Attitude May Be Everything, But Better Cash Flow, Favorable Legislation Sure Don't Hurt

NO STOPPING THIS TRAIN

BY JIM GAUNTT

For the past couple of years, RTA has reported that the fundamental demand for ties was increasing. Yet, caution was urged due to the cyclical nature of this business and because there will come a time when the demand curve moves against suppliers.

With all the uncertainties confronted—election worries, war in Iraq, fears of additional terrorism—it did not seem right to be overly bullish even though all the indications pointed to a better-than-average marketplace for tie producers.

So, previous forecasts erred to the conservative side, with admonitions to suppliers to keep a close eye on inventory levels and watch for any sign that the end was near. Oh, what a difference a year makes.

We have watched rail traffic improve and cash flow increase. And, now, the Holy Grail for short lines and others roads has arrived packaged in legislation that will infuse more money into infrastructure. It looks like there is no stopping this train.

Is it time to throw caution to the wind? This article will offer ideas on the short-term outlook and make another intrepid annual forecast for tie demand.

CLASS 1s

Last September, RTA reported that a seasonal lull in tie purchases might come toward the end of 2004 and stretch into the first quarter of 2005. Production was forecast to slow to levels below 19 million ties, and total market purchases were prognosticated to ease to a level near 17.3-17.4 million ties.

With November 2004 data firmly in hand, it appeared that this forecast was a bit conservative. Production continued to crank along at a 19.3 million tie pace, and purchases looked to approach 18 million by year-end. No lull here.

And, inventories continued to creep upwards, suggesting that even more demand is around the corner. This would seem to be the case. Even though CSX has announced that its program could be 500,000 less in 2005 than in 2004, the overall 12-month looking forward black tie demand reported by Class 1s in November actually went up 100,000 ties.

A further look at RTA's econometric model indicates that tie demand will indeed increase for Class 1s by 100,000 ties in 2005 from 2004 levels and grow an additional 500,000 ties in 2006. Students of past annual forecast articles will remember that the RTA econometric model looks at select general economic trends and railroad traffic to predict market demand scenarios.

Thus, everything depends on the overall U.S. economy and how it fares in a rising interest rate environment, not to mention all the aforementioned concerns that can affect economic growth.

But, with only two weeks left in 2004 at the writing of this report, economy watchers, including stock and bond market analysts, are generally quite bullish for 2005. The most recent bump in the federal funds rate was seen as positive by both the stock and bond markets, and expectations of interest rates marching steadily higher in 2005 isn't perceived as a negative—yet.

Will tie suppliers see another robust year in Class 1 demand in 2005? The answer appears to be a resounding "yes." In fact, tie demand should equal or slightly exceed that of 2004 in this market segment. At around 15 to 15.2 million ties for U.S. and Canadian Class 1 roads combined, that's definitely robust.

2005 RTA FORECAST

	Millions (000,000 omitted)
US & Canadian Class 1	14.9 - 15.3
Short Lines & Other Markets	3.5 - 3.9
Total Projected Range	18.4 - 19.2
Forecast	18.9

SHORT LINES, REGIONALS & CONTRACTORS

Shout hallelujah—years of work in Washington have finally paid off. Tax credits for infrastructure investment and a rollback of the 4.3-cent fuel tax are now a reality. What it all means in terms of tie purchases is still a little uncertain. But one thing's for sure. Purchases by this segment are sure to increase over the next three years—maybe by a lot.

The market has seen how the improving financial health of Class 1s has translated into more tie purchases. Now it is time to learn how it works for short line and regional railroads.

This market segment typically purchases 2.5-3 million ties a year (including contractors). Now, with the new tax scenario, will it purchase 3.5 million? Four million? Even more?

At this writing, it isn't known what the stimulus will mean. The available tax credits amount to a possible $350 million per year for three years starting Jan. 1. This means, of course, that the money has to be spent to receive the credit and that there has to be sufficient tax liability in the first place for it to mean anything.

But, if one were to speculate that only 25 percent of that $350 million were spent and that 35 percent of that went to ties, then it's hard to avoid calculating an additional increase in demand of less than 1 million ties. If more than that is spent, then the demand will go up proportionately.

Guessing is no fun when it comes to important market predictions. RTA's econometric model predicts that 2.9 million ties will flow into this market segment in 2005 without accounting for any effect from the stimulus. Add in a little stimulus, and how do you not come up with 3.8 million ties from this market segment in 2005? That sounds about right, doesn't it?

THE REST OF THE PICTURE

Some tie suppliers believe that over the next few years there will be renewed emphasis on transits and other forms of government-funded light rail projects. As fuel prices and traffic congestion grow, it would seem to be logical for this to occur.

RTA research designed to help illustrate the most economical maintenance methodologies for wood ties in high-speed passenger rail situations will be completed this year. If the results of this work are implemented in a way that sees the expansion of more passenger rail lines, then demand for wood may also grow in this market segment.

Reports from Mexico also indicate increasing demand for ties, which is logical given the additional cross-border rail traffic that growing economies are generating.

Both of these markets are difficult to quantify—partly because of lack of data but also partly because some of the demand for ties in Mexico is satisfied locally by non-RTA member producers.

It is safe to assume, though, that these markets are not shrinking, so no negative impact can be dialed in to the overall forecast.

