THE RAILROAD WEEK IN REVIEW
MARCH 14, 2008

"Some owners have found that their older railcars are worth considerably more than book value in the scrap steel market." – Peter Nesvold, Bear Stearns

Tony Hatch writes that this year's Rail Equipment Conference was a "huge success." I've lost track of how long Tony Kruglinski has been doing these but every year the attendance grows and the insights are worthwhile for everybody who has anything to do with freight cars – builders, leasing companies, financiers, and railroads of all sizes. Some take-aways:

"Equipment owners and managers face an uncertain volume outlook and rising equipment costs (steel, aluminum, technology and safety regs). The manufacturers' outlook is no brighter (unless you can continue to build through the downturn and stuff your associated leasing company investors with marked-up cars). One speaker from RailInc put the 08 production still at 50K+, although [car-supply gooroo] Toby Kolstad thought it looked more like 48K and some were thinking low 40s! There wasn't much on the consolidation rumor mill (more talk about Icahn and CSX than Icahn and GBX), although there were rumors a (the) large fleet owner exiting the business.

"There was also good further dialogue on what SWARS (Southwest Assn of Rail Shippers) had called the "carload myth" that rails' desire for unit-train-only business was spelling the death knell for merchandise traffic [and which BNSF clearly gave the lie to at the recent Analysts Day - rhb]. Boxcars still make up 10% of the fleet (although the only sector to show a significant decline in '07). Nevertheless, there was good long-term hope provided by the likes of the demand from Georgia Pacific.

"Overall fleet age of 19+ years means more than 200,000 cars need to be replaced or rebuilt by 2010. There were the usual negative rumblings on ethanol (overbuilt, moving towards unit trains – good for rails if not for tank car owners) and on rail accessorial charges (storage, repair, etc.) which are being seen by some fleet owners.

"Bottom line: railcar demand is flat to down, railcar costs are up, up and away. Yet the overall business remains healthy and we are all certainly better off than in the last trough – and will be in the next peak as well." All of which reinforces the short line message: he who turns cars the fastest gets the most cars to turn.

Meanwhile, Peter Nesvold, rail equipment analyst at BSC, writes, "We spoke to a senior manager at a large private railcar lessor about the trends he's seeing in the current market. Our contact noted that while it's somewhat counter-intuitive, the rapid rise in steel prices has actually worked to spur a modest amount of demand for new railcars. Specifically, our contact said that some owners have found that their older railcars are worth considerably more than book value in the scrap steel market. As a result, our contact said some owners are now selling their older railcars and ordering new railcars to replace them." Better dead than alive, I guess. I've heard scrap prices as high as $300 a ton. So why aren't they out there getting rid of all that sub-100-lb rail while they're at it?

Rick Paterson at UBS is without a doubt one of my favorite financial writers. He always finds the right turn of phrase and draws pithy references from a wide variety of sources. This week is no different as he offers some observations on Railroad Boards of Directors, triggered obviously by the recent TCI remarks before Congress.

Rick writes, "Yesterday's Congressional testimony by TCI reiterated the lack of railroad experience on CSX' Board of Directors. We wanted to see how this compared to the other Class Is, and -- news flash folks -- of the 78 Class I BOD members the number with direct railroad experience is exactly none. Zero. Zip. Nada. The exceptions of course are the current CEOs that also sit on the Boards. Drilling down, our favorites include a private-practice physician, the CEO of the Association for Supervision and Curriculum Development, and an Admiral. We also found 36 BOD members are CEOs of other companies; a few of which are also railroad customers (and likely outvoted when the BOD discusses rate increases). We've little doubt the railroad CEOs dictate and control the agenda for the Boards." Say amen, brother.

A note on the same hearings from BSC's Ed Wolfe opens up some on the TCI View. "Mr. Amin also rejected any suggestions that TCI would seek to reduce spending on maintenance or safety. Rather, he noted that TCI is only looking to freeze expansion capital during the current period of economic and regulatory uncertainty. Michael Ward again defended CSX's strong track record the past several years, including industry-leading improvements in safety and financial and stock performance. While we expect further scrutiny on TCI, when all is said and done, we do not expect any restrictions to U.S. rail investment from Congress following the hearings. We also do not expect any statute changes for the STB to regulate rail stock ownership by non-rail entities."

Still, even with the concern expressed in the TCI hearings about capital investment, the Oberstar re-regulation bill (oops – the "Railroad Competition and Service Improvement Act of 2007") has not gone away. The language looks awfully regulatory to my decidedly un-legal eye: "The [Surface Transportation] Board shall adopt a method for determining the reasonableness of rail rates…" (WIR 9/21/2007). But what the Act seems to dismiss is the relationship between total revenues and the ability to fund expansion capex out of operating cash flow.

Elsewhere, Wolfe sees weak results for the TL carriers at least through March. "We have reduced our Q1 estimates by an average of about 21% for the 6 TL providers under coverage based on our sense of continued weak y-o-y pricing, spiking fuel costs, weather and our expectation for a blah end of March into an early Easter holiday. We have not changed our estimates beyond Q1 and believe we are getting closer to an inflection point for tighter truckload capacity likely later in 2008. Demand is the least of the truckers' issues at this point; recent data show y-o-y improvement into easy comps."

