RAILROAD WEEK IN REVIEW
AUGUST 4, 2006

"Our second quarter results reflect a very large gain [which] leaves us with the strongest balance sheet in our history." Mort Fuller, CEO, Genesee & Wyoming

Genesee & Wyoming operating income in the second quarter of 2006 increased 2.0% to $16.3 mm, compared with $16.0 mm in the second quarter of 2005. The operating ratio was 85.6 compared to an operating ratio of 82.7 in 2Q05, though the present quarter includes ARG transaction-related expenses of $4.9 mm, an insurance gain of $1.9 mm, and $0.8 mm of additional stock options expense. Excluding these items, the operating ratio would have been 82.3. More on this anon.

Q2 revenue increased 22.5% to $113.6 mm, up 22.5% from $92.7 yoy. Of this $20.8 mm revenue gain, $3.8 mm was same-railroad revenue growth in the U.S. and Canada, $12.5 mm was from the acquisition of rail lines from Rail Management Corporation and the acquisition of a small rail property from CSX, and $6.7 mm the newly-formed Genesee & Wyoming Australia Pty Ltd (GWA).

These gains were partially offset by a $2.2 mm decrease in revenue in Mexico. The 4.6 % growth in same-railroad revenue in the U.S. and Canada was primarily due to freight revenue gains in coal, metals, and the paper group, though CEO Mort Fuller noted during the call that Class I rate hikes in the STCC 26 zone have caused some shippers to desert the rails for the roads.

Consolidated carloads were up 13% (24,000 cars -- note GWR counts intermodal platforms, not containers), half of it from acquisitions. But same store traffic (essentially North American) was off 6% -- 10,900 units – including a 1900 unit decline in Mex. Same store RPU increased 8.7 %, roughly 2/3 price and mix, 1/3 FSC. Ex-Mexico same railroad RPU increased 11.2% with price and mix making up three-quarters of it and the rest FSC. Recall that most GWR shortlines outside the Railink operation are ISS roads, meaning they negotiate their own divisions and are not subject to FAK allowances that may or may not include a share of FSC collected by the connecting Class I.

Below the line GWR reported 2Q06 net income of $117.7 mm vs. $11.4 mm a year ago and diluted EPS $2.76 vs. $0.27 yoy. The large yoy increases came mainly from AUS-related gains and charges that netted out to $183.3 mm ($102.6 mm after-tax, or $2.41 per diluted share). The details are in the press release, but suffice to say these gains were the end result of closing and selling the joint GWR-Wesfarmers ARG with GWR simultaneously buying certain South Australian operations of ARG and thus creating the above-mentioned GWA. Absent these gains eps was $0.35 vs $0.27, up 29%.

Hits were taken south of the border as GWR recorded non-cash charges related to the impairment of its operations in Bolivia and Mexico. First, GWR recorded an impairment of $5.9 mm on its investment in Ferroviaria Oriental (Oriental), a railroad located in eastern Bolivia, in which GWR owns a minority interest. This non-cash write-down reflects the heightened political uncertainty and risk of nationalization of the company's assets in Bolivia.

Second, GWI recorded a deferred tax valuation allowance of $1.0 mm against the net operating losses (NOLs) of its Mexican subsidiaries. GWI believes that it is more likely than not that a portion of its NOLs in Mexico will expire before being used due to the continuing adverse business conditions since Hurricane Stan washed out a portion of its track in October 2005. During the call Fuller reminded us that they have a Letter of Understanding for Mexico to fund 75% of the repair bill, not an *agreement* per se.

In closing, Fuller and his team talked a bit about acquisitions. Priorities are other extant shortlines (think Earl Durden), industrial rails, Class I spins and off-shore. Regarding this last, GWR is going to be very picky, balancing the successes in AUS vs the lass than happy results in Bolivia. What separates GWR from its peers is the regional railroad organization, and where individual shortlines do not fit that bill they may wind up in Billy Eason's Railink group (revenues up 30% yoy, BTW). In other words, GWR's contiguous railroad model has succeeded very nicely where others' any railroad-any-place model has not fared as well.

On the other hand, the 6% decline in same-store carloads bespeaks a weakening in the five regions (Railink cars are not included here). It carries through to the consolidated report where five commodity groups make up 74% of volume and 72% of revenue – paper, STCC 24 forest products, coal, minerals and metals. All but paper were down in car-count and the former was essentially unchanged. Paper, metals and coal got the biggest RPU increases, so it's probably mix.

