THE RAILROAD WEEK IN REVIEW

SEPTEMBER 24, 2004

Rail stocks again shrugged off the broader market's woes on Friday with all but KCS and GATX posting gains. A CBS Market Watch columnist cited a combination of increasing traffic volumes and an easing of congestion. Also this week there were reports that system train speeds were improving, though weekly improvements ("the best since week 8" said one) have to be taken in context.

Railroads are batch-process networks with extended queues. Yard dwell times, system train speed and cars-on-line are all interlinked and a disruption in one place quickly cascades throughout the system. The broader picture is one of continuous improvement across the entire railroad landscape. One way to keep disruptions to a minimum is to keep cars moving. UP's Jack Koraleski told the KC Forum (WIR 9/17/2004) shippers could help that by releasing Friday unloads on Friday or working weekends. Ditto shortlines.

Cars made empty on Friday too often aren't reported empty till Monday because by the time the crew hands in its paperwork the office staff has marked off. Or private cars loaded or made empty on Friday don't make to the interchange until late Monday. As a result cars sit idle for three days while others stack up behind them. Not a happy thought.

GWR North American traffic in August 2004 increased 22% yoy to 55,114 revenue units; excluding the GP properties bought in Jan 04 it was up 12%. For 3Q04 through August loads were up 23% yoy. Australian Rail Group (ARG) August 2004 loadings were up 18% yoy to 84,499 units. For the quarter thus far ARG loads increased more than 22,000 units to 164,535, a yoy increase of 15.8%. Drilling down into the NA numbers, the biggest percentage gains were in coal, forest products (both STCC 24 and 26), and metals. These three account for two-thirds of the NA traffic base and half of that is coal.

CFO Jack Hellmann's remarks at the Morgan Keegan Equity Conference were particularly instructive with regard to acquisition strategies and economics. Jack said right out of the box that GWR uses a "risk adjusted IRR" and any acquisition has to generate a positive EVA in the first three months. The South Buffalo transaction (see www.gwrr.com for conference replay, slide 9) goes right to the point.

Going in EBITDA was $5.6 mm and they paid 6.8 times that ($38.1 mm). Just 45 days into ownership GWR created synergies with its existing B&P operation that effectively increased EBITDA to $8.1 mm, reducing the effective purchase multiple to 4.7 ($38.1 mm over 8.1 mm). Putting that in perspective, GWR's corporate EBITDA for the 12-month period ending 6/30/04 was $113 mm. Enterprise Value (market cap plus debt, including half ARG's debt) was $957 mm, a healthy 8.5 times EBITDA. Nice.

Event reporting for shortlines and the effort to eliminate "Black holes" (WIR 9/17/2004) is getting some much-needed attention. The ASLRRA's Network Efficiency Management Committee (NEMC) recently found improvement across the board yet there are still 136 short lines (roughly 20% of the community) that fail to report car movements within the requisite 12-hours of the event itself. Of these, 85 interchange exclusively with only one Class 1 railroad.

Now before we collectively leap on these four score and five to get their acts together, let it be remembered there are two parties to every transaction. If one side isn't living up to an understanding, it's incumbent on the other to take steps to remedy. And so it is with ISAs and event reporting. In my experience it is often the Class I that fails its shortline partner. Let me say it once again: we hear all the promises and platitudes from senior management at shortline meetings yet the failures occur in the field. Troops only respect what the leadership inspects. C'mon guys, get out there and LOOK!

For their part, the shortlines are taking a leadership position. Morristown & Erie's Steve Friedland chairs the Remote Computing Working Group of the ASLRRA's Tech Committee and he writes, "Reference the black hole problem, we met in Morristown last week to discuss the possibilities, hardware, and needs of the shortlines. The highlight of the meeting was a focus group of ten shortline members and vendor reps on the challenges and opportunities for improvement in event reporting. Very, very successful. Look for much more on this in the near future." Ok, Steve, we will. Thanks for the update.

