The Railroad Week in Review
October 16, 2009

“The third quarter reinforces our view that the worst of the recession is likely behind us.”
– Michael Ward, CSX

Out on the railroad again. Again. Since there’s been so much talk about coal being off and my wanting to know how it’s affecting short lines and regionals, I spent a couple of days driving around and riding Tom Hoback’s Indiana Rail Road, one of the leading non-Class I coal haulers around. I am happy to report that they are doing quite well, indeed, and coal is definitely king.

There are three things a railroad can do with coal: originate it, terminate it and overhead it. INRD does all three. As for loading, there are two choices: at the mine or at a transload and here again INRD does both. The railroad has five regularly scheduled load-empty coal train pairs across its two divisions (the ex-IC Indianapolis Division and the ex-MILW/CP Chicago Division) serving five coal-fired power generating stations, three coal mines – one over ten miles of trackage rights on CSX and two local to INRD -- and a transload.

I rode two trains powered by their new SD90s and even did a simulator ride over a piece of the line segment I did in the cab. Having just spent two days riding on SD70s with UP and CSX, it was a treat to be on these INRD units. To be sure, track speeds were more modest, and distances were relatively short, but a train is a train is a train and dynamic braking is a wonderful thing. On all three railroads is was a treat to see how much attention is given to fuel conservation – tons per axle, for example is not a foreign concept on INRD.

And when Tom’s team is not moving coal around the countryside, there are covered hoppers of plastics for food packaging and grain to make products to go in those packages. In sum, “heat and eat” is alive and well at INRD. Look for more on this theme in upcoming WIRs.

Elsewhere in the east, new business for short lines is booming. In Pennsylvania, the Reading & Northern just built a 1,800-foot industrial siding for Sealy Corporation’s new plant in Mountain Top, Pennsylvania. The anticipated funding from the Pennsylvania Rail Freight Assistance Program (RFAP) fell through so the railroad agreed to build it as long as Sealy guaranteed specific volumes over a specific time period. That’s heads up ball and surely adds value to the Sealy relationship.

The Marcellus Shale Natural Gas deposit will also benefit the R&N with new business in the form of piping and “frac” sand. The railroad has cleared enough space at its Pittston Yard to accommodate some 200 cars of transload traffic plus 22 acres of storage space for pipe and related material. Railroad President Wayne Michel writes that the third quarter was the best revenue-producer on record for their non-coal business, a healthy sign.

Nearby, the North Shore Railroad Group is enjoying further new business successes. Their Lycoming Valley Railroad has loaded its first unit train of export met-coal at its Newberry Yard transload facility, where Marketing Manager Todd Hunter says they expect to run several more before the year is out. Also in Williamsport, Bulk-Matic is moving to a newer, bigger facility. The move should be complete mid-October and will double the capacity of railcars on site, increasing from about 20 railcars to 40, due in part to the five-track bulk-intermodal facility under way at Newport Yard.

At Pleasant Gap, the Nittany & Bald Eagle has begun receiving cars of Penn DOT rock salt off the Rochester & Southern in upstate NY for delivery at Hawbaker's White Rock Quarry where the receiver has just installed a new 42-inch belt radial telescoping stacker that literally dwarfs a standard hopper car. But that's not all. Hawbaker is in the process of installing two 4.7 million gallon asphalt tanks for railroad transload here as well.

And in New England Pan Am Railways sees new food-related volumes for existing customers for sweeteners, oils and flour in addition to the new auto facility in the area surrounding the Ayer, Massachusetts intermodal ramp. To be sure, the Pan Am Southern joint venture with Norfolk Southern is mainly driven by intermodal, however higher track speeds and more frequent train service will add value to the existing carload offerings.

The common thread of all these moves from the plastics to food-grade goods to the frac sand to the coal, rock salt and asphalt is that these are heavy, bulk commodities that are essentially fungible: one lump of coal is indistinguishable from another, frac sand is frac sand and ditto for rock salt – I grant you the plastic resins may be chemically unique to Sealy, but they are admirably suited to rail as long as supply chain needs are met. We're not seeing a lot of STCC 33-35 manufactured goods on the rails, nor are we likely to. My thesis remains in place: the short lines that will survive are the ones that thrive on bulk commodities.

