THE RAILROAD WEEK IN REVIEW
FEBRUARY 15, 2008

"The trends of the fourth quarter combined with the new business coming on line in 2008 make us optimistic for the coming year." – Jack Hellman, President and CEO, Genesee & Wyoming

Genesee & Wyoming's 2007 results for the fourth quarter and year are impressive. Freight revenues from the regional and shortline networks grew 9% yoy in the Q and 5.8% for the year. So-called "non-freight revenues" jumped 23% in the quarter and 34% for the year. There are four components to this group: switching (nine ports, 28 industrial switching locations, coal loading at 11 PRB mines), ancillary charges (demurrage etc.), "other" (crew and equipment leasing in Australia, transload and drayage services) and fuel sales to third parties in Australia.

The Q's top line came in at $134 mm, up 14% from $118 mm in 2006 and the year aught-seven was up 15% yoy. Drivers were strong pricing with average RPU up 16% in the Q (12% absent foreign exchange effects) even though total units slipped 6%, due in part to disappearance of a Class I haulage agreement that put out a lot of units but at a rather meager per-unit number. It went on for about six months into 2007 but with that gone one can see "other and haulage" RPU already ahead 7% in the quarter. Much of this was on the M&B (see my March 2008 *TRAINS* column on page 18).

Operating income for the Q hit $112 mm, up 21% as ops expenses were held at plus 13%. Annual ops income was $419 mm on a 14% expense delta. Operating ratios were 83.4 for the Q, down 79 BP and 81.2 for the year, down 69 basis points. Below the line, reported eps came in at 38 cents, up 13% for the Q but for the year dropped 55% largely on the $219 mm gain from the ARG sale; absent that and other items, eps for FY 2006 would have been $1.51 vs. $1.77 for 2007, a 17% gain, on a non-GAAP but more accurate apples-to-apples comparison. Happily, all that goes away in 2007-8 comps.

This was without doubt the clearest, most easy-to-follow GWR presentation in the years I've been following the company. Go to the presentation slide deck on the investors page at www.gwrr.com and see that starting in 2003 through 2007 sales increased at a 25% CAGR and that ops income raced northward at a 32% CAGR pace.

To see what else this gang is about, go to the BB&T Capital Markets Valentine's Day presentation. To begin, GWR is not a collection of railroads randomly spread across two continents. Rather it is a network of contiguous regional railroads that allow lower operating costs, the efficient use of capital and a *regional* marketing approach. And the safety record is within 7 basis points of the average Class I score Jan-Nov 2007: GWR 1.67 reportables per 200,000 hours vs. the Class Is' 1.60.

One final point: we've written before how the short lines that are paid on a per car allowance basis have little control over RPU or mix. When one set of commodity O-D pairs goes south, so does the revenue. There's no way to make it up with higher rates elsewhere. On GWR 55% of freight revenues are interline or ISS meaning when the class I rates are negotiated upwards, the ISS roads share the rewards. Take the classic example – STCCs 24 and 26. GWR carloads actually increased 3% but mix and pricing pushed revs up 11% and RPU up 8%. Try doing that on a handing line.

Having $200 mm cash in the bank comes in handy for acquisitions, and here's GWR is exceptionally well positioned. They've made 30 acquisitions since 1985 and except for the restructuring of the Australian relationship and some changes in Canada, I can't recall a single divestiture. We've seen how they will buy a property at what looks like an aggressive multiple only to work the effective multiple back down using the contiguous railroad rule. I expect more of the same going forward and I applaud the GWR team for a job well done.

CSX holds its 19th annual short line confab – the longest running show in the business -- this coming week at the World Golf Resort just off I-95 half an hour south of Jacksonville. The festivities begin with what I expect will be another lavish reception Wed eve and running through lunch Friday. It promises to be a lively couple of days what with CSX making significant progress in pricing, getting the mix right, running the railroad according to the same set of rules regardless of division, and getting rid of many of the predecessor road animosities that have plagued the company for as long as I've been in the shortline business.

And if that isn't enough, we have the TCI sideshow to contend with. The London-based edge fund's latest move was to call on CSX to allow its shareholders to call special Board meetings for the purpose of electing directors throughout the year. CSX responded to this love letter appropriately enough on Feb 14, saying in part, "TCI's criticism of the CSX Bylaw amendments is both unwarranted and disingenuous... Taken together with TCI's nomination of candidates to fill five of CSX's twelve Board seats, TCI's criticism of the CSX Bylaw amendments makes it clear that TCI's interest is not in good corporate governance, but in achieving effective control of the company notwithstanding its ownership of only 4% of the shares." I'm sure we all will be eager to hear what CEO Michael Ward is to say in his own refreshing and unequivocating manner.

