THE RAILROAD WEEK IN REVIEW

December 5, 2014

"When a trade is crowded on the long side, everyone has an itchy trigger finger to sell." — Ben Hunt, "Signs and Portents," December 1

Last Friday's oil price slide clearly spooked railroad and railroad equipment traders. I took a number of calls and emails from clients asking how low can it go and what's the effect on the railroads. I really don't have any big-a Answers. But my small-a answer is I don't know.

Unfortunately, neither do a lot of other people, but since they're in the business providing Answers, writes Ben Hunt,

> Global capital creates a multi-trillion dollar demand for The Answer, and financial service providers (or at least successful financial service providers) will always provide it. When there's a multi-trillion dollar market for The Answer, it should surprise no one that there is competition around the supply of The Answer.
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> Many, many, many answers with a small-a will be supplied, each vying for contention for a slice of The Answer market. Not only is every advisor or allocator in the world today an answer-supplier in his or her own right, but also there are layers upon layers of answer supply and demand within the financial services world itself.

Hunt concludes that the present supply-demand Narrative (what he calls the Conventional Wisdom of the moment) is such that it's hard for oil prices to get much below $70 and stay there for a long time. That may work for the majors, but, says the WSJ, "Companies loaded with too much debt or operating in fringe locations face big trouble if U.S. crude prices remain at $65 to $70 a barrel for long." It's a crowded long side, and fingers are itchy, triggering the sudden drop.

A Nov 28 note from Wunderlich advises, "This was pretty much the last shoe to drop in our supply-side view and now we must prepare for a $70/bbl world." Yet Kurt Wulff of McDep LLC sees $75/bbl as the current floor and is "looking for seasonal improvement in price before year-end and continuing in 2015." Barclay's estimates (Dec 3), that share prices of the major producers "currently reflect assumptions of $80/bbl Brent and $71/bbl WTI for the next 12-18 months."

The short lines I've spoken with are dealing mostly with the majors and where there exists the possibility of spending cuts on newer drill sites while still pumping from cheap-to-produce areas like the Eagle Ford and Permian in Texas. And some companies have oil-price hedges that will buoy profits even if crude is trading at four-year lows. One must keep in mind new fracking techniques facilitate longer horizontal reaches for every down-hole, lowering initial costs.

The Interchange Service Agreement push is on once again, and it's the commercial side that's pushing the idea. Folks on the operating side are, like the citizens in *Richard III*, mum, say not a word. That's not good because, if you're talking a scheduled railroad, the place of interchange is, in the old passenger sense, a station. And the time of interchange is a scheduled station stop, even as Amtrak's Crescent Limited is scheduled for Gainesville, Ga. at 0658 southbound. So operating folks have a huge stake in timely shortline interchanges.

We all agree a big contributor to the present situation of crowded mains is the lack of yard space. But if trains operated on schedule and arrived and left terminals on time, trains wouldn't be stacked up on the mains. Making stops between terminals on time also keeps trains on time so they arrive, like Gandalf says of wizards in *Lord of the Rings*, exactly when they mean to.

The ISA specifies the time window for the interchange to take place. It doesn't say the shortline crew has to be there, only that its cars' car hire liability has been transferred to the connecting Class I and there is yard space to take the inbounds. There still are short lines that don't see the need to set a specific interchange hour, preferring to make interchange at their convenience. Doing so is a huge disservice to the entire scheduled network, slowing down car velocity and making mainline congestion even worse by putting local trains out of their slots.

BNSF and NS, to name two railroads, are tracking interchange/on to interchange/off dwell times for short lines and this is a good thing. The short lines, for their part, need to score Class I compliance with the ISA schedule. There is anecdotal evidence that Class I serving locals are scoring cars interchanged to the short lines when they are merely in the neighborhood. C'mon, guys — if a short line can't get to your cars and you don't pull from the short line, the cars haven't been interchanged. And you're on the hook for the car hire.

One more thing, while I'm on this rant. Over the past several months, I've called on a number of Class I hump yards where cars from shortline interchanges are built into outbound core trains. Every terminal superintendent said he can take blocks of cars directly to the departure yard from the receiving yard, eliminating the need to hump the entire consist and saving as much as a day's dwell in the bargain. So if the shortline could pre-block by destination, days could be taken out of car cycle times and improve car miles per day. Better turns equal better margins. Got it?

Short lines for their part say they'd be happy to pre-block, but would like some compensation for the effort, either in the handling fee or in the ISS division. That seems to be a non-starter. Marketing controls the settlement amount and saving the operating department some time and expense doesn't count when bonus time comes around. I'd be most grateful if a reader or two could tell me it isn't so and add a word or two on how to make shortline pre-blocks work.

Quality of service was a thread throughout RailTrends two weeks ago. During the breaks I compared notes with my friend Tony Hatch (be sure to see his excellent January 2015 Trains magazine interview with Associate Editor David Lassen on page 8) on what he's seeing on the Street and what I'm seeing on short lines. We came up with four themes:

First, consistent service is essential if what Tony first called the Rail Renaissance some years ago is to be perpetuated. Improved volumes yield improved revenues, improved returns will yield more capital expenditures, adding capacity and improving service, accommodating greater volumes. Lather, rinse, repeat. Second, the rails themselves have to make the congestion problem go away and any attempt to legislate solutions would be counterproductive. Only the operators understand not only what it takes to improve fluidity today but also to assure a fluid system tomorrow.

Third, efforts are well under way to create space for more trains: more track (mains *and* yards); more locomotives; more train, yard and engine crew personnel qualified and marked up for service. But that takes money. BNSF, or example, will put $6 billion into the railroad during calendar 2015, roughly equal to the entire Class I capex program for 2000. Fourth, the present service difficulties haven't dampened shipper demand for increased rail shares of their transportation dollars.

Put it all together and the railroads have at the same time great growth prospects and an opportunity to regain the initiative in productivity and efficiency. In so doing, the rails will satisfy the demands of shippers, regulators, and shareholder/owners. Moreover, our favorite industry can certainly do all the above under the current regulatory environment.

GWR is paying Pinsly $40 million cash, about 7-8x ebitda, for the combined Arkansas Midland, Warren & Saline River and Prescott & Northwestern Railroads — some 137 route-miles of railroad, with AKMD the largest. Annual carloads come to about 35,000 for an average 255 cars/mile, some 2.6x my Rule of 100. The traffic base is forest products, aluminum and aggregates.

Wolfe Research estimates total annual revenues of $18 million or $500 a car, a reasonable number for this traffic base. The combined Pinsly roads are reported to be running a 75 operating ratio, implying operating income of 4.5 mm. Add back depreciation of $1.8 mm (10% of revs per my shortline model) and get a back-of-the-envelope EBITDA of $6.3 mm. GWR says $5.4 mm EBITDA so the price is 7.4 x EBITDA, a reasonable number.

PNWR and WSR are former Potlatch properties, each 5 miles long and connecting w UP. AKMD consists of five former MoPac lines Pinsly acquired in 1992.