THE RAILROAD WEEK IN REVIEW

May 7, 2010

"We are optimistic that 2010 will mark our return to positive full-year carload growth for the first time since 2006." John Giles, President and CEO, RailAmerica

RailAmerica freight revenue for the first quarter 2010 increased 14 percent year-over-year to $93 million on 5 percent more revenue units. Grains, metals, ores, waste and automotive revenues were up double-digits while the volume leaders were grains, ores-metals and chemicals. System revenue per unit increased 8 percent. Other revenues (ancillary services, etc.) increased 14 percent bringing total RA sales to $113 million, up 14 percent over 2009's first quarter and 7 percent over the preceding quarter. Units were up 2 percent sequentially.

Operating expense increased 19 percent to $94 million for an operating ratio of 83.4, a dip of four points. Operating income slipped 8 percent to $19 million as a result. However, to be fair it must be noted that without the $4 million 45G tax credit a year ago the current quarter ops expense was up 13 percent, the operating ratio was 83.5 and operating income was $17 million, meaning that apples-to-apples operating income was actually up 15 percent for the present quarter. Sequentially, the operating ratio came down 3.2 points.

I have long felt --at least since Giles & Co. came to town -- that RA is a work in progress. The $4 million tax credit hit taken until Congress gets its act together is hardly reflective of RA management practices. The 25 percent increase in shares is a function of the reorganization and hardly an indicator of weakness, as is the $3.6 million non-cash charge for interest rate swap termination costs. Better we zero in on railroad operating results.

As noted above, total sales grew 14 percent or $13.5 million, two-thirds of which came from mix, price and foreign exchange and a slightly less than a third from volume. This is good. If you compare what's happening now with the pre-Fortress RailAmerica financials, the trend is firmly toward higher RPU, lower per-unit operating expense, and an operating ratio closer to 80 than to 100. I see no reason why the trend should not continue into the second quarter and beyond.

Genesee & Wyoming checked in with first quarter 2010 total sales up 5 percent to $146 million vs. the 2009 first quarter. "Non-freight" sales -- port switching, certain short lines, etc. -- increased 13 percent, masking the 3.5 percent carload revenue gain and the 9.4 percent slippage in coal revenues. The appreciation of the Canadian and Australian dollars skewed year-over-year results and inflated freight revenues by $4 million; non-freight sales were similarly skewed and in the same amount.

Shortline revenue units including Australia declined 5.6 percent with negative deltas everywhere but automotive. Double-digit decreases in volume were seen in paper and coal; revenue per unit increased 6.4 percent. Operating expense was held nicely in check, up 2.8 percent, propelling operating income up 15.3 percent and knocking the operating ratio down two points to 79.3, a first-quarter record. Below the line net income was up 14.3 percent to $16 million.

The question of acquisitions always comes up during the GWR conference calls and this trip was no exception. The answer was not a bit surprising. Said CEO Jack Hellmann, the focus is more on leveraging GWR's operating expertise than on acquiring assets. That's one reason "non-freight" sales are growing faster than traditional carload revenues and why we see "natural resource" arrangements like the Labrador iron mines.

Moreover, you get better ROICs on equipment than you do on infrastructure. As I have written before (and in the lead to my June 2010 *Trains* feature on GWR), this is a financial company that just happens to be in the railroad business. The basic tenet of their "Genesee Value Added" approach is to nail down the expected ROI on any investment before they spend a nickel. If it doesn't meet the target internal rate of return the money stays in the bank.

Continuing Hellmann's mantra that good safety performance is good for the bottom line, GWR posted an injury record through March of 0.64 reportable injuries per 200,000 hours worked. The lowest rate for the period prior to the GWR number was CSX at 0.77, beating even NS. The Class I average is 1.50, regionals are at 2.7 and the Class IIIs (short lines and switch carriers) are still hurting people at a rate of 3.3 injuries per 200,000 hours.

After the call I phoned Jack and asked him how they do it. He said simply, "Focus." Employees come to work with safety forefront in their minds. There is no difference in safety ratios between North America and Australia, though injury rates tend to be higher in new acquisitions where that focus is missing. Hellmann adds, "Attention to safety leads to attention to operating details and that leads to lower-cost operations." He's right, and the 266 basis-point spread between GWR and the rest of the Class IIIs is inexcusable. Leadership counts.

