THE RAILROAD WEEK IN REVIEW
JUNE 26, 2009

"US gasoline pump prices are up one dollar from their lows – the equivalent of $130 billion drag on discretionary spending." – David Rosenberg, Gluskin Sheff, June 9, 2009

Last week I made the rounds of a number of short lines and came away with some common themes for these challenging times. First, stay in touch with your Class I short line managers to keep the information flowing between short line and market manager. Some short lines seem to think going directly to the market manager is the better way, but this misses on two counts. One, the individual market manager has many fish to fry and, two, where your request falls in the queue can determine results. The short line managers are your advocates; keep them dialed in.

Second, two short lines I visited are down in car counts over 2008 but are better off than they were in 2007. Both attribute their success to replacing weak customers with strong ones. Both are seeing growth in their paper-related businesses because they are more related to heat-and-eat than to read and toss. One has a chip mill that feeds a paper mill that makes frozen food packaging; the other feeds a printing plant that churns out grocery store coupon pages.

Third, both have been able to tap state rail program rehab funds to create solid FRA Class 2 railroads thus saving themselves the aggravation of slow operations, long swell times, high consumables per carload and the high L&D bill that comes with bad track. The bottom line is that even if car counts never get back to 2007 levels these short lines have positioned themselves to remain profitable even at reduced car-counts.

Iowa Pacific Holdings' 135-mile Arizona Eastern Railway is betting on the recovery of commodity prices, particularly copper, and has won STB approval (subject to certain environmental mitigation measures) to build a twelve-mile, single-track line to serve the Phelps Dodge mines in Safford, Ariz., The new line would diverge from the existing AZER line east of Safford, Ariz., cross the Gila River on a new 500-foot bridge, pass the Safford airport industrial park site and end at a new Phelps Dodge Mining Company copper mine complex. The line extension will likely see a daily round trip of sulfuric acid tank cars in and copper cathodes out.

AZER's operations currently extend between Union Pacific's Sunset Route at Bowie and the end of the line at Miami, Ariz, serving the copper mining region of southeastern Arizona, the agricultural Gila River Valley and the east end of the Phoenix metroplex. Primary AZER commodities are copper concentrate, copper anode and cathode, and copper rod and other copper processing materials. AZER also handles minerals, chemicals, building supplies and lumber. AZER operates a transload center for lumber, building materials and other consumer commodities at Globe, AZ.

Genesee & Wyoming is retrenching somewhat as it begins the process of discontinuing operations on its Huron Central Railway in southern Ontario. GWR says in a press release that the downturn in the economy has caused the road's traffic to decline substantially over the last 12 months, to the point that the railroad is not economically viable to operate for the long term. HCRY handled some 16,000 carloads in all of 2008, down a third from my 2007 estimated car count. The line generated revenues of $7.4 million (a respectable $462 per carload) against operating expenses of $9.5 million for an operating loss of $2.1 million operating loss. The line is 173 miles long, operating between Sudbury and Sault Ste. Marie under a lease agreement with Canadian Pacific Railway since 1997.

A couple of years ago I visited that part of the world on a writing assignment for *TRAINS* and at that time HCRY was a metals and paper railroad of old, jointed and light rail. With that commodity base I could never figure out how they could generate enough operating cash flow to support any capex. As I have written before in WIR, one of GWR's strengths is its practice of evaluating a lines' customers' competitive advantage and sustainability in their own industries – see Lehigh Cement and the MMID acquisition, e.g. Thus the closure comes more as a relief than as a surprise, particularly in light of the continuing slide in paper and metals revenue units.

Meanwhile, GWR estimates second-quarter profitability at between 35 and 37 cents a share, down at least 18% from its earlier projection of 45 cents a share, due to a continuing decline in freight traffic on its 63 short line and regional railroad properties. GWR expects its operating ratio to be between 81% and 83% during the quarter; it had expected a ratio of 79% to 80%. And to round out a busy week GWR priced an offering of 4 million class A common shares at $24.50 each. The company expects net proceeds of $92.6 million from the sale and expects to use it to repay "all or substantially all of the amounts outstanding under its revolving credit facility" and for general corporate purposes.

It certainly looks like GWR is becoming a financial company along the lines of the CN model as it adds strong properties and sheds weak ones, reducing debt, and improving operating cash flow. As it happens, my advance copy of the August 2009 issue of *TRAINS* has a map showing how CN has grown in the past ten years, adding some 10,000 route-miles of railroad. Similarly GWR added 15 railroad names in 2008, bringing the total to 63 marks thanks to the Ohio Central, CAGY, GSWR and Rotterdam buys.

