RAILROAD WEEK IN REVIEW
MAY 4, 2007

"LBO speculation and 'activist' hedge funds are a new phenomenon in the rail sector, and both are being fuelled by a growing perception the railroads are underlevered." – Rick Paterson, UBS

Kathryn McQuade is leaving NS to be EVP and Chief Operating Officer of the CP effective June 1. As many of you know, Kathryn has headed up the Strategic Planning team at NS since late 2004, and was formerly SVP in finance reporting to Hank Wolf. The common thread between and among Kathryn Hank and yours truly (not to mention a handful of other senior NS folks) is a business degree from W&M where Hank and I had the same Money & Banking professor and it was clear that his teachings influenced Kathryn even though she followed us by more than a decade.

Fred Green has assembled a truly remarkable team. Kathryn will be superb addition, complementing the talents of Marcella Szel in Marking, Brock Winter in Ops and Mike Lambert, CFO. In her hew role Kathryn will be responsible for providing the strategic leadership and integration among CP's railway operations, information technology and strategic sourcing groups.

She leaves NS after 27 years with the company having hired out as an accountant with the N&W. And now, after becoming the highest ranked woman in the history of NS, makes her own history as the first woman COO of a Class I railroad, Dagny Taggert personified at last.

Genesee & Wyoming's Q1 sales increased 16% yoy to $131 mm of which $20 mm was from acquisitions, primarily G&W Australia. Same-store railroad revenues slid $2.3 mm; $1.7 mm was attributable to the on-going difficulties in Mexico (during the Q&A Jack Hellman said they have an exit strategy for Mexico is there is insufficient progress in further talks with the Calderon government).

Forest products as a whole were a continued drag with pulp & paper loads off 9%; lumber was down 8% in revs and 18% in revenue units. However, merch carload revenues actually increased 7% and the RailLink switching and terminal subsidiary brought in $42 mm, more than double what it did in 1Q06. Operating expense was up 20% on big jumps in purchased services, casualties & insurance and purchased services so operating income was unchanged yoy. The OR was up 874 BP to 83.1.

The North American same-railroad revenue decrease was the result of a 7.3% decline in carloads, partially offset by an increase in average revenue per carload of 5.3%. The decrease in freight revenue was more coal than anything else. Average RPU increased only 1% as rate increases amounting to 7% per unit were partially offset by declines in fuel surcharge collections and mix.

It must be noted here that GWR has continually set the safety bar higher on safety and the quarter just past was no exception. Twenty GWR roads had no – none, nada, zip, zero – FRA reportables, up from 19 names a year ago. Looking ahead, GWR sees the acquisition market heating up with more competition for existing lines with potentially higher multiples. GWR remains open to "select" opportunities. (They ought to with net debt of a paltry $10 mm and nearly a quarter of a $billion in cash.) It was suggested during the Q&A that private equity and infrastructure investors represent "new pockets of money" though I don't expect to see GWR chasing any deals that are not immediately accretive.

This was Mort Fuller's last official appearance as CEO on these quarterly calls. Effective June 1 Mort becomes Executive Chairman and President Jack Hellman adds the mantle of CEO. Thanks, Mort, for a great ride (stock up six-fold in ten years split adjusted) as we've watched GWR evolve from a privately-held upstate salt-hauler to an international NYSE-listed company with a market cap north of a $billion. Jack, you've earned it. Congrats to you both.

It was good to see Jim O'Donnell, Charith Perera and John Meeks, collaborators in ShipXpress, the newest entrant in the shortline car accounting space, at the ASLRRA meeting in Baltimore. Recall than it was just last Jan that ShipXpress acquired Railinc's RailSync transportation management suite of software tools.

RailSync is an internet based, real-time shortline rail management system comprised of three major components. **Command** manages local and interline rail activity as well as customer service administration, **Control** is a car accounting system that tracks track car hire expense using data from any Transportation Management System, and **Concur,** a revenue management application enabling "certified ISS participation." ShipXpresss is presently supporting RailSync currently on some fifty shortline railroads.

Patriot Rail has purchased the Rarus Railway Corp., a 26-mile short line out of Anaconda, Montana. This is the former Butte Anaconda & Pacific, an electric freight hauler with some nifty box-cab units that I photographed – albeit dead -- on a swing through Montana in the mid-1970s. The BA&P opened in 1892 by Anaconda Copper investors to haul copper ore from the mines in Butte to the smelters in Anaconda.