TCI not withstanding, CSX short lines from the South, particularly the Carolinas and Alabama, will be cheered by CSX' outlook for these states, buoyed by Tuesday's WSJ editorial on a United Van Lines survey of family migration trends. North Carolina, Alabama and South Carolina ranked as the first, third and fifth most popular destination states thanks to a combination of low or no taxes, "economic prospects, quality of life and housing prices." Go to Kyle Hancock's slide 62 system map (www.csx.com/investors, September 6 Investor's Day) and see how the southeast is papered over with new and expanding business opportunities.

Short lines can capitalize on CSX growth strategy as depicted in this chart simply by looking at the 2007 results and following the money. The ticket is in looking to higher-rated commodity O-D pairs for customers who will turn equipment quickly and who embrace rail as a strategic supply chain partner. CSX has posted uninterrupted revenue growth for nearly six years, so clearly they're doing something right. And one of the main reasons CSX holds this annual short line meeting it to show its short line partners exactly how they too can follow the money.

One of the most gratifying aspects of running this newsletter is reader feedback on what's working and what needs improving. Rob Himoto recently bought California's Santa Maria Valley Railroad, an aggregates and agriculture based 14-mile short line connecting with the UP's ex-SP Coast Line Route about 175 miles north of LA. He writes, "During the Christmas season I noticed retailers were expecting a lean year and did a great job of inventory control and not ordering to much inventory. At least the big chains locally they were able to keep margins up, 30% sales vs. 70% blowout sales that I am accustomed to seeing.

"Despite the slowing economy, people still spend money; however they prioritize how they spend money. Rather than going on vacation on an exotic cruise or a trip to Europe, consumers want bang for the buck with limited funds. Which means taking the family to Disneyland where the chances of having a great time is very high. (I have owned Disney off an on through the years and my hunch is that their 4th quarter -- actually their fiscal 1st quarte -- would be very strong. They seem to be hitting on all cylinders with their theme parks, movies, merchandising, and entertainment all showing strong results. Disney is what I consider the best entertainment companies around.)

"Consumers do not cut their budget across the board; they will cut the most frivolous items off and tend to keep spending on comfort things. Take a vacation, go to Disneyland. For the Central Coast, the Amtrak Pacific Surfliner totally eliminates the need to drive in gridlocked Southern California. Consumers will still buy Coke and Pepsi. The strongest companies in consumer sectors will continue to do well because they execute the best.

"How does this relate to the railroad industry? Reading the fourth quarter results, I find all of the railroads did a great job of adjusting their operations to continue with good operating margins. I am impressed with CN: another quarter of the best operating ratio in the industry, running a scheduled railroad in not so nice operating conditions weather-wise. With CN operating on all cylinders, I would think the other Class Is would at least follow the leader where efficient operations coupled with good inventory control helps keep the margins up.

"It just goes to show that even in beaten-down industries the best companies can do well in a down economy. The best companies have the best execution, are very disciplined, and they tightly control lumber and building materials customers seem to be among the best-run companies on the Central Coast: carefully controlled inventory, smart buying, and great customer service. As a result, we have not seen the drop off among our customers. Great pricing and great customer service is really putting the pressure on other lumber and building materials customers. We are just fortunate that the well run companies in the area just happen to be on our line." Thanks, Rob.

There is an unfortunate short line criticism of the Class Is and unit trains in the Feb *Railway Age*. Written by the pseudonymous "Ray L. Rhodes" the piece would have the reader believe that if coal and grain doesn't move in unit trains they won't move at all. The writers(s) argue that a prospective ethanol plant on a certain short line won't get built because of the connecting Class I's unit train requirement for inbound corn. There is made a similar case for a co-gen plant, adding a gratuitous complaint about "contentious public meetings" having to do with unloading practices.

Without going into a lot of detail, it's safe to say the piece misses on a couple of points, One, no class I I've ever talked to about breaking unit trains to accommodate small unloaders has ever balked if there is a economic work around. Two, using two isolated anecdotes to damn the entire Class I industry does the whole shortline community a great wrong if only because there a so many places where unit trains work to the advantage of the customer and thus to the benefit of every railroad in the move. The RA piece cites two problem moves; IMHO there are many that work and work well.

The bywords here are "follow the money" and "do your homework." And if it turns out in the due diligence process that the economics don't work then go find a better opportunity. I mean, there's a reason KCS and CP -- to name two cited in these pages recently – have new business pipelines in the hundreds of $millions and their conversion rates are so high: they do their homework and follow the money. And whether there is a short line in the route or not makes no difference as long as everybody – shipper, short line and Class I – makes money in the bargain.