The Railroad Week in Review
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Watco Companies gets top billing this week. By way of review, Watco is a Pittsburg, Kansas based shortline holding, contract switching and railroad maintenance services company. They operate 2,300 route miles of track with eight shortline railroads in ten states; add the contract switching and Watco has operations in 23 states. A visit to the website, www.watcompanies.com is recommended. And be sure to click on the **NEWS** tab and see a sampling of ***The Dispatch***, one of the better shortline newsletters I've seen.

Watco's unique Annual Operating Plan and core values were featured in WIR for 3/26/2004. "The AOP starts with the customer and ends with the financial numbers. The process starts with customer meetings so we can get a better understanding of the customer's business and the service requirements. Then customer satisfaction standards and measures are established and from them we develop a service and operating plan." In other words, they start with what the customer wants and build a budget to provide the requisite service plan.

This week I got to see the AOP process in action. The occasion was Watco's semi-annual strategic review and lenders meetings, hosted this time by the Eastern Idaho Railroad in Twin Falls, Idaho. The theme was a financial and operational one, however through it all ran the "Foundation Principles: Improve Customer Satisfaction, Improve Profitability, and Maintain a Long-term Vision."

Putting the 2002-2003 yoy financials through my Benchmarks website one finds double-digit increases in revenue and net income with slight southerly drift in operating income. However, Watco is a private company as opposed to a Listed company and so expenses as much as it can. Some of their railroads received significant track upgrades and had those projects been capitalized the ops income would have been comfortably on the plus side.

Looking ahead, I'm comfortable saying there will be double-digit gains in revenue, EBITDA (a better measure than operating income in this low-capex environment), and ROA. The calculated ROE (margin*yield*leverage) is already well north of 10%. Throughout the presentations Watco's record of turning around under-performing properties convinced me they can continue to generate the cash flow to build on this strength.

There's a lot to learn here, and it's my intention to delve more deeply into what makes them tick in WIRs to come. For the nonce, let me quote a reader who wrote (WIR 4/2/2004): "This is not a railroad. This is a transportation company. Watco is doing everything possible to communicate *and* make it one-step simple to contact them. On any level. I know nothing about them but I would probably buy the stock were it public." I'll wager his sentiments are not changed by this.

The AAR reports that the FRA has released a preliminary report strongly indicating that the deployment of remote control locomotives (RCL) in and around rail yards is safer than the usual manned operation. For the period covering May 1, 2003 through Nov. 30, 2003, the RCL train accident rate was found to be 13.5% lower than the rate for conventional switching operations. Over the same period the employee injury rate was 57.1% lower.

Also this week the AAR said the Senate passed S. 1637, repealing the 4.3 cent per gallon fuel tax paid by railroads and barge companies. The legislation now moves to the House, where the

Committee on Ways and Means has already approved H.R. 2896, a separate bill that does not address the 4.3 cent tax in its present form. (So what else is new?) Another aspect of S. 1637 would accelerate the introduction of clean coal technology for electricity generation. Needless to say the National Mining Association (NMA) is delighted with the legislation's $2.2 billion in tax incentives. CSX and NS ought to benefit in particular with their hotter (but dirtier) eastern coal.

Carload freight for Week 19 (ending May 20), excluding intermodal, was up 5.0% yoy. Sharp yoy gains were reported in grain (23.4%), petroleum products (14.5%), chemicals (13.8%), and coal (5.9%). Among commodities registering declines were primary forest products (7.3%) and automotive (3.8%). In a shift of previous patterns TOFC led COFC gains, 13.7% to 6.0%.

As we've noted before, and quoting Vermont Rail's Eric Moffett, truckers prefer 53-foot trailers because their customers like the higher cube for their lighter-loading commodities. And if rails want to take trucks off the highways, what better place to start than with the trucks most prevalent on the highways? One has to wonder where the CP decision to walk away from TOFC fits.

To put this in shortline context I put the AAR gains against the Genesee & Wyoming 1Q04 gains. Table 1 compares GWR's commodity volume with the AAR figures. Granted, it's somewhat apples-to-oranges, however the shortline-class 1 comps help flag the lags and leads. Also, as I am reluctant to count intermodal units as carloads, I've omitted that category and it's less than 1% of GWR's unit volume anyway. Ditto most shortlines.

So focus on the carload biz. The right-most column shows the lag between the Class I carloads and the shortlines as represented by GWR. The Class Is are up 5% total and yet lag significantly in the commodity groups cited, confirming intermodal as their growth leader. More important, it confirms the carload business importance to shortlines.

All the Class I roads save BNSF make more than half their revenues from carload, and nearly half that touches a shortline someplace, arguing still further in favor of moving still more of the carload business to the shortlines for gathering and distribution. Once I get the Q1 carload data from RailAmerica I'll match them by STCC (breakouts courtesy of Treasurer Larry Bush) with the AAR numbers. I'm willing to bet it's more of the same. Any takers?

Turning to the supplier side, **Wabtec** Corporation (NYSE: WAB **-** News) reported diluted eps of 11 cents, net income of $4.8 mm and EBITDA of $16.8 mm for the 2004 first quarter. In the year-ago first quarter, the company had earnings per diluted share of 13 cents, net income of $5.7 mm and EBITDA of $17 mm. The company also affirmed its previous guidance for 2004 full-year earnings per diluted share of about 70 cents, a growth rate of 35 percent compared to 2003. Based on 1Q04 orders of about 18,000 units, WAB expects 2004 freight car deliveries to be about 41,000, up from the original estimate of 36,000.

Sales were 11% higher than the prior-year quarter. In the Freight Group, sales increased 9%, mainly due to higher sales of freight car components in North America and electronics components in the United Kingdom. Gross margin was 25.2%, off 150 BP yoy, due to higher steel prices, Canadian FX, and the ramp-up of low-margin rail door contracts in the Transit Group. Operating expenses were up 9% primarily due to higher medical and insurance costs.

Table 1. GWR First Quarter 04 Carload Growth vs. AAR Week 19

GWR Revenue Carloads (000)

	1Q04	1Q03	Pct. Chg.	AAR Pct Chg	Spread*
Paper	22,984	17,874	28.6%		
Lumber & FP	18,034	12,079	49.3%	-7.3%	-56.6%
Pet Prods	8,310	8,690	-4.4%	14.5%	18.9%
Mins & stone	12,665	12,636	0.2%		
Metals	17,838	15,217	17.2%		
Chemicals	7,468	5,675	31.6%	13.8%	-17.8%
Farm & Food	11,452	8,271	38.5%	23.4%	-15.1%
Automotive	4,197	3,757	11.7%	3.8%	-7.9%
Other	2,854	2,456	16.2%		
Total	105,802	86,655	22.1%		
Coal Coke & Ores	44,042	41,979	4.9%	5.9%	1.0%
Intermodal	1,364	1,296	5.2%		
Mdse CL Equiv	802	762			
Totl Revenue Units				5.0%	

*Spread in percentage pts, AAR vs. GWR

Source: GWR 1Q04 press release; AAR