THE RAILROAD WEEK IN REVIEW
FEBRUARY 18, 2005

The Railroad Earnings Season concluded with encouraging results from FEC, GWR and RRA. Each expects the momentum to continue into 2005. As in the past the WIR zeroes in on present operating results before non-operating items (asset sales, special credits, etc.) as the best indications of what's really happening out on the line. We applaud the carriers that can grow revenue faster than expense as that's the fastest road to improved operating income.

We see some shortlines sharing in fuel surcharges and revenue increases, however the actual hard cash will vary significantly between and among commodity lanes. Moreover, even as the Class Is win higher prices, shortline allowances are not likely to increase as fast given their higher proportion of lower-rated commodities in less lucrative lanes.

Florida East Coast Railroad reported record Q4 revenues of $56 mm, up 19% yoy, driven by hurricane rebuilding efforts and a strong economy that could support more aggressive pricing. FEC reported Q4 operating expense of $40 mm, up 16%, and an OR of 71.9 vs. 73.9 in 4Q03. However, there was a governmental $1 mm reimbursement for hurricane-related expenses that once removed adds back a $million to the expense line for an adjusted OR of 73.7, still an OR that most roads would kill for.

Revenues for the full year rose 9% to $201 mm while expenses were held to a 6% increase and that spread generated a 10% gain in operating income and an adjusted OR excluding the government grant of 76.4 vs. 76.3 for 2003. Fuel surcharges added $1.5 mm to the top line, up from $600K in 2003. FEC does not provide the usual commodity carload breakouts at this time, so we'll have to wait for the 10-K in early March. However, the press release noted that carload revenues were up 14% and IM was up 26% yoy, marking the sixth consecutive quarter of IM gains. Given the congestion on Florida's I-95, that's good news.

Elsewhere, CEO Bob Anestis steps down March 28, 2005. His successor is Adolfo Henriques, presently CEO of Regions Bank (South), who has long-standing ties in South Florida where FECI has significant rail operations, commercial real estate, and raw land. Mr. Henriques has served on the FECI Board of Directors since 1998 and as Chairman of the Audit Committee for four years. I first met Bob Anestis shortly after his arrival at FECI and it's been a fun ride as he has transformed the company into a modern transportation and real estate company. We wish Bob well.

Genesee & Wyoming North American revenue in Q4 was up 30% yoy or nearly $20 mm to $80 mm. Credit $9.6 mm same-railroad growth, $6.6 mm from the GP line, $1.9 mm from the Tazewell & Peoria (ex-PPU) buy, and half a $mill form the Savannah Wharf. Half of this goes to the RaiLink switching sub while the freight railroads rang up a 30% gain in merch carloads ex-coal, coke, ores and IM, essentially all same-store. Forest products (paper, lumber), metals, chems, farm & food saw double-digit revenue gains and nominal RPU increases. The same pattern held for the year as well.

Operating expense increases were held to 29% in the Q, boosting ops income 40% to $12 mm and taking the OR down a point yoy to 85.5. For the year, revenues increased 24% to $304 mm and expenses increased just 22% leveraging a 38% gain in ops income and taking the OR down to a respectable 83.5, a 166 BP improvement.

Below the line, quarterly operating income from Australia and South America (combined $3.7 mm) was enough to offset the provision for income taxes however higher interest expense pushed diluted eps down to 26 cents from 28 cents a year ago. For the year diluted eps came in at $1.35, up 31% yoy aided significantly by the 37% gain in equity earnings from Australia.

Looking ahead, Tom Wadewitz of Bear Stearns writes, “We believe GWR’s growth prospects remain solid in 2005 given strength in the industrial economy and a potential acquisition catalyst from planned branch sales at BNSF and CSX. Although we don’t see a near-term catalyst we feel that the reward-to-risk profile for GWR stock on a long-term basis is attractive.”

RailAmerica’s Q4 and Full Year railroad revenues both rose 12% yoy to $104 mm and $396 mm respectively. Operating expense rose 24% and 22% in the quarter and year respectively due mainly to fuel price increases (65% yoy in the quarter to $1.62 a gallon) and a 70% yoy jump in casualty expense. Absent charges and credits for asset impairment and sales, yoy ops income went south 41% and 28% for the Q and year respectively. Operating ratios deteriorated to 90.1 and 87.1 from 81.1 and 79.9 for the Q and year based purely on ops expense before adjustments.

Though we don’t have specific carload-commodity-RPU data (RRA holds them for the Qs and Ks) we’re told (presentation slide 11) revenue units for Q4 increased by double digits in food and petroleum products offset by similar declines in ag & farm and metals. Total carloads were up 6% yoy though same-store sales were off a point yoy. This, while disappointing, is not totally unexpected due the relatively light traffic densities (under 100 loads per mile per year) on several properties.

Below the line, Q4 net income was 11 cents vs. a nickel in ’03 including discontinued operations. The company reported a full-year loss of 74 cents a share including several very large one-time items; absent them income from continuing operations would be a healthy 57 cents, clearly, IMHO, a better picture of what RRA can do, and a more reasonable figure given last year’s 46-cent net.

