THE RAILROAD WEEK IN REVIEW
AUGUST 5, 2005

Genesee & Wyoming's North American operating income for 2Q05 grew by 19% yoy to $16.1 mm from $13.5 mm as operating expenses grew 27% against the 25% revenue gain. Every single expense category from compensation to materials increased by double-digits. These were not small DDs, either: rents 28%, purchased services 35%, casualty and insurance 49% and of course fuel 57%. The operating ratio added a point in the bargain, 82.7 this year vs. 81.7 a year ago.

Most discouraging. They did everything right on the commercial side with heady double-digit increases in every commodity group save intermodal, which, at half a $million in sales pales before the whole $92.7 mm revenue package, of which nearly a third comes from Billy Eason's Rail Link switching and terminals group. There are some big swings, too. They can't be a function of the recent RMC acquisition because that went mostly into the Rail Link Group, so it's mix elsewhere. For example, chemicals revenue increased 28% on 138% more units, taking the RPU down 46%. Farm & Food revenue was up 25% on a 60% volume increase, taking RPU down 22%.

Both categories look very much like they've got more short-haul business in them We know from past experience that GWR likes to find short-haul moves on or between its own lines, and as its stable of shortlines and S&Ts grows so will the opportunity to do just that. Of course, there's a risk that the Class Is connecting the dots for GWR will see itself in competition with GWR. I remember one Class I marketing manager who most emphatically did not cotton to the idea of being a virtual railroad overheading FAK business between shortlines.

Carload commodity groups average $421 a car on GWR. Five of the nine groups average less than that, representing 59% of volume and 51% of sales. As it happens, I was looking at revenue/cost ratios by commodity group for a couple of Class Is this week and it seems these low-end GWR commodity groups match the Class I low-end groups in terms of per-car revenue as a multiple of per-car operating expense.

A continuing theme at Class I shortline meetings is the need to increase the revenue/cost ratio of the shortline business. And since so many shortlines get a flat per-car handling fee out of the Class I's revenue, it makes sense to keep that fee as a low percent of the Class I's RPU. Having 60% of the portfolio at the low end of the Class I commodity chain does just the opposite. Where margins are already thin – say south of a 1.5 multiple – asking the commodity manager to give up another 15% of his RPU to a shortline will not make him a happy camper.

Below the line, equity earnings from ARG were off a third to US$2.3 from US$3.5 mm yoy. Collateral expense rose against a 2% dip in revenue as the Australian dollar strengthened nearly 7%. Net income for the corporation increased 6% to $11.4 mm and diluted eps rose 5%. The stock (NYSE:GWR) initially lost $1 to $29 after the call on Tuesday but the very next day gapped back up to $32, possibly on the Bear Stearns upgrade, only to fall back to $30, ending the week unchanged.

Florida East Coast Railway (FECR) did its own hat-trick posting 18% more revenue on 11% more volume while holding ops expense increase to 15% propelling a neat 26% operating income gain. The biggest single commodity continues to be crushed stone for the construction trade at a consistent yoy 55% of revenues and just under 70% of volume. However, this is unlike any aggregates traffic you've ever seen – fast, scheduled point-to-point unit trains with rapid loading and rapid discharge to maximize equipment turns. If you run it like this, $500 a car is good money – FEC averages about $550 a platform for intermodal, not to put too fine a point on it.

Intermodal revenues increased 17% or $3.5 mm (pricing $1.4 mm, volume $2.1 mm) for the 8th consecutive quarter-over-quarter growth due largely to FEC's local intermodal product plus a very healthy international trade. Drayage revenues increased as did outside contractor delivery costs for driver services. (If FEC can expense paying a drayer to deliver a box for FEC, why can't a Class I expense paying a shortline to do the same thing? See WIR 6/17/2005.)

Compensation is the largest expense line item at $14 mm, up just 4% yoy due mainly to general wage increases and stock compensation cost and bonuses. Fuel was up 60% or $2.2 mm though the fuel surcharge program recovered about $1.6 mm of that. According to the 10-Q, as of 6/30/2005 FECR had hedged 5.4 mm gallons for delivery 7/1/2005 through 6/30/2006. This represents 48.3% of estimated consumption through 12/31/2005 for an average pre-tax price of $1.433 a gallon. FEC is 23.87% hedged for the next six months at $1.522 a gallon.

