THE RAILROAD WEEK IN REVIEW

June 11, 2010

"A massive 'second wave' of adjustable rate mortgages is scheduled to reset over the next two to three years. If this second wave is anything like the first wave, the U.S. housing market is about to be absolutely crushed. -- http://theeconomiccollapseblog.com

"If you thought deficits and unemployment have been bad lately, you ain't seen nothing yet." -- Arthur Laffer, "Tax Hikes and the 2011 Economic Collapse," WSJ, June 6, 2010

I drove around central Connecticut on Tuesday with a railfan/investor buddy of mine looking at what's left of the state's industrial heartland. It wasn't pretty. Waterbury, once big in brass, with industry tracks everywhere, is now a railroad ghost town. Plainville, once the junction of two busy NH branches, is now a Pan Am Rail outpost with an Amerigas rack (several tank cars) and not much else. New Britain, home of Stanley Tools -- another railroad ghost town. Middletown, where the original "Air Line" route between New Haven and Boston crossed the River Line between Hartford and Old Saybrook, same thing; Providence & Worcester has the honors.

The bottom end of the Danbury branch around Norwalk was once teeming with rail-served industry. No more, but the traces are there -- we found a railhead poking through the dirt at the edge of a boat yard, for example. All the industry I remember seeing as a kid who regularly rode the New Haven to New York -- gone. All that remains is one lumber dealer near Darien and another in the Bronx on the Harlem Div that CSX serves by coming around the Mott Haven wye with its Hudson-Division crew. How long can that continue?

Now put this in the context of the most recent AAR "Rail Time Indicators" for May 2010 compared not only with 2009 but also with 2008. Petroleum products (natural gas included) are down 9.2 percent 2010 vs. 2008, lumber and wood products down 30.8 percent in the two years, metal products down 21.3 percent, aggregates down 9.5 percent.

To help keep all this in perspective, I maintain a running six-quarter review of Class I carloads and use the 2007 third quarter as my base. Through the first quarter of 2010 total Class I (the Big Six plus KCS) loads are down 15.4 percent. And we know there's been a great shift in mix as gains in domestic intermodal and energy-related commodities offset losses in paper, lumber and building materials. How bad is it for those single-carload commodities?

Compare RMI's RailConnect Index for year-to-date carloads at the end of May 2005-2010. The table following the disclaimer tells us the four commodity groups represented by what we saw (or did not see) in Connecticut peaked in 2006-7 and, with the exception of the aggregates group, had not recovered their 2005 levels through the end of last month.

As Deborah Hewett of the William & Mary Mason School of Business said on an economic panel in December, "Recovery is not return." That is to say, getting back on our economic feet

does not mean going back to “the way we were.” If Connecticut is any indication, there will never be a return as the recovery takes place elsewhere. And it may not mean as much work for the railroads in that state.

On the other hand, look at what’s happened in central Pennsylvania thanks to the Marcellus shale activity. Yards like Pittston (Reading & Northern) and Williamsport (Lycoming Valley) are once again beehives of activity. The Wellsboro & Corning has gone from annual carloads measured by the handful to carload volumes being measured in the thousands.

Thus one state’s loss of carload volume is offset by another’s gain. Net-net, the totals are improving. But for places like central Connecticut, what’s gone is gone and the likelihood of its ever coming back is slim to none. Thus the recovery on the national scale is anything but a return for places like Waterbury. Thanks for making the distinction, Professor Hewett.

Genesee & Wyoming has signed an agreement to acquire the assets of Australia’s FreightLink, owner and operator of the 1,400-mile Tarcoola to Darwin railroad, linking the Port of Darwin to the Australian interstate rail network in South Australia. The rail line is located on land leased to FreightLink by the AustralAsia Railway Corporation under a concession agreement that terminates in 2054.