As is my usual practice, I've put a summary chart comparing the first quarter results of all the Class Is at the end of this note following the disclaimer. There are a lot of empty spaces in the BNSF column. That's because BNSF has ceased to be a publicly-traded company so there are no financial reports for the analyst community to feed on. But there *is* carload data, and that's more important to short lines connecting with BNSF than earnings per share and all that.

Moreover, since I'm using AAR data, I get better detail on industrial commodity car-counts than before. What I'm calling merchandise carloads includes what BNSF puts under industrial products, agriculture and automotive. First quarter 2010 merchandise carload commodities were up 11 percent year-over-year. Industrial products were up 9 percent: chemicals up 12 percent, forest products up 2 percent, metallic ores & minerals up 18 percent, non-metallics up 4 percent. Ag rose 13 percent and auto 24 percent.

Outside the merch group coal was off 8 percent and intermodal slipped 3 percent, putting total revenue units off 0.8 percent year-over-year. Go to the railroad comp chart following the disclaimer and note the BNSF merch carload group had the poorest showing of the lot, just behind CSX and 4.7 percentage points behind arch-rival UP. As for total revenue units, BNSF fared less well than anybody else, trailing next-to-last CSX by nearly four full points.

Fellow rail-watcher and pundit Don Phillips hied himself to the Berkshire Hathaway meeting last week. He writes in part, “During Saturday’s Q&A there was just one question about freight railroads throughout the hours of questions from dozens of shareholders. It was as if Warren Buffett's $44 billion purchase of BNSF Railway, by far his largest holding, either satisfied investors or mystified them — perhaps both.

“Then, at Sunday's two-and-a-half-hour press conference, there was also only one question about rail — from me. Warren Buffett and partner Charlie Munger gave what I considered a significant and surprising answer, but no other reporter seemed to understand how significant. Even after Buffett's largest purchase, reporters seem mystified that freight railroads are anything more than an old smokestack industry that somehow continues to survive.”

Don asked whether Berkshire Hathaway would “oppose any future major railroad mergers on the grounds that months or years of turmoil would be likely as two vastly different cultures clashed. The answer boiled down to: no, railroad management is different today, and neither man saw any particular problem with a new round of mergers that would consolidate the big-four U.S. railroads into two giant systems.

“Answering the other half of the question, Buffett and Munger said that the future success of railroads does not depend on any problems in the trucking industry or a failure to spend enough money on highways. Buffett added that rails are not dependent on a crumbling highway system and they will be successful for a number of solid reasons including the growth of the economy.

“As Buffett has said in the past, railroad deregulation and a new cadre of rail management have made railroads a smart investment, and he regrets he didn't see that three years earlier. Munger agreed that he should have seen the possibilities much sooner. Munger appeared even more enthusiastic about rail than Buffett.” Thanks, Don.

Shortline Tidbits. The *Yadkin Valley Railroad,* a unit of the Gulf & Ohio Railroad family of shortlines, has teamed up with the North Carolina Department of Transportation Rail Division to install the state’s first solar-powered highway-rail grade crossing warning system. Consisting of the usual lights and bells, this system uses solar panels to charge the batteries. The solar array has a back-up generator for emergency use. Kudos to the YVRR are in order.

The *New York & Atlantic Railway Co*. (NYA) recently obtained a federal grant to install equipment designed to reduce its locomotive emissions by more than one-third. The equipment will reduce engine idling for NYA’s 11-unit locomotive fleet and reduce the railroad’s carbon footprint by 35 percent, the short line estimates.The USDOT's Congestion Mitigation and Air Quality (CMAQ) program provided funding for the $1 million project. The grant culminates a three-year effort by the short line to improve air quality on its 269-mile line, which serves much of Long Island. NYA is the second Anacostia & Pacific short line to "go green,"following the lead of sister short line Pacific Harbor Lines.

Florida East Coast may join the ranks of passenger-hosting regional railroads if Amtrak and Florida Governor Charlie Crist have their way. FEC and Amtrak hosted an inspection train over the entire 326 miles of its Miami to Jacksonville main line. Later this year, the Florida

Department of Transportation (FDOT) will apply to the FRA for funding under the new Passenger Rail Investment and Improvement Act (PRIIA). Federal funding will require a local/ state match of 20 percent of the project's estimated cost of $268 million.