The wikepedia.com entry says that "The BA&P was an electrification pioneer, converting in 1913 and being the first primarily freight railroad to electrify. Electrification was at 2,400 Volts DC; the work was performed by General Electric and the railroad's own staff." The road dieselized in 1967 but when the smelters closed traffic dried up and, according to the UP shortline page, "The BA&P property was transferred to the State of Montana in 1985 and subsequently purchased by Rarus from the State in 1990."

By 2006, traffic stood at a little more than 11,000 cars a year, primarily copper tailings, impacted soils, copper concentrates and slag. The Patriot acquisition includes the Copper King Express, an excursion train that last year carried approximately 10,000 round-trip passengers between Anaconda and Butte (see also www.copperkingexpress.com). Patriot has said it will continue to operate the Express and is developing a program to expand ridership and provide additional services.

When is enough leverage enough? We've written before that that there are those who say the rails could support more debt, and now comes the best argument yet from UBS' Rick Paterson. Quoth he, "LBO speculation and 'activist' hedge funds are a new phenomenon in the rail sector, and both are being fuelled by a growing perception the railroads are materially underlevered.

"Ironically, as the companies have recently succeeded restoring leverage ratios to historic levels following the mergers of the nineties, they now find the fundamentals have changed and they've gone too far. Using a proprietary UBS model we estimate optimal sector leverage at 64% net debt/capital and 3.2x debt/EBITDA, compared to current ratios of 44% and 2.2x, respectively. This additional debt adds 5.4% to the sector's equity value from the debt tax shield and 11% from EPS accretion. We also argue this wouldn't require sacrificing investment grade ratings.

"We see a growing disconnect between stockholders and managements on this issue but it's going to take time before CFOs start thinking materially differently. While it's a case of 'baby steps' in the near term, this issue is real, gaining momentum, and we expect a material levering up of these companies over the longer term.” Rick concludes by suggesting that all rails will benefit, specifically Burlington Northern, Canadian National, Union Pacific and Norfolk Southern.

Personally, I see opportunities for other Class Is to follow CN’s lead in acquiring leading regional Class I roads with which they have – or could have strong strategic ties. Think CN’s aquisiton of the DM&IR, WC and BC Rail or UP’s purchase of a former MKT line from RailTex in northeast Kansas. I get the distinct impression somebody’s making a run at the FEC based on what the stock price has been doing – up 27% since mid-Mar. Might be a better use of excess free cash flow than buying back shares or increasing the dividend at this point.

In a separate UBS note, Paterson offers this tidbit: “From 1940 to 2005 the eastern rails had the bulk of revenue, earning $3 million for every $2 million in the West. By the late-70s the western rails had usurped the position of market share leader, and today the split has returned to 60%/40%—but now the West has the lion’s share.

“Western rail revenue growth has outpaced that in the East (4.6% CAGR since 1940 vs. 3.2%) thanks to the construction of the interstate highway system aiding growth in western markets, outsourcing to Asia boosting import container volumes into the West Coast ports, and coal production growth in the West (Powder River Basin) surpassing growth in the East (Appalachia).”

Not a lot of this is merch carload business, bad for shortlines. On the other hand, as BNSF in particular has shown, having the resources to focus on the intermodal and unit train business where margins are highest mandates finding a better way to handle the merch business that remains. BNSF has chosen to do it through an aggressive leasing program thus benefiting shortline operators.

Union Pacific, with a larger stake in the merch carload sector as a percentage of total revenue, has not been as aggressive in shifting branch line operations to shortlines. And, frankly, it is doubtful they ever will. My sense is that Jim Young has brought a new sense of urgency to network operations and, like Canadian National, may conclude they can do a better job on the branch lines than a third party, the better to keep the branches aligned with the network.

The trick in the east will be for both NS and CSX to get their hundreds of shortlines to toe the network line and buy back those that do not but which offer work-arounds and shortcuts that afford better asset management practices (see above). I also think that operators like RRA and GWR can start filling in the blanks in their contiguous networks with currently independent operators who are not making it on their own but where sharing the overhead can improve EBITDA as a percentage of revenue for both.

Help Wanted Dept (seriously!!) Jim Wrinn writes that he’s looking for another Assistant Editor for *TRAINS* to be domiciled at Kalmbach WHQ. Send any supplicants my way and I’ll tell them where to go.