Looking ahead to the full year, FEC estimates revenues to range between $222 and $230 mm, an increase of 11% to 15% over 2004, with operating income between $56 and $58 million, an increase of 18% to 23% over 2004. This implies an operating ratio as low as 74.8 at the extremes, respectable in anybody's book.

Kansas City Southern Railroad (KCSR) revenues for 2Q05 rose 16.8% to $178.6 mm, the ninth consecutive quarter of substantial quarter-over-quarter top-line growth, on a 4.5% revenue unit increase. Every commodity group but auto and coal posted a double-digit RPU increase. The press release gave no data on mix, though carload represents 70% of total revenue, coal 15% and intermodal 9%, the balance being "other."

Operating expense for KCSR was up 18% and as a result operating income increased by 8%. Fuel was the biggest culprit with the largest dollar gain yoy, up $11 mm or 75%. Here again, KCS lags its peers in reporting as there is no consumption data, no information on cost per gallon, nor on GTMs. I'm concerned because on the face of it KCS spent nearly twice as much on fuel as it did in 2Q04 yet moved only 5% more revenue units.

Excluding intermodal (88,600 units is only about 49,200 carload equivalents), the paper and forest products group is the largest in terms of both revenue units and revenue, generating $50.5 mm in sales on 53.2 mm units. In contrast, all those intermodal units generated but $17 mm in sales, averaging $202 per unit to forest product's $950.

This quarter for the first time KCS consolidated financial results for Grupo Transportacion Ferroviaria Mexicana (GTFM) under KCS as of April 1, 2005. GTFM is the holding company for TFM, the railroad operating company in Mexico. Thus KCS consolidated 2Q05 revenues increased 12.5% to $381.1 million over the pro forma second quarter 2004 combined revenues of $338.8 million, principally from its three rail operating companies: KCSR, Tex-Mex and TFM.

On a non-pro forma basis revenues increased 148% from $154 mm in 2Q04. The effect on yoy earnings was significant. Total operating expense for the combined railroads increased 188%, producing a net operating loss of $5.3 mm vs. 2Q04's positive $19.5 mm. Below the line, the near-tripling of interest expense pushed net income available to common shareholders to a $26 mm loss or 32 cents a share from a plus 11 cents a year ago.

Quoth KCS in the release, "TFM revenues increased 8.7% to $184.1 mm from $169.3 mm but the quarter's financial result was adversely impacted by tax rulings, purchase accounting and other costs. Q2 consolidated operating expenses for the second quarter of 2005 were adversely impacted by a non-cash, pre-tax charge of $35.6 million related to a series of Mexican Supreme Court rulings, which eliminated TFM's ability to use net operating losses to offset future employer statutory profit sharing contributions." Then there was another $11.7 mm spread across four other areas of disputed costs and claims.

The result was the very real $5.3 mm operating loss incurred in the first two months of combined operations. The good news is that if volumes and revenue mix hold, these one-time items will be history by the end of 3Q05 and the merger will begin to produce as scheduled. Wall Street must agree because the charts say they're still buying and are likely to keep buying. Late Friday the stock (NYSE:KSU) was at $22 with the indicators all pointing to further increases. It's a bit rich with a PE of 33 and a PEG of 1.7, but that's probably a bet on Mexico and an acquisition premium.

Edward H Harriman made this week's list of The Twenty Most Influential Businessmen at Forbes.com. "Harriman perfected a template of American capitalism: improving underperforming businesses by pouring capital into them." And it holds today as UP has the largest rail franchise in the free world, generating buckets of cash.

Over the five year period 2000-2004 UP averaged revenues of $11.5 billion a year, generating pre-capex cash from operations at a rate of $2.2 bn a year. From that UP has financed some $1.7 bn a year in capex and rewarded its shareholders to the tune of $230 mm a year in dividends.

At UP annual free cash flow is cash from operations less capex less dividends. The five-year average is $202 mm a year. That's *left over*, folks, even after "pouring capital into" the railroad at a rate of $1.7 bn a year. Every time I go out on the UP it's another lesson in how you can fix anything by throwing money at it.

It's one thing to carp about the UP's STB performance metrics and operating ratio; it's another to spend half a day at Gibbon or Missouri Jct. and see how this investment really works. It ought to be a required field trip for every Wall Street analyst. As for the performance metrics, it's like Cosmo in "Moonstuck" says: It's *temporary!* Just follow the money.