

THE RAILROAD WEEK IN REVIEW

MAY 27, 2005

GWR will acquire substantially all the rail operations of Rail Management Corporation (RMC) for some \$243 mm in cash plus \$1.7 mm of debt. The acquisition is subject to customary closing conditions and the expiration of the 7-day notice period required by the STB for GWR to obtain authority to control the railroads owned by RMC. GWR expects to close the acquisition and commence operations on June 1, 2005.

RMC has 14 shortline operations covering some 928 route-miles and handles about 170,000 revenue units a year, half of which is paper and forest products. It's a beautiful fit with GWR's Rail Link sub, especially having bought three Georgia Pacific railroads in 2003. RMC's port operations in Galveston and Wilmington complement GWR's seven port operations on the Atlantic Southeast and Gulf Coasts. Rail Link will manage the lot under the able leadership of Billy Eason.

The press release says simply that GWR "expects the acquisition to be immediately accretive." And how. The stock closed Wed night at \$24 and the press release came out well before the market opened (I first learned of it on CNBC's Squawk Box). The stock gapped up \$2 at the open and closed at \$27.68, up 15% on the day. The Wednesday close enterprise value (market cap + debt) was \$777 mm; 24 hours later it stood at \$1,120 mm, up 44%. Moreover, the pre-acquisition debt-to-cap was 19%; after it was 51%, still within the RR "sweet spot."

But wait – there's more. The Bear Stearns report gave RMC revs as roughly \$65 mm based on a conversation with GWR management. To sanity-check this number I averaged the FY04 forest products RPU for CSX and NS (because RMC is primarily a southeast operation), assumed a nominal 25% shortline allowance payout and multiplied the result by half the 170,000 reported carload volume. Result: \$64 mm. To this I added the reported \$8 mm in depreciation for an EBITDA of \$32 mm. Thus GWR paid about eight times EBITDA and increased EV by 11 times in the bargain. Did somebody say accretive?

North American RailNet (NAR) and OmniTRAX have reached an agreement whereby an OmniTRAX affiliate will merge with NAR and acquire NAR's U.S.-based rail operations. The three U.S.-based short lines being acquired by OmniTRAX are the 297-miles Georgia & Florida RailNet based in Albany, GA, the 113-mile Illinois RailNet out of Ottumwa, IL, and the 560-mile Nebraska, Kansas & Colorado RailNet operating out of Grant NE. The addition of these three lines brings OmniTRAX shortline portfolio to 17 properties with more than 2,500 total route-miles, vaulting them to fourth place among holding companies in terms of total mileage operated.

A fourth property, the 364-mile Alberta RailNet (ARN), was sold to Savage Companies of Salt Lake City through its wholly owned subsidiary, Savage CANAC Corp. According to the shortline page at www.cn.ca ARN handles about 28,000 cars a year and the main commodities are grain, coal, sulfur, forest and industrial products. CN sold the property to RailNet in 1999.

This past week I had the privilege of sitting in on Watco's Lenders' Meeting in Lewiston, Idaho. One particularly noteworthy thread is the company's approach to productivity measurement. Whereas GAAP measure expenditures, the approach we saw here measures what CEO Rick Webb calls "consumables" – man-hours, gallons of fuel, revenue moves, and so on. That's Part I.

Part II is the Annual Operating Plan (AOP) that matches customer expectations up with the consumables required to support those expectations. What you get is a revenue move budget upon which Watco managers can predict man/hours per revenue move and gear that to the rate at which consumables are consumed.

The elegance of the scheme is it strips out non-operating, non-cash line items like depreciation. It tells one exactly what's expected in terms of cold, hard cash. Start with revenue moves, budget the man-hours (fuel, car days, etc) to support the moves and keep score daily, weekly, monthly and YTD. Only in this way can one see what's not working and take corrective action right away.

I particularly like this method for dealing with items like car hire. Railroad A may get five days car hire relief on everything, Railroad B may get three days on covered hoppers, and railroad C may not get any. As a result, car hire expense as a percentage of revenue will be more favorable for A than B or C. On the other hand, since asset turns are so key to managing capacity, car days per revenue move tells a predictive, non-cash story liked to specific customers rather than a historical cash line-item story that's hard to link to any specific customer requirement. Look for more on this theme both here and in the Shortline Toolbox at www.rblanchard.com.