FreightLink commenced operations in 2004, following the A$1.2 billion construction of the Alice Springs to Darwin portion of the rail line, and has been in receivership since November 2008. The purchase price is A$334 million plus assumption of A$1.7 in debt. First year operating income will be in the neighborhood of A$34 million, roughly ten percent of the purchase price. If GWR’s internal hurdle is a ten-year payback under its Genesee Value Added discipline (see my GWR story in *Trains* for June, 2010) then this transaction surely fits the mold.

FreightLink is both a provider of rail haulage to customers on its railroad, “above-rail services,” as well as a track owner, charging access fees to any rail operators that run on its track subject to a certified state-based access regime, under Australia’s National Access Regime, “below-rail services.” FreightLink’s above-rail business currently handles approximately 60,000 carloads per year using 23 locomotives and 430 railcars.

Its business is divided into two main components: general freight and bulk minerals. General freight is primarily composed of long-haul, domestic intermodal traffic to the Northern Territory. The bulk minerals category primarily serves customers in the mining industry who ship iron ore, copper and manganese. These mining customers use FreightLink’s rail infrastructure to export minerals to Asia, mainly through the Port of Darwin and the Port of Adelaide. For the 12 months ended December 31, 2009, FreightLink’s revenues were composed of general freight (62%), bulk minerals (33%), and other revenues (5%).

FreightLink will be operated as part of GWR’s Australia Region, Genesee & Wyoming Australia (GWA), which has managed FreightLink’s above-rail services since its inception in 2004 and currently provides the majority of its crews, manages its train operations and also leases locomotives and wagons to FreightLink. Given the operational overlap, GWR anticipates significant cost and capital efficiencies from combining FreightLink’s operations with GWA. For

the 12 months ended March 31, 2010, GWA, not including the impact of the FreightLink acquisition, generated US$101.7 million of revenues.

The acquisition makes good sense as it's a natural extension of GWR's existing rail business in South Australia. GWR expects its Australian operations to become an A$275 million (US$228 million) revenue company with the operating expertise, safety record and financial strength to serve new customers in central Australia and beyond.

Says GWR President and CEO Jack Hellmann, "While FreightLink is in receivership due to its original financial structure, the railroad is a high quality asset that is of great importance to the development of the mining industry in the Northern Territory and South Australia as well as a vital transportation link in the Adelaide to Darwin corridor. We believe that the rail line will continue to be a catalyst for unlocking major new mining projects that were not economically feasible without it. As countries such as China and India continue their long term trajectory of industrialization, we expect to see direct benefits to the FreightLink minerals franchise, and we look forward to investing in the rail infrastructure for the long term."

JP Morgan rail analyst Tom Wadewitz writes, "Based on GWR's forecasts, the purchase price implies a 5.3x EV/EBITDA valuation, which we view as attractive. We believe GWR's forecast of US$29 mm (A$35 mm) in operating income in the first 12 months is achievable because they already operate on the FreightLink property; projections imply an OR of ~75, which is better than our 79 forecast for GWR's overall operating ratio in 2010."

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe click on the Week in Review tab at www.rblanchard.com. A publication of the Blanchard Company, ***© 2010.*** ***Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned in WIR. Specifics available on e-mail request.***

Short Line Commodities	YTD thru May					
	2005	2006	2007	2008	2009	2010
Aggregates	164,927	177,577	224,123	256,110	208,821	225,780
Lumber & FP	121,679	123,942	136,672	100,662	72,994	77,280
Petrol, Coke	107,858	110,460	120,415	122,270	76,768	101,530
Mets & Prods	220,419	231,058	243,881	234,921	124,603	168,847
	2010 vs					
Aggregates	36.9%	27.1%	0.7%	-11.8%	8.1%	0.0%
Lumber & FP	-36.5%	-37.6%	-43.5%	-23.2%	5.9%	0.0%
Petrol, Coke	-5.9%	-8.1%	-15.7%	-17.0%	32.3%	0.0%
Mets & Prods	-23.4%	-26.9%	-30.8%	-28.1%	35.5%	0.0%