

THE RAILROAD WEEK IN REVIEW

JULY 18, 2008

“CSX continues to demonstrate the secular strength of our business.” – Michael Ward, CEO

CSX led off the second quarter earnings season with a 17% yoy ops income gain on 15% more revenue and just 14% greater ops expense. This was quite an accomplishment in the face of a 72% leap in loco fuel expense. Revenue units dipped 3% and GTMs slid 2% but CSX cut fuel consumption by 5% and GTMs per gallon went up 3%. Clearly, when fuel is burning up a quarter of the entire operating budget something needs to be done. Cutting fuel burn per GTM is one way; the mech forces and T&E folks at CSX have done a fine job here.

Pushing revenue up faster than ops expense always levers a nice OR delta as well as an improved OR. Except when fuel eats you alive. As is, the OR improved a mere 47 BP to 75.3 yoy. Strip out fuel for its outsize impact on performance and see ops expense ex-fuel barely moved -3%. In other words, fuel added 11 percentage points to the yoy expense delta. Not surprising when you consider the average price per gallon jumped 81% to \$3.62 from two bucks and CSX went through 138 mm gallons of the stuff.

Revenue by commodity group saw double-digit gains in phos & ferts, metals, agriculture, intermodal and chems. Coal revs were up a whopping 29% even though revenue units grew but 2%, reflecting “robust” overseas demand even as domestic steam coal was off a tad. “Fuel recoveries” (CSX-ese for fuel surcharges) were cited for contributing to revenue increases in most commodity groups with RPU gains in double-digits in every group.

I don't recall ever seeing this across the board rate increase phenomenon. What this tells me is that the Tom Peters “perceived quality in the eyes of the customer” is hard at work on CSX. Moreover, the May 2008 “The State of the Freight” report from Wolfe Research says, “Shippers continue to note the improving service performance on CSX.” This was in response to a survey question asking shippers to rank each of the Class Is on the “perceived price-to-value” relationship.” On a scale of one (low) to seven (high) CSX earned a 4.3 vs. first-place BNSF at 5.0 followed by NS at 4.6.

We know how fickle shippers are. Grain transportation buyers will kill for a penny a bushel and the dirt guys want dirt-cheap rates. But equipment costs money and fuel surcharges will never fully recover from that nightmarish story. Which tells me CSX is doing a better job than its competitors on land and the waterways. As Michael Ward says, “It all begins with the customer.” Nice job.

The CSX Boardroom drama unfolded a bit more as the TCI forces seem to have captured four of the five board seats they were seeking. I say “seem” because CSX is challenging the vote count. Recall that last month US District Judge Lewis Kaplan ruled the funds had bent disclosure rules but declined to rule that the 6.4% of shares voted and challenged by CSX should be thrown out.

Ward's objection seems to me well founded. The TCI and the 3G Capital own 8.7% of CSX outstanding shares according to The Yahoo business page. It turned out they also controlled an additional 12.3% of shares through stock swaps, per the WSJ. It appears from Judge Kaplan's exhaustive treatise on swaps that the short side of the swap can pretty much tell the long side how to vote their shares when there is an investment banking relationship between the two.

In the Court Opinion, Judge Kaplan writes, “From the inception of its total return swaps (TRS) acquisitions in October 2006 until the end of October 2007, TCI carefully distributed its swaps

among eight counterparties so as to prevent any one of them from acquiring greater than 5 percent of CSX's shares and thus having to disclose its swap agreements with TCI. On October 30, 2007, however, TCI began unwinding its TRS with Credit Suisse, Goldman Sachs, J.P. Morgan, Merrill Lynch, Morgan Stanley, and UBS and replacing them with TRS with Deutsche Bank and Citigroup. Ultimately, it shifted exposure equal to approximately 9% of CSX from other counterparties into Deutsche Bank and Citigroup." (As of 3/31/2008, the top institutional holders of CSX shares were Deutsche Bank (9.0%), Citigroup (4.6%), TCI (4.4%) and 3G (4.3%) – the combined 8.7% for the last two cited above.)

It would only be right for CSX to prevail in its challenge. The whole idea is for shareholders to vote, not options holders. If I want to vote as a shareholder, I buy the shares. If I want just to capitalize on the ups or downs in share prices, I buy options. But I don't get to vote those shares. Another way, the shares one owns are one's ticket to the voting booth. No ticket, no vote.

Genesee & Wyoming Q2 carloads were essentially unchanged yoy. Of the more than 196,000 units moved, the only double-digit increases came in chems, minerals & stone and farm & food. The big decliners included haulage & other, the STCC 24 side of forest products and automotive. Same-store sales dropped by 6,300 units, which the recent CAGY and MMID acquisitions offset, adding 6,800 units. This is a little disturbing because, regardless of industry, it is not a good sign if a company's only recourse to growth is through acquisitions.

The top three commodities by volume for GWR are coal (including coke and iron ore), minerals & stone and pulp & paper, which together comprised 56% of total volume. First quarter RPU for these groups was \$368, \$291 and \$602 against a system average of \$463. So two out of three of the top volume commodities are low-margin producers. I can hardly wait for the details on the Aug 4 earnings call, but from this report I cannot be optimistic about the outlook for GWR.

RMI's RailConnect Index for YTD through Week 26 (attached) pretty much mirrors what GWR experienced in its Q2. Coal, ores and chems were up though aggregates were off a smidge. The farm STCCs (01 and 20) were strong while both forest products STCCs (24, 26) were down, with the 24 side down double-digits.