During the conference call CEO Charlie Swinburn started off his remarks noting that even though total accidents were down yoy the FRA reportables went up – fewer accidents but the ones they had were more expensive. RRA’s reportable accident rate was 3.0 for the year vs. 2.5 in 2003, still half the shortline average, but higher than the Class Is. That said, RRA has undertaken a comprehensive program to reduce the rate (MOW 101 for all MOW employees being held this week, e.g.). See slides 5-7 for specifics.

Swinburn closed the call saying 2004 was “a transforming year” for RRA. They shed the last of the off-shore lines, pushed the debt-equity ratio south of 50%, shed some marginal lines (I can think of a few more that would not be missed), spent roughly $6,000 a mile on track, and instituted a very aggressive safety program. Looking ahead, RRA expects to pick up another 10% in revenue and get the OR into the mid-80s.

The analysts following RRA were generally encouraging. Jon Langenfeld of R. W. Baird writes, “We remain encouraged by the increased focus on N.A. operations, an improved balance sheet following divestitures, and good pricing momentum moving into 2005. The elevated cost structure plus modest organic volume growth within the existing rail lines present the primary challenges, in our view.”

To which Jason Seidl of Avondale Partners adds, “Indeed, the company remains poised for strong EPS growth in 2005 as it should benefit from an improved top line, diesel fuel hedges, and expanded safety initiatives. The company also should benefit from the track rehabilitation tax credit and a lower interest expense attributed to a significantly improved balance sheet. We estimate that the company will generate $18 million in free cash during the year—which likely could be used to pay down senior subordinated debt and help fund potential acquisitions.”

CSX held its annual shortline meeting in Jacksonville this week. CSX, like BNSF and UP, brought out its CEO, COO, and Chief Commercial Officer – Ward, Ingram, Gooden – but unlike its peers also brought out CFO Oscar Munoz. His was the best non-financial financial presentation I’ve ever heard, with an emphasis on “show me the need.” You need a $billion for new track? Show me. A hundred new boxcars? Show me. It gave a perspective much needed but otherwise lacking at most of these gatherings.

Shortlines handled 14% more carloads for CSX in 2004 than they did in 2003. Putting that in perspective, CSX revenue units increased 3.4% to 7.5 million all-in. CSX merch carloads, where 99% of the shortline business lies, were up 2.4% to 3.6 mm units. Here's where it gets interesting. CSX says shortlines touch 20% of the merch loads – call it 700,000 units of CSX' 3.5 mm merch loads in 2003. A 14% increase on that base is about 97,000 cars. Yet the CSX yoy merch carload change was only 82,000 units. Which raises the interesting question of whether shortline gains are masking CSX organic losses or the gains to the shortline side stem from line sales.

Overall it was an excellent program, chock full of good ideas to take home and enhance the CSX-shortline partnership. Two themes stood out: pricing and operations. The move to market-based pricing has not been communicated well. Selling freight service is no longer a question of low rates; it's a function of low total cost from a supply chain perspective. CSX has taken the lead in assuring shortlines they'll be kept in the loop and advised of upcoming increases before their customers are.

Alan Blumenthal, SVP-Service Design, zeroed in on "fixing the last mile" by showing where shortlines and their customers can increase capacity by taking out work – number of handlings en route, multiple blocks and intermediate yards, multiple train-starts, etc. A good first step is moving the shortline interchange into the serving yard. Phase 2 of the One Plan – local operations – is set to roll out in 2Q05. Shortlines already thinking about how to pull "fewer pins per cut" will be ahead of the curve.

Finally, car supply – something that bears both on pricing and ops. I'm concerned because there was a lot of chatter in the halls about car shortages, yet Jim Snyder, AVP-Car Management, says shipper dwell and intermediate yard time are the biggest impedances to improved car cycle time. Making too few turns a year creates "deficit traffic" that doesn't earn its replacement cost. Pushing up rates helps, maybe, up to the point the shipper opts for a truck. But cutting customer dwell is a great place to start. The Canadian National "Guaranteed Car Order" gets is right as does BNSF's LOGS program.

Factoid: Rails take trucks off the highways? Maybe not that much. Every intermodal shipment begins and ends as a truck on local streets, as does every rail move touching a transload. Grain does not magically appear in elevators and sawmills are often at a distance from the rail-heads. Maybe the better phrase is trucks off the Interstate highways. One study estimates as much as 65% of rail carload business involves a truck someplace before or after the train ride.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via-mail 50 weeks a year. Individual subscriptions and shortlines with less than $12 mm annual revenues $125. Corporate subscriptions $500 per year. The Quarterly Review, a statistical analysis of the ten largest publicly traded railroad operating companies is $50 per copy to subscribers, $100 per copy to non-subscribers. Both are publications of the Blanchard Company, © 2004. Subscriptions are available at www.rblanchard.com/week_in_review/index.html or by writing rblanchard@rblanchard.com .