THE RAILROAD WEEK IN REVIEW

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Tom Wadewitz, JP Morgan

On the eve of the election, Oct 31 to be more precise, Ed Wolfe of Wolfe Research wrote that this is a critical time for transportation. "Our nation's transportation infrastructure suffers from years of neglect towards air, highway, rail and port policy and the highway trust fund has been depleted. The past five-year highway reauthorization bill expires in September, 2009 and industry experts believe about double the $286 billion approved last time could be required going forward.

"Obama has possibly the most detailed transportation policy in history. He favors an immediate $60 billion stimulus infrastructure bill to support needed transportation projects and create jobs. He also favors a major change in the FAA for airlines and potential legislation that would make union organization easier. With an anticipated solid majority in Congress, he is more likely to generate change in the sector."

But there are risks. "For the rails, we don't believe re-regulation is likely. We view an infrastructure tax credit for rails as possible under either candidate but more likely under Obama. For the trucks and express carriers, we don't expect a material change regarding unions, but expect Obama to be more supportive generally to unions. Both parties seem likely to curtail non-clean coal at some point in the future, a potential negative for rails after 2012." Moreover, "If Obama pulls back on NAFTA trade policies KCS could be a loser."

Then on November 5, JPM's Wadewitz wrote in a client note, "In our view, the combination of stronger Democratic party majorities in the House and Senate and control of the White House are a source of increased risk for the transports in general. In particular there is now greater risk that legislation will pass which would facilitate efforts to unionize transport companies.

"At this point the outcome of four senate races is not clear but the Republican appears to have an advantage in these races. We believe that passing the most union friendly legislation is far from assured if the Democrats do not win any of the four unresolved races and their majority stands at 56 seats to 44 in the Senate. [I shudder to think what card-check could do to the shortline railroad business, though.]

"Based on a letter that President-elect Obama sent to the National Industrial Transportation League, in which he presents a positive view on both passenger and freight rail as an efficient means of transportation, we believe that an Obama presidency is unlikely to favor legislation that would be harmful to the rails. Nevertheless, given the changes in DC, we suspect that there will be an increased inclination towards regulation in general, which could be unfavorable for the rails at some point."

Nonetheless, we continue to see signs of consumer pullbacks and budget cuts at the city and state level. The front page of Thursday's Philadelphia *Inquirer* was quite ebullient about what the Obama win means for the city while elsewhere on the same page we read that city budgets have been frozen, planned reductions in business taxes eliminated, libraries and recreation facilities are closing and there's a hiring freeze. Local restaurants see patronage off 15% and in one case the owners have become the wait-staff and have given themselves salary cuts. And the blogosphere has a note from the owner of a local dry-cleaning establishment that has let staff go in order to meet the higher tax level. So Mr. Obama will have his hands full, no doubt.

One indication of tough times for short lines is to be found in the short line attendance at the Eastern Region ASLRRA in Williamsburg (WIR 10/17/2008). Of the more than 200 people registered, 78 were

from short lines, including spouses and companions. A quick count of the attendance list shows 34 different short line names, including members of the headquarters staffs from a number of the holding companies. I counted 33 short line owners, of which 18 have multiple lines and 15 are wholly independent operators.

To put that in context, the ASLRRA website lists nearly 200 different names for the Eastern Region, essentially Maine south to Virginia and west to lower Michigan plus eastern Canada including all of Ontario. Thus a mere 15% of the names were represented. My sense is, knowing many of these operators and having seen many of the properties, that the smaller the railroad the smaller the margins and the greater dependence on the single-car business model (and the less the free cash flow support jaunts to Williamsburg). Yet that is the very sector most in jeopardy given the direction of supply-chain preferences and railroad economics.

These marginal short lines will likely go down one of three roads: be absorbed by a holding company (see GWR remarks re acquisitions below), be successful in landing new customers or new business from old customers that can be handled with little additional new variable expense, or simply go out of business of their own weight. But there is hope. The ASLRRA is well-positioned to help member short lines find new partners and to be stronger in new business development. Moreover, even though there are myriad programs for government assistance, the more one can do for oneself without relying on these subsidies the stronger the business case and the more attractive a regional partner for the connecting Class Is and the more desirable for an acquirer.

As for the broader outlook, Ed Wolfe writes in his 60-page Recession Report, "We believe the transports are likely to outperform the market during the impending recession as they benefit from declining fuel costs and lagging surcharges, relatively easy comparisons after two years of down freight volumes, mostly U.S. exposure, relatively few credit issues and potential operating leverage into an eventual recovery (which can also continue to swing against them) as early cyclicals."