Reinforcing that theme, seekingalpha.com's Don Dion posits "the transportation industry has some positive characteristics that could help continue its recent gains, now running 10 points ahead of the S&P 500 YTD. Economic activity in much of the world remains brisk and…rail companies generally were able to cope with the loss of business through rate increases even as trucking companies struggled.

"The transportation industry is often seen as the bellwether of the US economy so some analysts think strength in transports augurs a strengthening economy [that's called the Dow Theory, BTW]. The recovery may be sooner rather than later – if oil prices decline and if lower interest rates and the government's stimulus package succeed in re-igniting the economy." But the recovery may also be later rather than sooner, and the rails have to play defense. Go where the business is good and be less aggressive where the returns are weak.

Food and energy are necessary elements of a civilized life. So why do economists talk of "core inflation" as the cost of everything but these? Similarly, some observers of the railway scene prefer to track operating expenses ex-fuel because prices are so volatile. Ever try to run a railroad without fuel? You can't, ergo the cost of fuel is a cost of doing business. And like households that have to adjust spending patterns for iPods and flat-screen TVS, so must the rails decide what costs to cut to accommodate higher fuel prices.

It now appears that some economists – notably at Lehman and the Federal Reserve Bank of Cleveland – seek a definition of core inflation that includes food and energy. The Bank has come up with something it calls a “trimmed mean” that tries to account for the volatility of all consumer prices. For Jan, it was up 3%, more than the “core” rate.

So a month from now when first quarter earnings start coming in WIR will continue to look at total operating expenses including fuel. At the end of the day, operating income is still operating revenue less operating expenses. The winners will keep the percentage increase in ops expense below the percentage increase in revenue before fuel surcharges. Of course, nobody I know is holding their breath waiting for the revenue line to break out fuel surcharges from tariff- and contract-based revenue. But we’ll deal, as usual.

The Canadians are coming to the US for their Annual short line meetings the week of May 12, right on the heels of the ASLRRA Annual in San Antonio (May 4-6). The CN show will run Mon-Tues in Chicago, happily downtown and not a jillion-dollar cab ride from ORD. Details at www.cn.ca. Then you can catch the Builder up to Minneapolis for the CP show that opens Wed eve with a reception. There are also golfing and touring for those arriving earlier. The meeting concludes with a sumptuous breakfast Friday. Unless you’re on the Builder back to Chicago, in which case you will be treated to some of the best-running track in NA, according to a friend who was on that train just two weeks ago.

Week 9 YTD Revenue Units provide an intriguing contrast between Class Is and short lines. Class I numbers derived from the Credit Suisse report (the best of breed IMHO) show merch carloads (ex-coal, IM but including grain) off half a point. The short lines on the other hand are up 2.3% ytd based on the attached RMI report with coal and IM taken out of the totals shown.

Class I merchandise carload gains were in grain (+11.5%) and STCC 20s (+22.4%) with single-digit declines pretty much across all commodities save coal and chems, each up three and a crumb. The short lines shone in grain (+9.8%), STCC 20s (+9.2%), ores (+28.3%), petroleum/coke (9.9%) and metals (+10.4%).

What is telling is that the short lines increased merch revenue volume by more than 18,000 units while the Class I delta was down nearly 13,000 units. In other words, the short line gains in carload traffic offset Class I organic losses. It is safe to say that most short line cars move beyond the confines of the short lines’ rights-of-way and so are in the Class I totals. Looks to me like this proves that short lines are better at providing customer value in the first-mile-last-mile segment of the railroad business. And if this is so why aren’t we seeing more branch-line spin-offs rather than less?

RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 3/1/2008

Week Number: 9

Carloads Handled	Current Week			Year-To-Date		
	2008	2007	% Change	2008	2007	% Change
Coal	15,556	11,637	33.68%	129,575	124,705	3.91%
Grain	14,436	13,776	4.79%	131,303	119,590	9.79%
Farm & Food (Exc. Grain)	5,931	4,748	24.92%	46,945	42,994	9.19%
Ores	3,021	2,240	34.87%	26,973	21,023	28.30%
Stone, Clay, Aggregates	9,910	10,855	-8.71%	81,012	80,223	0.98%
Lumber & Forest products	5,245	6,339	-17.26%	42,376	53,975	-21.49%
Paper products	7,669	8,799	-12.84%	69,616	78,297	-11.09%
Waste & Scrap materials	6,334	5,918	7.03%	57,589	53,915	6.81%
Chemicals	17,295	17,262	0.19%	154,099	147,879	4.21%
Petroleum & Coke	5,764	5,109	12.82%	52,821	48,083	9.85%
Metals & Products	12,666	11,628	8.93%	107,185	97,075	10.41%
Motor vehicles & equip.	2,472	2,384	3.69%	16,857	18,163	-7.19%
Intermodal	14,830	15,572	-4.76%	127,740	132,317	-3.46%
All Other	3,156	3,115	1.32%	24,540	24,959	-1.68%
Total	**124,285**	**119,382**	**4.11%**	**1,068,631**	**1,043,198**	**2.44%**