THE RAILROAD WEEK IN REVIEW
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"Having a clean balance sheet and access to capital puts you in a very good position vis-à-vis the competition in the industry." Fortress Investment Group CEO Wesley Edens

Baird's Jon Langenfeld does a very good job of keeping track of transportation trends and suggesting what might be coming down he track. He writes in his August 3 report, "We see stabilizing transport fundamentals a common theme throughout 2Q reporting. Though less negative demand trends on the horizon may provide near-term stock catalyst, we are still not expecting a sustained recovery for several quarters, but cyclical recovery prospects provide longer-term stock catalyst.

Here's how Langenfeld's group sees the next few quarters rolling out: The transports' second quarter earnings reports were largely in line on expense controls; "however, earnings estimates for the second half of this year and into 2010 were largely lowered. Trends remain well below prior-year levels across modes on continued volume declines and incremental pricing pressure.

"Stabilized demand was a common second-quarter theme across all modes (domestic truck, rail, international). Monthly year-over-year freight contraction has been stable since March, with seasonal sequential build experienced throughout the second quarter."

On the truckload side, where competitive pressures are of vital importance to the merchandise-heavy short lines, Baird sees " fundamentals bottoming given demand trend stabilization, unsustainable industry pricing, and an improving industry supply/demand balance; we believe 2009's third quarter will represent the trough in industry fundamentals for this cycle."

Baird sees no immediate "demand catalyst" near term. "Most companies noted normal July trends, but a few commented on a better-than-seasonal July. Inventory de-stocking should begin to slow and [the clunker program and other incentives may cause] a pickup in auto production" as we enter the seasonally "stronger second" half period. Thanks, Jon.

My favorite economic pundit, Schwab Chief Investment Strategist Liz Ann Sonders, writes: "Most regular readers know that I have felt since early May that the recession ended in this year's second quarter; more recently, many have joined me in that camp. The most recent economic reports have been particularly encouraging, pulling in even more disbelievers." More important, these reports could be good omens for the short lines whose volumes have been so horrendously hit of late.

Among other things, says Sonders, "unemployment claims are down sharply from the peak, home prices are recovering and vehicle production is rebounding smartly (partly thanks to the 'cash-for-clunkers' program). The stock market had a terrific July -- not to mention since the March low, high-risk bond yields have plunged (along with spreads) and corporate earnings have been well ahead of expectations.

"Even the first read on second quarter US gross domestic product (GDP) was better than expected, thanks to relative boosts from business investment, exports and government spending. We continue to believe that exports will be a very positive driver of US GDP in this cycle. Caveat: The Bureau of Economic Analysis' long-term revisions showed the recession having been weaker than originally thought; hence the better rebound from those lows." I'll buy that.

A note on the Railway Age newswire tells us Economic Planning Associates has released its second-quarter 2009 freight car analysis, and, "based on production figures obtained from the Railway Supply Institute American Railway Car Institute Committee, the freight car market won't begin to pick up until 2011."

EPA cites the fact that about one car out of every five in the general fleet is in storage and the continued decline in year-over year rail transportation demand isn't going to get any better. "After 2,374 units were ordered in the first quarter, the latest survey shows that only 2,165 cars were ordered in the second quarter. As a result, first-half assemblies of 14,120 cars served to drop net backlogs from 31,921 units at the beginning of the year to 21,558 cars at the end of June."

However, the EPA report notes that "Much to the credit of the railroads, in spite of steep year-over-year declines in volumes and revenues, [the Class Is] continued to cut costs and improve efficiency" which led to modest earnings deltas in spite of all. EPA concludes, "We currently expect deliveries of 24,800 cars this year and 14,750 cars in 2010. Beginning in 2011, far stronger economic activities will provide support for certain railcar assemblies while an improvement in the financial environment and higher gasoline prices stimulate demand for ethanol and DDG cars.

"Replacement pressures and technological advances as well as legislative measures will also play a role in promoting the demand for a variety of railcars." Boding well are potential returns of the construction business (forest products and aggregates), ethanol-related shipments, as well as chemicals and steel. After two dismal years, we look for railcar deliveries to rebound moderately to 27,500 cars in 2011 and then expand annually to the level of 57,000 units in 2014."

Fortress Investment Group's "Private Equity" portfolio, where RailAmerica lives, posted $32 million in second-quarter "pre-tax distributable earnings" *vs.* $28 million a year ago for a gain of 14.3 percent. In a note to the 10-Q, Fortress points out distributable earnings "is our supplemental measure of operating performance" and, unlike GAAP net income, excludes certain below-the-line items like one-time "contingent revenue." For WIR purposes, it's enough to know it's a positive year-over-year delta.

As for RailAmerica itself, the IPO says the company "generated total operating revenue of $508.5 million, net income of $16.5 million and adjusted EBITDA of $137.4 million for the year ended December 31, 2008 [a respectable 27 percent EBITDA margin] and total operating revenue of $103.2 million, net income of $1.0 million and Adjusted EBITDA of $33.4 million [32 percent margin] for the three months ended March 31, 2009.

