THE RAILROAD WEEK IN REVIEW

May 4, 2012

"We expect improving business trends for the remainder of 2012 in North America." -- Jack Hellman, President, Genesee & Wyoming

Genesee & Wyoming's newly formed subsidiary, the Columbus & Chattahoochee Railroad, Inc. (CCR), has signed an agreement with Norfolk Southern to lease and operate a 26-mile segment of NS track that runs from Girard, Alabama, to Mahrt, Alabama. The CCR will interchange with NS in Columbus, Georgia, where GWR's Georgia Southwestern Railroad also has operations.

The CCR expects to commence operations on the leased line in July 2012 with 17 employees and six locomotives. The CCR anticipates handling approximately 17,000 carloads per year, consisting primarily of coated paperboard-related traffic as well as other general merchandise shipments. The CCR will be operated as part of the GWR Southern Region under the leadership of Gerry Gates. The map above places the CCR and adjacent GWR properties and shows clearly how the GWR "contiguous railroad" acquisition strategy works and why it's a boon for producing significant incremental margins.

The investing website www.seekingalpha.com can generally be counted on for a refreshing view or two about our favorite industry from observers who have little formal connection with trains or tracks. On Monday contributor "Traders Huddle" wrote about how shares of truckers and railroads often seem to move in lockstep because both are transporters of goods between raw goods suppliers and manufacturers and manufacturers and their customers.

The writer cites the rail advantage in an era of elevated fuel prices thanks to the rails' fuel efficiency and the labor intensity of a two-man crew hauling nearly 300 boxes on one train. However, two trucking companies have confounded conventional wisdom with significant share price surges: Old Dominion (ODFL) and J.B. Hunt (JBHT).

> Old Dominion has outperformed, by fair margins, Union Pacific, Norfolk Southern and CSX. J.B. Hunt has outpaced the railroad firms by such an impressive distance that the year-to-date returns offered by CSX, Union Pacific and Kansas City Southern would have to be combined to exceed what Hunt has delivered on its own. [*Of course, the rails helped Hunt. See adjacent photo taken on the NS (ex-PRR) Middle Division at Lilly, Penna. -- rhb*]

> Unfortunately, the tide may be turning against the truckers. Diesel, the number one source of fuel for trucking firms, is steadily rising in price. Shares of J.B. Hunt, Old Dominion and some of their rivals are now viewed as overvalued. The combination of a macroeconomic flaw (rising fuel prices) and rich valuations could make trucking stocks a favorite target of short-sellers. Actually, some professional traders could short the truckers and go long the railroad operators as a hedge.

> Yes, the trucking firms have provided nice returns this year, but until all trucks are able to run on natural gas, railroad operators will be the superior long-term bet. Along those lines, as a group, railroad firms are better dividend payers than truckers, doubling the allure for patient investors. [*Disclosure: I am long NSC and UNP. -- rhb*]

Genesee & Wyoming rounded out the 2012 first quarter railroad earnings season Monday with $207.4 million in consolidated revenues from North America, Europe and Australia, up 8.1 percent year-over-year, and operating income of $41.3 million, up 5.4 percent. North America and Europe (Rotterdam and Belgium) provided 69.5 percent of sales and 75.8 percent of operating income. Below the line, GWR reported net income of $22.2 million and 52 cents in earnings-per share, essentially unchanged year-over-year.

However, one must adjust reported EPS for last year's nickel a share in 45G tax credits (none this year) and add eight cents a share this year related to the Edith River bridge closure in Australia, bringing EPS comps to 60 cents for this year vs. 47 cents last for an adjusted gain of 27.7 percent. GWR reported consolidated operating ratios of 80.1 this year against 79.6 last year, a 50 basis-point degradation. But the personal injury ratio improved to 0.6 injuries per 200,000 hours worked, second only to the 0.5 Jan-only number for NS and well-ahead of the sorry 2.0 to 2.9 ratios for the shortline industry as a whole.

North America/Europe revenues increased 8.9 percent to $144.1 million on $102.1 million in freight revenues, up 12.5 percent, and $42.0 million for the non-freight sector, up 1.1 percent (29.2 percent of revenue, down from 31.4 percent of revenues a year ago). Operating expense was up just 7.0 percent; operating income gained 16.3 percent year-over-year. Total revenue units dropped 10.3 percent on a whopping 41.0 percent dive in coal plus another 41.6 percent hit in "other," mainly NS overhead coal in Ohio. On the call GWR cited the usual suspects of customer-specific changes, the warm weather, low-priced nat gas and shifts in export coal patterns.

Double-digit carload gains in aggregates (15.1 percent), metals (18.3 percent), farm & food (12.5 percent) and chemicals (18.8 percent) ameliorated the disastrous coal and "other" declines. Moreover, RPU in each of these commodity groups ranges from $445 to $729 vs $348 for coal. Consequently, system RPU increased 25.4 percent to a very respectable $586 per unit.

Wrapping up the call, CEO Jack Hellman said, "We expect improving business trends for the remainder of 2012 in North America. Our non-coal traffic continues to grow and our newly acquired Arizona Eastern Railway and Hilton & Albany Railroad are performing well. Although our U.S. coal traffic is weak, we expect some improvement in the second quarter as shipments resume at two power plants. The fact that our North American & European Operations operating ratio improved 1.3 percentage points to 78.3 in the first quarter of 2012 despite the decline in our coal traffic also means that we are well positioned to benefit from any future improvement in shipments." Can't argue with that.

The Lumber and Forest Products commodity group is regaining strength, according to the RMI's weekly RailConnect Index of shortline carloadings. The 2007 year-to-date number at the end of March was just over 80,000 units, the same number as recorded as of April 21, 2012. As to individual short lines, your numbers may vary according to where you are.

The Wall Street Journal on Monday and Tuesday ran a pair of stories on the housing recovery -- or lack thereof. On Monday,

> Markets that are more quickly absorbing the stock of foreclosures amid an improving economy, such as Phoenix, and in those where the overhang wasn't as severe, such as Denver and Washington, D.C., have probably hit bottom. Others face a longer haul, particularly in overbuilt cities such as Atlanta and Las Vegas. Many cities in Florida and the Northeast, where banks have been unable to satisfy court-administered foreclosure processes, have a glut of foreclosures that has yet to be digested.

And on Tuesday,

> The homeownership rate fell in the first quarter to the lowest level in 15 years as more Americans lost homes to foreclosure and shifted to renting amid the weak economic recovery.The homeownership rate fell in the first quarter to the lowest level in 15 years as more Americans lost homes to foreclosure and shifted to renting amid the weak economic recovery.
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> Economists say the rate could slip further. While low mortgage-interest rates and falling home prices have made homes more affordable than at any time in the past decade, mortgage-lending standards remain tight. Also, more Americans may feel less confident about property ownership after the steep price declines of the past six years.

In other words, short lines would be well-served tracking any changes in Class I lumber (esp STCC 24 211) vols into their service areas by origins, carloads and revenue per carload in each lane. Take the WSJ mention of Phoenix, for instance. In 2010 -- a pretty good year for recovering short lines -- the three top origins for lumber into Phoenix were British Columbia, Portland and Eugene (Ore.) in center-beams at 100+ tons per car.

I'm using 2010 as a base year and am looking at some 2,400 units priced in the range of $7-9,000 per car. If I'm a Phoenix area short line, and I'm seeing the glimmerings of an uptick in lumber loadings, I'd like to know where I might best set my division. Since the average $8,000 price tag represents a Class I revenue to variable cost ratio approaching two, perhaps there's room for discussion.