UBS' Rick Paterson writes in a similar vein, "Fourth quarter is shaping up to be a carbon copy of Q3. Fuel has continued to fall in the face of lagging fuel surcharges, and legacy contracts repriced earlier in the year should ensure pricing strength sufficient to grow the operating margins in the face of falling volumes. Positive pre-announcements are likely, but will the market care more in January than it did in October? We shall see."

Genesee & Wyoming had its third-quarter earnings call Monday and I think it went quite well. This is a company that invariably executes well, has a strong sense of mission and how to accomplish same, and does it all with astonishingly little leverage. CEO Jack Hellman says that Australia is practically immune to cyclical variability and in North America 60% of the business book is "less sensituve to the weak economy" (the Illinois and Rock Mountain Regions plus Rail Link) and the balance (Oregon and Canada -- the latter including the St Lawrence & Atlantic) gets hit a little harder -- paper, lumber and some commodity steel being the main points of weakness.

Overall, total revenues increased 22% to $159 million. Carload freight revenues increased 16% to $78 million while revenue units increased but 2% thanks in part to the loss of the M&B haulage, a Utah mine closure, and shifts in grain stockpile timing in Australia. All-in, commodity revenues increased 15% to $96 million on essentially unchanged revenue units. "Non-freight" sales (Rail Link and most of Australia increased 33% to $64 mm and now represents 40% of total sales, up three points year-over-year.

Same-railroad revenue-per-unit gained 15% over last year -- nine percent on pricing (on average 200 basis-points better than the Class Is), four percent on fuel surcharges and two percent on mix. Of the $28 million increase in freight revenues, acquisitions contributed $13 million and same-railroad sales brought in the remaining $15 million. It is constructive to know that the two most recent acquisitions -- Ohio Central and Georgia Southwestern, break more to the non-cyclical side of the house; the former has municipal solid waste and construction debris revenue streams as well as a healthy steam-coal franchise

while the latter is big in peanuts, hardly a cyclical commodity -- feeding everything from hogs to kids to bar flies.

Operating expenses increased 23 percent and operating income grew 17% to $36 mm. Bellow the line net income from continuing operations dropped 13% thanks mainly to a $10 mm tax hit in the quarter. GAAP net income was up a healthy 31% after a $7 mm discontinued ops debit last year. The operating ratio worsened a point to 78.3 from 77.4, though excluding the gains from asset sales in both years the current number is two points better than in third quarter oh-seven. And the recently passes tax credit program will be worth some $10 million a year for this year and next.

On acquisitions, Hellman said they can put their hands on $170 million in "immediate capital availability" and they are trolling for "good investment opportunities at attractive valuations. If look at the way GWR intergrated the Oho Central and Georgia Southwestern into their existing franchises, it's not hard to see where they're taking this model. If I were a short line anywhere close to a GWR property and could offfer atrtactive valuations, I know whose door step I'd be camping on.

Man bites dog dept redux. Canadian National announced on Monday that it had reached an agreement to acquire four shortline railroads from the Quebec Railway Corp (QRC, or, more familiarly in Canada, the CFQ or Chemins de fer du Québec), originally formed in 1993 following the purchase of Canadian National Railway's Murray Bay subdivision, running east from Quebec City. The four lines in question are New Brunswick East Coast Railway (NBEC) and its sister companies Chemin de fer de la Matapédia et du Golfe (CFMG), Compagnie de gestion de Matane (COGEMA), and the Ottawa Central Railway (OCRR; see my September 2007 TRAINS column) for $C49.8 million. CN expects that the required rail lines will be integrated back into the CN network with no significant changes, other than introducing CN locomotives and rolling stock to train operations, as well as significant capex investments.

Dave Dealy, formerly with the BNSF, writes in an e-mail following my most recent quarterly reports, "We have probably had this conversation before, but I continue to be amazed at the focus on OR as a real measure of efficiency. It should really be operating expenses per gross ton mile. The quality of revenue has really been the driver of the improved operating ratios, It is really difficult to tell how the railroads are truly becoming more efficient using OR as the number."

Dave is right on both counts. We first chatted about this on an investor's trip on a business car trip out of Chicago some years ago. And I agree that operating expense per gross-ton-mile is a much better measure of how a railroad runs. As we have seen this year, sequential quarter-to-quarter gains in top-line sales and revenue-per unit drive down the OR simply by increasing the denominator. Operating expense as a percent of revenue goes down if operating expense is unchanged and revenue goes up.

To those who would strip out fuel expense to get apples-to-apples expense comparison I say it misses the point. No fuel, no trains. Everybody's paying the same ballpark per-gallon cost; the trick is to wring more GTMs out of each gallon. More GTMs per gallon, the lower the fuel cost per GTM. Ergo operating expense per GTM is the better measure. I future WIR let me run some charts comparing third quarter GTMS per gallon. The answers may surprise you (hint: the railroad with the lower operating ratio does not have the lowest operating expense per GTM.

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