

THE RAILROAD WEEK IN REVIEW

FEBRUARY 12, 2010

“In 2009, we generated \$75 million of free cash flow, which was the second best performance in Company history. In the context of the recession, we think this is an important accomplishment.” – Jack Hellmann, President & CEO, Genesee & Wyoming, Inc.

The Genesee & Wyoming Earnings Call Monday morning was yet another example of what I call excellent transparency in results. Take the Cash Flow Statement. When I downloaded the financials before the call I noted the huge number -- \$345 million -- for 2008 acquisitions so I made a note to go back to the 10-K and see where it all went. Didn't have to.

It's right in the press release: “The 2008 period includes 1) \$212.6 million in net cash paid for the acquisition of the Ohio Central Railroad, 2) \$16.7 million in net cash paid for the acquisition of Georgia Southwestern Railroad, 3) \$89.9 million in net cash paid for the acquisition of CAGY Industries, 4) \$22.6 million in net cash paid for the acquisition of Rotterdam Rail Feeding BV and 5) \$3.7 million for final working capital adjustments related to the December 2007 acquisition of Maryland Midland.” Like the man says -- \$345 mm.

The 2009 story is more modest in acquisitions – a mere \$10 million and change essentially for cleaning up the crumbs left over from the 2008 acquisition banquet. But the free cash flow numbers are remarkably similar. GWR generated roughly \$125 million in cash from operations each year and averaged \$93 million a year across the two years on capex, offset by some \$25 million a year in grant proceeds (you spend the money first and then apply for the grant so there's always a lag).

Free cash flow – I use cash from operations less capex before acquisitions – was \$62 million for 2009 vs. \$56 million a year ago, even though net income for the year came in at \$61 million, \$12 million shy of 2008's take. That spread was roughly the capex spread between the two years, with 2008 being the greater of the two and leads to the \$6 million increase in free cash flow -- my definition again – with 2009 being the higher number.

Continuing to work backwards, operating income for the full year decreased 14 percent to \$99 million from \$116 million in 2008; for the fourth quarter, the year-over-year operating income shortfall was just under ten percent. Operating expense for the year came down eight percent for the year and five percent for the quarter against annual revenues down nine percent to \$555 million and quarterly revenue off six percent to \$140 million. The quarterly operating ratio, adjusted for asset sales and acquisition expense, remained at 80.9 for both periods.

Though total sales were down six percent in the quarter, non-freight sales (switching operations, small short lines, etc.) actually increased seven percent and grew to 41 percent of sales from 36 percent. This shift to non-freight from freight is likely to continue as GWR seeks further acquisitions in the “natural resource” area as opposed to classic purchases of short lines. I take it “natural resources” is shorthand for new mines or factories with their own railroads or needing railroad operations where GWR can do both. An announcement of one such arrangement is imminent.

Summing things up, I think Jason Seidl at Dahlman & Rose gets it about right: “While uncertainty as to when rail traffic might experience a significant turnaround may restrict GWR's growth opportunities, we believe that the company's effective cost controls coupled with volume stabilization enhance the short line's earnings potential.” Not bad for this business environment.

RailAmerica January 2010 carloads increased 4.6 percent to 67,444 units over January a year ago, excluding the discontinued Ottawa Valley operation. This is the third month in a row with little change from the preceding month, January being down 1.5 percent from December, which was less than a point above November.

Seven of 12 commodity groups scored were up, albeit slightly, however ag products and chemicals scored double-digit percentage gains from reasonable bases. Ag products got its boost from the delayed harvest in the Midwest and chemicals rose with general economic activity. Continued softness in construction still wears on the forest products and aggregates commodity groups while lower coal volumes in the Central Region took that number down six percent.

BNSF shareholders approved the complete sale of the company to Berkshire Hathaway by a margin of seven to three, comfortably above the two-thirds vote required to sanction the transaction. The fallout could get interesting. Tom Wadewitz at JP Morgan suspects “that a large portion of the [BNI] shareholders who may have wanted to buy other rails” are doing so and if that be the case there could be a nice bumps in other rail shares.

Meanwhile today’s *Wall Street Journal* says on Page One, “Berkshire Hathaway is going mainstream as it joins the Standard & Poor’s 500-stock index.” That’s putting it mildly. Think of all the mutual funds that track the S&P. They’re all going to have to pick up the Berkshire “B” shares as part of their holdings. And since institutional investors account for something like 85 percent of the shares traded daily, that’s a huge demand for a fixed supply of tickets. It may also behind the recent run-up of share price to \$76 and change from \$65.