The "official" debt to cap ratio is around 48% but the AUS transaction so loaded the balance sheet with cash that the net LTD drops to $7 mm, making GWR essentially debt free for the moment. So with more than $200 mm in cash and a revolver loaded with another $200 mm, GWR is well armed and ready to go hunting. Let's see what they bring home.

I'd hate be an allowance-based shortline in this environment. Charlie Swinburn (RRA) said they saw some carload losses relating to Class I pricing and service. A shipper client tells me the business a Class I has come back asking to regain business that six months ago they ran off due to "congestion," meaning they couldn't get rates high enough. A shortline lost a lucrative aggregates move because they had no control over pricing. Another shortline has an opportunity to grow the connecting Class I franchise but it'll take some product differentiation. The Class I refuses.

ISS roads have the best of all worlds. They are part of rate negotiations and seek divisions that'll keep the traffic moving at a profit to all. They also handle collections and interline settlements. Junction Settlement roads are likewise part of the rate negotiation process but the Class I handles collection and interline settlement. But "handling lines" get FAK allowances that come out of Class I revenues and therefore anathema to market managers whose compensation is in part based on the revenue they bring in. Shortline allowances come out of that bucket.

The common thread through all the Q2 earnings calls has been double-digit revenue increases on single-digit volume gains. A secondary theme has been the need to improve service to get even more revenue gains. The question is whether the potential revenue gain in a given commodity lane is worth the cost of improving service enough to earn the price increase.

We know where there are Class I terminals and branch lines with operating ratios of 140 or worse. We also know that shortlines have the proven ability to take that ratio down to 90 or less even after the Class I deducts the shortline fees revenue attributable to the property. Moreover, Class I power and crews are freed up to run rnore core trains thus contributing to congestion relief, pushing down gallons consumed per GTM and equipment rents while increasing yield per RTM.

Some Class Is are further up this curve than others, at least as far as identifying opportunities. Based on the number of recent line transfers I'd have to say BNSF has done the most in analysis and execution with CSX in second place. Stuff I've seen behind the curtain elsewhere tells me the tools are there in varying degrees and when the decision is made to address the cost of service question those roads will be able to move quickly.

That's when we'll start to see the rates of volume increase approach the revenue increase rates we saw this quarter. Business that's currently being pushed away because yields are too low will come back as shortline operators lower branch line and terminal avoidable costs, improve yields and make losing commodity O-D pairs attractive once again.

Rail stocks are still cyclical, or at last the way they're traded these days. We've seen some really terrific numbers this quarter but still the group is trading down. Moreover, it's interesting to see how TRN and BTU have traded in lock-step over the past six months. Street sentiment still seems to point to rails as having further to fall and the tech signs seem to support that sentiment.

Also, it's instructive to see how TRN and BTU have traded in lock-step over the past five years, albeit with BTU at a much higher level. But in the last six months they practically trace each other. And ADM, another user of TRN products, has traded between the two over five years and did not stumble as badly as TRN and BTU when the Fed started tightening in May.

Over the past 20 days the top three sectors for stock price appreciation have been utilities, consumer staples and energy. Within these the leading industries have been gas utilities, beverages and consumable fuels though coal stocks have slid nearly 20%. Thus if I were running a shortline I'd be looking to my corn sweetener, feed grain, ferts and ag products in general to carry the day. Recall that the Big Six Class Is' Q2 results all showed ag revenue gains in the high teens or better.

Concerning ADM, for example, S&P gives a four-star rating : "We believe corn processing results should benefit from strengthening demand for ethanol and improved high fructose corn syrup pricing due to more favorable industry capacity levels." This is one curve to stay well ahead of.

NS promotions: Gerhard A. Thelen has been named vice president operations planning and support, headquartered in Norfolk. He will be responsible for the corporation's operations planning, policies, budgets, research and tests and quality management functions. He has a masters degree from Pennsylvania State University and graduated from the Fachhochschule Munich (university for applied sciences).

Thelen joined Norfolk Southern in 1977 and served in quality, engineering, research, and mechanical positions before being named vice president mechanical in 2004. Tim A. Heilig has been named vice president mechanical, headquartered in Atlanta. He will be responsible for maintenance and repair of the railroad's motive power and rolling stock. A graduate of Georgia Tech, Heilig joined Norfolk Southern in 1971 and served in management information, intermodal, engineering, mechanical and transportation positions before being named assistant vice president transportation network in 2001. Congratulations, all.

Earnings calls concluded this week with KCS and FEC. Look for discussions of their results next week. Added bonus: what some of my analyst friends wrote about the rails' Q2 performance.

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