Infrastructure improvements include the construction of eight new stations, a new connection between FEC and the South Florida Rail corridor in Palm Beach County, and several long passing sidings. Restoring this service brings back memories of the PRR-ACL-FEC "Champion" series of streamliners between NYC and Florida points.

Today's three Amtrak Florida train pairs use the former Seaboard Air Line Railroad routes (now CSX) in the middle of the state to reach Tampa and Miami, only hitting the Atlantic Coast at West Palm Beach. Bringing back these trains (missing since the 1960s) would make Henry Flagler proud.

What-others-are-saying Department: The *Morgan Stanley Truckload Freight Index* "continues to show strong trends with both improving incremental demand and supply. Current index readings are similar to April 2005 readings. Flatbed is particularly strong with index readings at record levels."

Dalhman Rose & Company's Jason Seidl writes in his First Quarter Summary, " The railroads delivered generally better-than-expected 1Q10 results, setting the tone for what appears to be a somewhat faster, more robust recovery in 2010 than initially thought. Most railroads beat consensus expectations on both top and bottom lines. Pricing, which we believe has reached bottom and is likely to begin rebounding, was not as strong as some may have hoped."

Larry Kaufman's "Rail Trends" column in *Argus Rail Business* for May 3 is instructive: "Putting the superior financial performance in perspective, traffic may have topped 2009, but it still hasn't reached levels seen in 2007 and 2008. The Association of American Railroads, which releases weekly traffic data, continues to provide 2008 data as well as that for 2009, just so those who read the numbers won't be mislead into believing that railroads have fully recovered from the recession when they have not." [*It gets even starker if you go back to 2006. rhb*]

I have the full reports. Let me know if you'd like to dig deeper.

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Class I Commodity Carload Comps
Quarter ending **3/31/10**
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)		$ 1,965	$ 1,167	$ 2,491	$ 436	$ 2,238	$ 3,965
YOY Pct. Change		**5.7%**	**5.2%**	**10.9%**	**26.1%**	**15.2%**	**16.1%**
Revenue Units (000)	2,150	1,108	625	1,486	443	1,583	2,082
YOY Pct. Change	**-0.8%**	**16.1%**	***8.5%***	**4.7%**	**15.4%**	**8.7%**	**12.7%**
RTMs		44,080	30,203	54,300	11,277	43,300	126,803
YOY Pct. Change		**13.9%**	***16.5%***	**2.3%**	**14.1%**	**9.6%**	**7.1%**
Carload revs (2)		$ 1,305	$ 715	$ 1,368	$ 317	$ 1,199	$ 2,220
YOY Pct. Change		**2.4%**	**7.3%**	**16.9%**	**27.7%**	**23.0%**	**18.0%**
System RPU Pct Chg.		**-9.2%**	**-2.5%**	**5.9%**	**11.2%**	**5.9%**	**2.8%**
Pct carload		66.4%	62.9%	54.9%	72.7%	53.6%	56.0%
Pct Intermodal		17.9%	27.4%	13.0%	9.8%	18.3%	17.4%
Pct Coal		5.5%	9.7%	29.5%	13.5%	28.1%	21.3%
Mdse Carloads (000)	598	672	300	613	221	542	824
YOY Pct. Change	**11.2%**	**17.5%**	**14.9%**	**11.9%**	**13.5%**	**15.8%**	**15.9%**
Rev/CL x coal, IM		$ 1,942	$ 2,381	$ 2,232	$ 1,437	$ 2,212	$ 2,694
YOY Pct. Change		-12.8%	-6.6%	4.5%	12.4%	6.2%	1.8%
Operating Expense		$ 1,362	$ 962	$ 1,857	$ 328	$ 1,683	$ 2,977
YOY Pct. Change		**-1.2%**	**-1.6%**	**7.7%**	**10.0%**	**7.9%**	**8.5%**
RR Operating Income		$ 603	$ 205	$ 634	$ 108	$ 555	$ 988
YOY Pct. Change		**25.4%**	**55.1%**	**21.5%**	**127.3%**	**44.9%**	**47.2%**
RR Operating Ratio		**69.3%**	**82.4%**	**74.5%**	**75.2%**	**75.2%**	**75.1%**
YOY Point change		**(4.81)**	**(5.66)**	**(2.22)**	**(11.04)**	**(5.09)**	**(5.27)**

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal
Source: company financials
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