Unlike GWR, the commodity carload break for the 332 short lines reporting shows only 18% of loads coming from the groups that make up more than half GWR's traffic base. To be sure, we can't tell how the GWR base breaks between North America and Australia however loads are loads and margins are margins. It bodes well for the RMI short lines that they are essentially even YTD with less than one car in five in these low-rated groups.

On the Class I front, YTD through Week 26 total revenue units were off 1.1% with the double-digit digits coming from the usual suspects – forest products and automotive and to a lesser degree building materials. Given the slow-down in consumer-discretionary spending it's not hard to see why intermodal is off two points while the farm STCCs were up 9.5%.

Investors Business Daily (IBD) says that at the end of this year's first half, railroad stocks ranked No. 14 among the 197 industry groups it follows. "The rail boom that began five years ago shows no signs of derailing with most railroads racking up double-digit earnings growth," said IBD in a July 3 report. It quoted Norfolk Southern CEO Wick Moorman as characterizing the railroad story as "a tale of two economies." While shipments of consumer goods, motor vehicles, and construction materials continue to decline, demand for coal, corn, grain, and soybeans "keeps soaring," and "railroads haul much of it."

Moorman dated the beginning of the rail renaissance to passage of the Staggers Rail Act of 1980, which substantially deregulated the industry. “Even with the economy where it is today, we’re operating much closer to capacity than we did from 1980 to 2000,” said Moorman. “What’s more, the industry has pricing power, while the ailing trucking industry continues to reel from high fuel costs, labor shortages and highway congestion—all factors that play to railroad’s strengths,” IBD noted. “Analysts expect railroads to enjoy strong pricing power for the foreseeable future.” IBD cautioned, however, that “regulatory changes—especially the possibility of re-regulation—might take some of the steam out of railroads’ growth engine.”

So might a President Barack Obama. He has promised to “preserve the sanctity of the Railroad Retirement and Federal Employers Liability Act (FELA),” The UTU, which originally backed Senator Hillary Clinton (D-N.Y.) for the nomination, was quick to make its peace with Obama and earn the prized “personal letter,” which is dated July 5.

This unique adversarial relationship between company and employee is nearly 100 years old and is another arena in which the rails must catch up with the rest of the world to be competitive. Preserving FELA as we know it makes a lot of lawyers very rich and does not serve the employees particularly well, especially since working on the railroad is a lot safer than working in many other industries. FELA got its start before workers comp had been invented, just as RR Retirement pre-dates Social Security. But now that we have the later, it’s time to abolish the former.

Watco celebrates its 25 Anniversary this month. The company started out quite literally as a mom and pop operation with Kaye Lynne and Dick Webb running the eight-employee operation from the kitchen table. Fast forward to today and son Rick Webb is president, overseeing an enterprise of more than 2,000 employees in 23 states across four time zones, with revs approaching \$300 mm.

There are 17 railroad names, three car repair companies, a leasing services division, and a transloading and warehousing company, meaning that Watco is a fully integrated transportation company. As Rick likes to say, “Watco customers can call on us for everything from moving their freight to fixing broken doors *in situ* to transloading to non-rail served facilities. In other words, Watco services do not stop at the edge of the property.

I’ve had the pleasure of working with Rick and his team on a number of projects over the years and have identified their Unique Selling Proposition: The Annual Operating Plan that starts with the service the customer needs and works backwards to designing the service to meet the need. Watco managers measure everything in terms of “consumables” – what each revenue unit consumes in diesel fuel, car hire, man-hours and so on from interchange-on to interchange-off.

The Watco model is one that more short lines must emulate. You’ll find a write-up on the AOP process at www.rblanchard.com/resources/cosumables.htm that ought to trigger some ideas. And once again, asset management is key. Look at car-days per revenue move (another Watco consumables metric) for a real eye-opener. Metrics like these plus thinking beyond the railhead ought to keep Watco going another 25 years. Congratulations, all.

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RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 6/28/2008

Week Number: 26

Carloads Handled	Current Week			Year-To-Date		
	2008	2007	% Change	2008	2007	% Change
Coal	16,658	14,936	11.53%	383,221	367,005	4.42%
Grain	13,908	14,637	-4.98%	372,391	344,805	8.00%
Farm & Food (Exc. Grain)	5,317	4,936	7.72%	136,663	125,109	9.24%
Ores	3,057	3,141	-2.67%	79,832	68,199	17.06%
Stone, Clay, Aggregates	12,788	12,041	6.20%	280,467	282,557	-0.74%
Lumber & Forest products	5,713	6,707	-14.82%	129,226	162,800	-20.62%
Paper products	7,800	8,295	-5.97%	200,821	218,087	-7.92%
Waste & Scrap materials	7,010	6,680	4.94%	169,548	162,511	4.33%
Chemicals	17,005	16,512	2.99%	447,947	435,874	2.77%
Petroleum & Coke	6,443	5,467	17.85%	156,451	143,252	9.21%
Metals & Products	12,158	12,942	-6.06%	310,975	290,837	6.92%
Motor vehicles & equip.	2,384	1,915	24.49%	53,709	52,540	2.22%
Intermodal	12,691	17,014	-25.41%	334,894	384,687	-12.94%
All Other	3,135	3,369	-6.95%	78,759	81,200	-3.01%
Total	126,067	128,592	-1.96%	3,134,904	3,119,463	0.49%