It is my understanding after having checked with a number of individuals close to the transaction that BNSF will no longer provide quarterly financial reports. Instead, such results as Berkshire deems appropriate will go into the Berkshire 10-Qs where we do get details on subsidiaries from time to time. (See for example “Results from Operations” beginning on page 22 of the third quarter 2009 report.) The AAR will continue to include BNSF in its weekly carload commodity reports and the financials will go in the annual R-1 filed with the STB.

The AAR’s Feb 2010 Rail Time Indicators reports “seasonally-adjusted” U.S. rail carloads in January 2010 “were up 2.6% from December 2009 and were the second highest of any month in the past 11 months. Carloads excluding coal were up 5.8 percent in January 2010 from December 2009 and were at their highest level since October 2008.” A word on what “seasonally adjusted” really means is in order and the AAR obliges.

“Seasonally-adjusted data remove seasonal components that can mask underlying trends, including changes in the direction of the time series. Seasonal adjustment allows more meaningful comparisons of data for neighboring months. There’s no doubt that U.S. rail traffic overall and certain individual commodities are affected by seasonality issues — e.g., intermodal traffic tends to peak in the fall as stores stock up for holiday sales; coal mines undergo maintenance in the summer leading to a decline in rail coal car loadings; auto factories often retool in July to get ready to produce new models leading to a decline in rail auto car loadings that month; and so on.

“Even in the best of circumstances, seasonal adjustment produces estimates — sophisticated estimates, to be sure -- but still estimates. The seasonal-adjustment process for rail traffic involves more complications than most other economic time series” thanks to the very nature of traffic patterns and customers’ behavior that can cause traffic levels to fluctuate by the day of the week.

“Then there are the calendar effects. Daily data are not available, some months have four weeks of rail data and some have five; holidays may be in one month one year and a different month a different year; traffic levels vary depending on the day of the week, and more).” The fact remains, however, that you can’t eat seasonally-adjusted carloads. And the pundits are saying factors beyond the railroads’ control -- like small business hiring -- are limiting the upside potential for rail freight traffic in 2010.

Short lines in the Corn Belt might best serve themselves and their country elevator customers by getting and staying long of covered hoppers. Once again Dennis Gartman is on the case. In his Feb 9 Letter he writes, “There is talk of corn ‘going out of condition’ in the fields and in farmer storage, which leads to two interesting concerns. Firstly, if it is ‘going out of condition,’ then farmers shall have a very strong propensity to sell before it does so, putting downward pressure upon prices, even at discounts at their local grain elevators.

“Secondly, if it is indeed going out of condition, then the end result is a reduced crop size and higher prices later. All we know for certain is that today’s supply/demand reports will show that inventories of corn and soybeans have been reduced since the previous report by the USDA, but likely not sufficiently so to send prices higher... at least not for long.”

In other words, “out of condition” corn is worthless and getting rid of it becomes an expense. Second, if this season’s shortfall pushes up 2010 prices as demand outstrips supply, the same might well apply to availability of covered hoppers. Corn will gravitate to the roads that have the cars, and if that’s a BNSF shuttle terminal away from the branch line country elevator... well, cuz.

And while you’re getting long covered hoppers, please re-read Tony Kruglinski’s page in the November 2009 *Railway Age*: Car owners are starting to recover cars from storage and shortline shops are well-positioned to get those cars ready for service, avoiding possible embarrassment for the owner at a later date.

UBS’ ubiquitous Art Cashin writes on Tuesday Feb 9, “It is a widely accepted thesis among economists that the small business area is the source of most job growth. That’s why a Bloomberg story yesterday caught my eye. Here’s how it began: ‘Small businesses are becoming the Achilles heel of the U.S. recovery by limiting growth and job creation. Whereas companies with fewer than 500 employees helped lead the economy out of the four recessions since 1980, this time around they continue to cut capital spending and dismiss workers, eliminating 3,000 jobs in January.’

“Improvement in the unemployment rate, which fell to 9.7 percent in January from 10 percent in December, may stall later this year if these firms aren’t hiring, and growth likely won’t meet the median 2.7 percent annual rate forecast for 2010 by 67 economists in a January 14 Bloomberg News survey.” Closer to home for WIR readers, short lines I’ve queried in this regard say they’re not hiring either, at least not in T&E. There’s more overtime and some train-start consolidations yet it still presents a picture of being very hunkered down.

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