The shortline allowance model is broken. There is a continuing tug-of-war between market managers who are under the gun to get revenues up and ops managers who are under the gun to get costs down. As long as shortlines are paid out of Class I revenue market managers will see shortlines in a negative light. But ops managers who see shortlines as the ones who can cut operating costs will be on the opposite side of the argument.

The solution is to pay shortlines out of ops expense while marketing gets credit for all the revenue. It's not a new idea. Here's what I wrote in WIR 3/19/2004:

[start] Contribution is what's left after paying all the operating costs directly related to the movement of freight. As a general rule crew, fuel and equipment (e.g. car hire, loco ownership and maintenance expense) make up 75% of the total per-car operating expense. Another way, one minus the operating ratio times revenue divided by carloads equals contribution per carload. A decrease in operating expense improves the operating ratio even if revenues remain flat (all dollars per car):

| | | | | | | | | | | |
|------|----|-------|----|-------|----|-------|----|-------|----|-------|
| Revs | \$ | 1,000 | \$ | 1,000 | \$ | 1,000 | \$ | 1,000 | \$ | 1,000 |
| Exp | \$ | 1,000 | \$ | 900 | \$ | 800 | \$ | 700 | \$ | 600 |
| OR | | 100% | | 90% | | 80% | | 70% | | 60% |

However, if revenue goes up and expense remains the same the effect on the OR is more dramatic. You can tell by inference what happens to the OR when revs go down on flat exp:

| | | | | | | | | | | |
|------|----|-------|----|-------|----|-------|----|-------|----|-------|
| Revs | \$ | 1,000 | \$ | 1,100 | \$ | 1,200 | \$ | 1,300 | \$ | 1,400 |
| Exp | \$ | 900 | \$ | 900 | \$ | 900 | \$ | 900 | \$ | 900 |
| OR | | 90% | | 82% | | 75% | | 69% | | 64% |

Now put a shortline in the picture and pay it 25% of the Class I revenue. The large railroad operating expense does not change because it costs as much to move a private car of plastics as it does a system

car of wood chips ex-car hire. And this, folks, is why Class I market managers are reluctant to do business with shortlines on low-rated commodities.

| | | | | | | | | | | |
|-------------|----|-------|----|-------|----|-------|----|-------|----|-------|
| Revs | \$ | 1,000 | \$ | 1,100 | \$ | 1,200 | \$ | 1,300 | \$ | 1,400 |
| SL Allow | \$ | 250 | \$ | 275 | \$ | 300 | \$ | 325 | \$ | 350 |
| Net to Host | \$ | 750 | \$ | 825 | \$ | 900 | \$ | 975 | \$ | 1,050 |
| Exp | \$ | 900 | \$ | 900 | \$ | 900 | \$ | 900 | \$ | 900 |
| OR | | 120% | | 109% | | 100% | | 92% | | 86% |

On the other hand, look what happens when the shortline gets a flat fee out of expenses as opposed to taking it off the top in revenue. Suddenly the low-rated commodity works.

| | | | | | | | | | | |
|-------------|----|-------|----|-------|----|-------|----|-------|----|-------|
| Revs | \$ | 1,000 | \$ | 1,100 | \$ | 1,200 | \$ | 1,300 | \$ | 1,400 |
| Exp | \$ | 600 | \$ | 600 | \$ | 600 | \$ | 600 | \$ | 600 |
| SL Allow | \$ | 200 | \$ | 200 | \$ | 200 | \$ | 200 | \$ | 200 |
| TTL Expense | \$ | 800 | \$ | 800 | \$ | 800 | \$ | 800 | \$ | 800 |
| OR | | 80% | | 73% | | 67% | | 62% | | 57% |

Of course, this only works when the shortline allowance is less than the Class I would have spent doing the work itself. In this case the shortline did the work for \$200 when it would have cost the Class I \$300. The concept proves its worth, for example, when consolidating shortline interchanges or bringing the shortline interchange into the serving yard. The point of all this is to increase Class I contribution per carload. [end]

Notes from the recent BNSF Seattle shortline meeting indicate they delved deeply into operating matters like on-time performance, merch carload velocity, terminal dwell and staffing. In each there are ample opportunities for shortlines to cut BNSF ops costs while protecting the present revenue stream and building new ones through increased asset use, hence more efficient operations, hence more value added, hence greater revenue opportunities.

Remember, it's a BNSF mantra to have every commodity group cover its cost of capital. Paying the shortline to do the same or more work for less than it costs BNSF without denigrating the top line will help. The mix of marketing and ops presentations in Seattle seem to indicate BNSF is positioned to take the lead. I can hardly wait.

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