- the question is: What is the denominator? What if the denominator were "taxpayers" with some lead/lag modifications to account for deferred effects?

"I am made very suspicious by the swing in (apparent) savings rates from 1.5% to upwards of 6%. Granted some of it (maybe a lot) is driven by involuntary savings, but how does a whole population driven by economic hardship swing its savings rate so spectacularly with no resources? Who is saving – the entrepreneurs who are not hiring or investing mayhaps?

"And while on the subject, what is the true state of housing and what are the longer term effects of just knocking the peaks of 2006-8 off the trend line? Well, it just so happens that disposable income is growing despite the recession while personal outlays has dropped 21 months straight. The difference flows to saving. And that, friends, is why the roads and rails (and planes) are jammed." As somebody quipped here a week or so ago, just look out the window if you want to know what's really happening out there.

Larry Kaufman offers these observations: "I obviously agree with your uber-view about 'stuff.' Railroads are moving prodigious amounts of stuff. The unrecognized story is container traffic [*Frailey and McClellan the elder have nailed this one, too. -- rhb*]. As Trans-Pacific volume is good but not as good as in the past, this traffic is coming from somewhere, and domestic is about the only place it can come from. If you're a trucker looking at restrictive HOS, high insurance, high diesel, urban congestion, etc., intermodal looks more attractive. And if you are a 3PL or broker, it probably looks even more attractive.

"The fact still remains that economic activity is occurring or railroads would not be exceeding the comparable 2009 weeks (no matter how bad the economy was a year ago, the performance is

impressive). Productivity always has increased as the country recovered from recessions, and the deeper the recession, the greater the productivity gain. Translation: business produces more with less, the less being employees.

"Moving along to the comments in your newsletter, some of your readers clearly are smarter than the average WSJ reader. Railroads have done such an effective job of converting fixed costs into variable that they can keep chugging along, even carry a bit less, and still earn reasonable profits. Some of us who were around pre-Staggers still are amazed at the transformation. Recessions used to be accompanied by railroad bankruptcy filings.

"Your reader who commented on Wall Street analysts intrigued me. I've had the same conversation, perhaps even with you. When I started covering railroads there were several analysts (Henry Livingston and Burt Strauss come to mind) who had worked on railroads. Today's analysts may be better number-crunchers, but I do think they lack the "feel" that their predecessors had. That may not be all bad, though, because this is a different industry than when Henry and Burt were doing their thing. The analysts who I read are almost unanimous in their appreciation for what the railroads have been able to do through the recession.

"Your reader who raised the issue of railroads poking customers in the eye by pushing prices up, etc., must be with a utility or chemical company. Politely, that's bull! I don't see intermodal customers or any other customer that has [modal] options complaining. They simply shift to the highway when the price gets above a level they are willing to pay. My local utility has not hesitated to file two general rate cases this year, gaining approval to put the $1.3 billion investment in a new coal-fired plant into the rate base so I can pay for a facility that has yet to produce its first kilowatt hour. Utilities haven't hesitated to use the 'safety nets' in Staggers and to lobby for what would be a return to regulation. Hypocritical is what utilities are."

As for price-book multiples, short liner Tom Loftus points out, "One answer to your question of why companies like Apple and Google enjoy much higher share price multiples than the railroads is, as you know, capital intensity. Companies like Apple and Google have much lower fixed assets, lower capital expenditure requirements and thus are perceived to be capable of generating higher returns.

"I took a quick look at Apple versus selected RRs using Yahoo Finance. Over the last twelve months, Apple's net margin was 21.4%, OR was 71%, ROA was 18% and ROE was 35%. In comparison, GWR's numbers were 14%, 81%, 4.5% and 11%; UNP 15%, 73%, 6%, and 14%; NSC 14%, 73%, 5.5%, and 12%. While Apple and the RRs are in the same range for Operating Ratio, RR net margins and returns are quite a bit lower. This reflects the capital intensive nature of the freight railroad business." And that's good analysis.

Taking the other side, it's said that four out of every five shares traded are for the accounts of institutional investors. If so, then what you or I think a company is worth is of little import -- the fund manager or quant trader is gunning for short term gains to keep his numbers up. And in case you think otherwise, be sure to read Alan Abelson in *Barron's* this week. He cites "The Marginalization of the Individual Investor" argument that high-frequency trading may be "undermining traditional value investing strategies." You can find it on-line by searching on the

title. There you can read how one of the CEO of one HFT outfit said, the longest time he ever held a given stock was -- gasp -- seven seconds.

So what's this got to do with short lines? Simply this: if institutional traders drive down the prices of railroad stocks thanks to perceived weakness in the economy, it becomes a trend. The HFT guys step in, accelerating the trend and the share prices slide even faster. Shrinking share prices can effect how Class I employ capital and control operating expenses so the net result is less capex and service reductions on non core lines. That in turn harms the railroad value proposition for supply chain managers.

You can't make this stuff up. Just this week I got a call from a pro-railroad building materials supply chain manager who -- even in this down economy -- has kept using rail because the rates were competitive and transit times dependable. But the Class I cut interchange frequency to twice a week and the serving short line cut back daily switches accordingly, thus adding days -- and inventory cost -- to this vendor's supply chain. At the end of the day, this railroad retrenchment had put a rail advocate in the position of no longer being able to defend the use of rail transportation. Good bye, Mr. Railroad; hello, Messrs. Hunt and Schneider.

September marks the beginning of the fall meetings onslaught and I've gotten caught up in five: the ASLRRA Eastern Region in Baltimore Sep 12-14, the monthly Transportation Research Forum lunch in NYC Sep 23, RailTrends in NY Sep 28-29, NEARS on Cape Cod Oct 6-8 and the BNSF gathering for short lines Oct 31-Nov 2. For TRF, I will be holding forth on my Railex train ride experience (see Trains, Feb 2010), ably assisted by Railex' own Paul Esposito. And at NEARS they've asked me to do a panel of Class I managers on creating and measuring customer satisfaction -- rate discussions are off limits and it's more Q&A than PowerPoints.

I think the ASLRRA session is important because on Monday the program features three panels on shortline commercial and operations metrics. Presenters include Farmrail's Charlie Marshall and SMS chief commercial officer John McCreavy. RailTrends -- Number Six, for those who are counting -- again promises a stellar collection of railroad movers and shakers. My good friend Tony Hatch has helped pull together a superb program of timely topics such as railroad execs on the economy, why Wall Street behaves as it does, how the White House sees rail policy and the lenders' take on railroad investments. It's what sponsor *Progressive Railroading* magazine calls "a rare opportunity to learn from some of the rail industry's most influential deal makers, trend setters and high rollers."

Further details on NEARS and BNSF anon.

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