PULLING IT ALL TOGETHER

This year looks to be a superb year for tie suppliers. All cylinders are firing, and the outlook is bright. It is hard to imagine a scenario that would not see at least an 18.9 million tie demand projection for 2005—15.1 million for Class 1s and 3.8 million for short lines, regionals and contractors. And it could exceed 19 million. But what if this prediction is too optimistic?

Take out the 100,000-tie increase for Class 1s and predict the exact same purchases total as 2004. Pull out half the stimulus from the tax credit legislation and reduce the smaller market segment purchases to 3.4 million ties, and you still arrive at a total market demand of 18.4 million ties in 2005. Even this conservative estimate is 500,000 ties higher than the expected final year numbers for 2004. Clear the track, the train is coming through.

Are there no extra words of caution, no additional concerns? After all there has to be something in there for those chronic worriers. Why dwell on the negative? Everyone has had all the "what ifs" drilled into them during the past couple of years (aren't you glad the election is over?).

Suffice it to say that if the economy stays healthy, railroads will stay healthy. That means capital investment in track. It also means more phones ringing at the tie yards. Expect 2005 to be remembered as a vintage year. §

SALES TO INVENTORY RATIO

	Mo/Yr	Tie Production	Tie Inventory	Change In Inventory	Tie Purchases	Annual Purchases Rolling Total	Inventory To Sales Ratio
	Jan	1,151	14,263	363	788	15,186	0.94
	Feb	1,103	14,153	(110)	1,213	14,772	0.96
	Mar	1,059	13,750	(403)	1,462	14,494	0.95
	Apr	1,038	13,129	(621)	1,659	14,711	0.89
	May	1,191	13,002	(127)	1,318	15,001	0.87
2000	Jun	1,218	12,636	(366)	1,584	15,277	0.83
	Jul	1,036	12,143	(493)	1,529	15,608	0.78
	Aug	1,385	12,177	34	1,352	15,634	0.78
	Sep	1,280	12,740	564	716	15,268	0.83
	Oct	1,394	13,174	434	960	14,952	0.88
	Nov	1,239	13,473	299	940	14,714	0.92
	Dec	889	13,648	175	714	14,235	0.96
	Jan	1,128	13,811	163	965	14,412	0.96
	Feb	1,117	13,839	28	1,089	14,288	0.97
	Mar	1,274	13,719	(120)	1,394	14,220	0.96
	Apr	1,109	13,398	(321)	1,430	13,991	0.96
	May	1,363	13,009	(389)	1,752	14,425	0.90
2001	Jun	1,213	12,427	(582)	1,795	14,636	0.85
	Jul	1,267	12,315	(112)	1,379	14,486	0.85
	Aug	1,414	12,108	(207)	1,621	14,756	0.82
	Sep	1,147	12,114	6	1,141	15,180	0.80
	Oct	1,415	12,382	268	1,147	15,367	0.81
	Nov	1,226	12,764	382	844	15,271	0.84
	Dec	1,284	12,624	(140)	1,424	15,981	0.79
	Jan	1,446	13,057	433	1,013	16,029	0.81
	Feb	1,399	13,118	61	1,338	16,278	0.81
	Mar	1,312	12,760	(358)	1,670	16,554	0.77
	Apr	1,370	12,482	(278)	1,648	16,772	0.74
	May	1,359	11,996	(486)	1,845	16,865	0.71
2002	Jun	1,401	11,735	(261)	1,662	16,732	0.70
	Jul	1,533	11,751	16	1,517	16,870	0.70
	Aug	1,647	11,602	(149)	1,795	17,044	0.68
	Sep	1,611	12,006	404	1,208	17,111	0.70
	Oct	1,893	12,927	922	972	16,935	0.76
	Nov	1,370	13,174	246	1,123	17,215	0.77
	Dec	1,127	13,406	232	895	16,686	0.80
	Jan	1,288	13,782	376	912	16,585	0.83
	Feb	1,143	13,748	(34)	1,177	16,424	0.84
	Mar	1,255	13,544	(204)	1,459	16,213	0.84
	Apr	1,525	13,354	(190)	1,714	16,280	0.82
	May	1.439	13.148	(206)	1,645	16,080	0.82
2003	Jun	1,365	13,037	(111)	1,476	15,894	0.82
	Jul	1,577	13,136	98	1,479	15,856	0.83
	Aug	1,587	12,997	(139)	1,725	15,786	0.82
	Sep	1,651	13,020	23	1,628	16,207	0.80
	Oct	1,725	13,403	383	1,342	16,577	0.81
	Nov	1,378	13,658	255	1,124	16,577	0.82
	Dec	1,127	13,406	232	895	16,686	0.80
	Jan	1,615	14,023	596	1,019	17,301	0.81
	Feb	1,470	14,129	107	1,363	17,487	0.81
	Mar	1,927	14,140	12	1,916	17,943	0.79
	Apr	1,583	14,254	113	1,470	17,699	0.81
	May	1.497	14,284	30	1,467	17,521	0.82
2004	Jun	1,876	14,384	100	1,776	17,820	0.81
	Jul	1,532	14,343	(41)	1,573	17,914	0.80
	Aug	1,656	14,243	(100)	1,755	17,943	0.79
	Sep	1,789	14,342	99	1,691	18,006	0.80
	Oct	1,655	14,728	386	1,269	17,933	0.82
	Nov	1,373	14,865	136	1,236	18,046	0.82
	Dec						

NOTE: The information in this chart is calculated from reported production and inventory numbers by RTA members. This represents more than 95% of the U.S. and Canadian market for wood crossties.