RailAmerica is a public company once again. Shares began trading on the New York Stock Exchange Tuesday October 13 with the ticker symbol RA. The Initial Public Offering was for 10,500,000 primary shares of common stock, as well as the offering of 11,500,000 secondary shares of common stock by RR Acquisition Holding LLC, an entity wholly-owned by certain private equity funds managed by an affiliate of Fortress Investment Group LLC.

The shares were priced at $15 making the IPO worth $330 million before expenses. According to Bloomberg.com, RA had sought something in the $16-$18 range in its September 29 filing with the SEC. Still, the company realized a net gain of $158 million through the sale, a sum that it will use to pay down debt and for "general corporate purposes."

Traders initially took RA down eight percent to $13.75 the first day. RA owner Fortress Investment group itself sold 11.5 million shares at the lower price. RA is not alone, however, in seeing shares drop quickly below the opening price. *Forbes on-line* notes that in the last month 14 companies have brought new listings to the major exchanges and of these six have fallen below their offering price.

I figure that RA generated $126 million in EBITDA for the full year 2008 based on the S-1 released in conjunction with this IPO. The $330 mm asked in the IPO represented a multiple of 2.6 times, not out of line in "normal" times, perhaps. But with bankers pulling back to covenants of one time EBITDA, getting 2.4 times in the IPO after the sell-off isn't doing too bad.

The AP note suggested that RA "prepared for the IPO by slashing expenses and may have overdone it" and, moreover, "investors can't expect any more surprises on the cost-cutting side." Maybe not. But that's not all bad, either. I've watched as John Giles and his team have taken a lot of operating fat out of the expense side and with the fat gone, new revenues can go straight to the bottom line.

The AP also cites RA's SEC filing in which it said it believes there will be more short lines coming to market "because of tighter credit markets and declining transportation volumes." Right again. However, the pace of short lines changing hands is bound to accelerate as the new safety regs from Hours of Service to PTC to bridge management take hold. I can see first-generation shortline owners who got their starts on the heels of the Staggers Act more than 20 years ago starting to think about hanging up their spikes.

My sense is the RA initial offering could not have come at a better time for adding mom-and-pop properties that can use the economies of scale from the larger organization and which are logical contiguous "tuck-in" railroads that can be comfortably run with little or no added assets or staffing. And, to the extent they are "heat and eat" railroads serving customers who have their own competitive advantage in their own industries, RailAmerica will be worth a lot more than 15 smackers a ticket in very short order, IMHO.

CSX was once again the leadoff batter for the railroad earnings season. Total revenue came in at $2.3 billion, about $100 million better than the 2Q09 number but still down 23 percent year-over-year Revenue units were off 15 percent and system RPU dropped nine percent. Every commodity group but food and consumer and ag products was off double-digits and every group dropped double-digits in year-over-year revenue. In fact, the only positive number on my quarterly commodity spreadsheet was domestic intermodal, up two percent.

Happily, operating expense came down 24 percent as GTMs dropped 15 percent and fuel-burn fell 18 percent, taking the operating ratio down 1.3 points to a respectable 73.9 from 75.2 a year ago. Operating expense ex-fuel (which I like because it shows how the company is doing at Railroading 101 without the vagaries of fuel prices) dropped 15 percent even as GTMs per gallon increased three percent to 892 (a number, coincidentally, that was close to what I saw on the SD90 console in Run 8 during my INRD ride, above). Clearly, the sharpened CSX operating practices I saw on my recent Railex cab ride from Buffalo to Albany (WIR 9/4/2009) are having the desired effect.

So what's down the pike for CSX? Third quarter results in terms of revenue, revenue units, revenue per unit, operating income, operating ratio, gross ton-miles and operating expense ex-fuel per GTM are much better than the second quarter and marginally better than the first quarter. The third quarter of 2008 was the peak performer among the trailing six quarters and there are those (including me) who doubt this performance will be repeated any time soon. In fact, on the call CSX said little about the forward prospects other than better days for chemicals, ag products and fertilizers on the revenue side and more cost take-outs.

Take-away for short lines? Concentrate on strong players in the bulk side of Heat and Eat where you can do large blocks of cars coming and going between a limited number of OD pairs. Minimize railroad events like class yards or train starts per move and get the customer to provide the cars. See CSX slide 30 for clues as to how to make fixed costs variable and make the shoes that fit part of your operating strategy. The non-Class Is mentioned above are good examples of how to make lemonade out of this lemon of an economy.

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