Railinc's recently-released "Control" is the third and latest module to be added to their RailSync software suite. Specifically designed to meet Class II and III railroad car hire and event-reporting needs, this Internet-based suite includes car reporting, interline data exchange, interline revenue settlement and now -- car accounting. And since it is internet-based there is no software package resident on the shortline computer. All one needs is a web browser and so the tool can be accessed from any computer anywhere.

The other two elements of the RailSync Suite are "Command" and "Concur." The former is a Transportation Management System (TMS) that simplifies the accurate and timely reporting of car movement events. The latter enables full Interline Settlement System (ISS) participation and control of interline revenue settlement and receivables while allowing for the efficient and accurate management of freight revenue. Check it out at www.railinc.com.

Fellow pundit Larry Kaufman has a few things to say about the "sinister shift of manufacturing jobs." (WIR 9/17/2004). He writes, "With regard to your labor comments, you are, of course correct, but before considering it 'sinister' I would add the following comments. First, welcome to globalization. I do not believe many jobs have gone elsewhere simply because of the difference between organized labor contracts and non-union labor costs. Most manufacturers go overseas either to be near growing markets, or to gain incredibly lower labor costs (pennies per hour vs. dollars per hour) that no American workers, union or non-union, would accept.

"I also think your assessment comparing AFSCME gains to the losses of Reading, CNJ, LV and others is a bit superficial. They were done in only in part because of labor costs. Don't forget the regulatory scheme at the time that required operation of lines that clearly had lost their business and therefore any reason to exist, required them to operate passenger and commuter service without requiring that the government bodies demanding it pay for it."

Larry also was good enough to give us some history behind John Lanigan's comment (WIR 9/17/2004) about each line of business at BNSF being required to earn its cost of capital: "I'm reminded that the same concept was enunciated by Dick Bressler at the old BN in 1980, only at that time each line of business referred to railroad, mineral mining, timber, real estate, oil and gas. Same concept quarter of a century later, still just as sound a business model, only BNSF no longer has the non-rail businesses and applies the concept to individual lines of business within the railroad. Sound then, sound today. Ain't institutional memory grand?" Yep.

Earlier this month (9/3/2004) I posited that RRA's Australian venture looked like "a pretty good deal." Now I can say exactly how good a deal: a CAGR of 16.2%. RRA's initial equity investment in 4/99 was $44mm. There were positive operating cash flows through 2002 but after capex (and before taxes) they gave that all back and more – see Net Cash Flow in the Table below. They probably made a fair amount of money in 2004, earning perhaps $9.4 mm before the sale.

RRA Australia Investment - Rate of Return

Start April 1999, end August 2004	4/99	12/99	12/00	12/01	12/02	12/03	8/31/2004
Investment	103,000						
Less: Debt	58,800						
Equity Investment	**(44,200)**						**124,000**
Cash Flow from Operations		9,254	18,055	14,963	11,353	1,317	14,771
Capital Expenditures		11,557	18,345	20,214	17,094	15,028	5,333
Free Cash Flow - Before Taxes		(2,303)	(290)	(5,251)	(5,741)	(13,711)	9,437
Net Cash Flow	**(44,200)**	**(2,303)**	**(290)**	**(5,251)**	**(5,741)**	**(13,711)**	**133,437**
PV - Net Cash Flow	(44,200)	(2,058)	(223)	(3,475)	(3,269)	(6,720)	59,944

Implied Equity Rate of Return	**16.20%**	**CAGR**

Last month Australia generated gross sale proceeds of $204mm. After taxes and transaction expenses of $20mm and repaying Aussie debt of $60mm, RRA is bringing back home net sale proceeds of $124mm. These cash flows are shown in the table and yield an exceedingly respectable 16.2% internal rate of return on invested equity. Still "a pretty good deal."

Note to subscribers: Week in Review is expanding coverage of shortline financial performance. The acquisition pace is getting lively. The Top Twenty shortline operators will be on the prowl for accretive acquisitions and investors to back them. Look for more WIR score-keeping as above.

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