Thanks to the IPO, we now have the first full year-over-year quarterly comps – first quarter 2009 vs. the previous year -- since Fortress took over. I have long had a sense that the RA team was busily putting the house in order and the results bear me out. For the quarter, operating income increased 25.4 percent to $21.8 million even as revenues declined 17.5 percent on a 22.4 percent drop in revenue units. Operating expense for the quarter dropped 24.4 percent year over year, taking the operating ratio down more than seven points to a respectable 78.9 for the period. Revenue per unit was $482, a six percent increase. Net income after discontinued operations jumped 154.6 percent to a positive $993,000 from a negative $1.8 million last year.

By way of comparison, first quarter 2006 (the last first quarter before the Fortress buyout), operating income was $14.3 million on $115 million in sales and an 88 operating ratio; revenue per unit was a paltry $311. Net income was $14 million. So in a matter of two years the new RA broom has swept the RPU up 55 percent and taken nine points off the operating ratio though total revenues only

increased two percent and revenue units dropped by some 111,000 units – half of which were overhead empties generating barely a C-note per car. Not bad, considering the economic picture.

Fortress CEO Wesley Edens said in his opening remarks for the second quarter 2009 earnings call, "We have successfully refinanced and/or extended the maturities of debt in a number of our companies, you know two notable financings that point you towards for the issuance is $740 million in high yields from our railroad company in May and the refinancing of Florida East Coast, the financing which we completed right at the end of July.

"In addition, we recently filed for an IPO for RailAmerica. If the IPO comes off as we anticipate later this year, it will be the first from one of our portfolio companies in several years, further signs of the healing of capital markets. Later in the call, Edens added , "Having a clean balance sheet and access to capital puts you in a very good position vis-à-vis the competition in the industry. So the IPO that we have filed for [RailAmerica] is reflective of our views about what we think that the future portends and what our ambitions are for that particular company in that particular industry."

During the Q&A Fortress President Pete Briger added this caveat -- a shoe that fits every shortline operator, especially the smaller independents: "At Fortress we feel that [the economy is] still going to see significant employment loss and you're going to see economic deterioration for some period of time. You're certainly going to see asset value disruption. We don't think that financing levels are going to return in a short period of time to where they were two and three years ago, and that equals asset value disruption."

Briger's comment goes right to the point GWR's CEO Jack Hellman made recently, namely that available multiples for short line transactions are less than they were eighteen months ago. Valuations are down in part because ebitda margins are down due to contracting revenues and essentially unchanged or even increasing operating expense. In fact, it appears to me smaller short lines could be hard-pressed to meet the new hours-of-ervice requirements and the employer obligations for health care benefits being proposed by the Adminstration and Congress.

Whether in the *Wall Street Journal* on the right or the Philadelphia *Inquirer* on the left, there is a steady stream of news releases, editorials, op-ed pieces and Letters to the Editors about how mandated employer health care contributions could actually slow small business hiring. Short lines are clearly small business, but the effect of higher health care costs on them is not well known. Perhaps somebody out there in readership land can enlighten the rest of us.

I am particularly concerned because more money on comp and benefits, currently about a third of shortline revenues, means less available for infrastructure improvements and perhaps a greater appetite for RRIF loans. Which leads me to another knowledge gap: Is the FRA taking the cash effects of the new hours-of-service laws and the potential health care drag into its RRIF loan deliberations?

Book Review Dept. *Coal Trains, The History of Railroading and Coal in the United States* is another handsome tome from authors Brian Solomon and Patrick Yough via Voyageur Press. Given our recent WIR screeds on the coal business, its arrival could not be more timely, scheduled for release this past week. Lavishly illustrated with 120 color and 47 black and white photos, the book traces the growth of the railroads' coal business from the first diminutive two-axle wooden cars and tiny 0-6-0s of the 1850s to the 18,000-ton unit rains and power to match that are the rule today.

Not only are the Big Six Class Is featured but also the short lines get excellent coverage. It is good to see the props given the Reading & Northern for continuing the anthracite tradition even after the

Lehigh Valley, O&W and Reading left the field. The section on Appalachian coal gives nods to the Western New York & Pennsylvania and the Ohio Central. Indiana Rail Road is in the Illinois Basin coal section, Montana Rail Link shows up as a PRB player and Utah Railway has a role in the Uintah Basin coal territory.

As typical of all Voyageur publications, one not only gets a sense of the business reasons behind the enterprises, but also of how they really work: "Key to Norfolk & Western's [coal] success was reaching in a variety of directions to provide multiple conduits for its traffic." Then there's the "smoke and brake shoe dust" aspect of good railroad writing. The accompanying photo is of an N&W class Y 2-8-8-2 double-heading with a class A 2-6-6-4 o the Blue Ridge east of Roanoke. Suffice to say for me it was a gratifying read because I found so many of my own tripod holes. At $37 it's a steal.

The RailTrends conference returns to NYC October 6-7. Sponsored by *Progressive Railroading* magazine and now in its fifth year, the conference continues to provide industry executives a comprehensive overview of the railroad industry as well as detailed, critical insight on leasing and finance from industry experts, analysts and investors. As a special treat this year, CN's outgoing CEO Hunter Harrison will be on tap to receive his award as *Progressive Railroading's* "Railroad Innovator of he Year."

Once again the event will take place at the Affinia Hotel on Seventh Avenue in NYC, a block down from Amtrak's Penn Station. And of course my good friend Tony Hatch will preside and moderate as usual. See you there.

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