Morgan Stanley analysts William Greene and Adam Longson say freight rails could benefit from what they call "a large increase in North American auto production" during the third quarter. Citing the latest *Wards* North American auto production forecast, Greene and Longson "estimate that the likely increase in [railroad] auto volumes could add up to 2.0% and 1.0%-to-3.5% to our EPS [earnings per share] estimates for the railroads in 2009 and 2010, respectively."

"Among freight carriers, railroads are the laggards in the group, and we've been hesitant to build in a large volume rebound given economic headwinds. However, if the latest auto production forecasts are correct, we will need to bring forward our auto recovery and raise our auto volume forecast materially," Morgan Stanley said, adding, "While not a game changer for EPS, it could have a large impact on sentiment."

The note cites improved prospects for Norfolk Southern, due to its "large Ford exposure," and Union Pacific, through its "large auto franchise." Beyond specific companies, Morgan Stanley says, "While the auto production forecast may not be a significant catalyst by itself, we think analyzing auto carloads alone understates the significance. A number of commodities, namely steel and chemicals, have a large automotive component. Steel inventories are already low and our steel analyst expects U.S. production to increase in [the second half of 2009] on greater demand, particularly in the automotive sector."

However, an increase in vehicle production does not necessarily translate into more carloads of finished vehicles. The trend is toward more Accords and fewer F-150s as the transplants surpass the Big Three in vehicles produced for the first time ever, ergo more finished vehicles per auto rack. Also, the transplants do not appear to have the same widespread network of suppliers so carloads of finished parts will likely continue its southerly drift.

BNSF has a new intermodal savings calculator on their website that addresses four questions: How much can I save using BNSF intermodal vs truck, how much less carbon to I put into the air

using train vs truck, and how much time will my move take via intermodal vs highway? For the first, enter the data and get the answer in two days via e-mail. Not very helpful. On the other hand, the carbon foot print calculator and transit time estimators are enlightening and useful.

For example, I put in 1000 cars of plastics Houston to Spokane. The calculator using "BNSF default assumptions" returned the number of tons of carbon produced by both rail and truck with the latter producing 3.7 times as much carbon for a rail savings of 73 percent. An interesting factoid is the highway assumptions are 6.5 miles per gallon highway and 6.1 mpg city. As for transit time, I put in Stockton to Chicago and the tool returned cutoff times Mon-Sat and target transit time in hours for two types of service, the availability day and tine for each cutoff and the "goal hours."

I see this as a highly useful competitive tool for BNSF because it addresses the dual questions of how fast and how consistent and the environmental impact of having one's own truck, driver and trailer tooling across the countryside. Moreover, the transit time tool returns dray miles at origin and destination and the number of trailer and container schedules operating in the selected lane.

Now compare this with the carload transit time calculator. A car departing the yard in Amarillo Texas at 5 PM for Birmingham AL will need 174 hours to make the thousand-mile trip, an average of six miles an hour. Given the choice between the intermodal option and the single-carload option, it is easy to see why companies seeking lean supply chains and green suppliers will opt for intermodal over highway or even carload.

Ed Wolfe met recently with Kathryn McQuade, CFO at CP and Janet Weiss, head of CP investor relations and came away feeling that CP's recent stock price rally, up 69% since the market bottom on March 9, "is likely related to the strong rally in commodity prices (where it has high-end exposure), on top of some mean reversion following its underperformance during the market downturn... CP's earnings remain under material pressure from the massive 50%+ declines in its export coal and potash volumes—likely CP's two highest margin business segments—which have deteriorated further y/y in 2Q relative to 1Q... Finally, the status of CP's negotiations with Teck Coal (key contract expired at the end of March) adds further earnings uncertainty."

But since neither coal nor export potash have a big presence in the CP short line family, the small railroad impact ought to be minimal. Manitoba and Saskatchewan are the big grain-producing areas for CP and there are only four short lines in these two provinces combined. All are in the grain business.

However, with but 1000 route-miles of railroad among them and being light-density lines, their portion of CP's nearly 400,000 annual cars of grain is relatively small. CP's total grain volumes were off three percent through Week 20, less worse than any other commodity group but "food & kindred products" (-1.5 percent). Ergo these short lines will emerge relatively unscathed.

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe click on the Week in Review tab at www.rblanchard.com. A publication of the Blanchard Company, © 2009. Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned in WIR. Specifics available on e-mail request.