RAILROAD WEEK IN REVIEW
FEBRUARY 16, 2007

"The best investment decisions are made by rationally analyzing the facts rather than watching what others are doing." – Morningstar ad in Barron's

Genesee & Wyoming (NYSE: GWR) reported a Q4 net income gain of 34% yoy and a whopping 168% for the year. Revenues were up 20% or $21 mm to $124 mm for the Q. The AUS acquisition accounted for some $20 mm, with the balance same-railroad revenue growth in the U.S. and Canada partially offset by a revenue decrease of $0.9 mm in Mexico. U.S. and Canada non-freight revenues increased $2.3 mm primarily due to higher Rail Link revenue from new industrial switching contracts, higher rates and volumes at its port railroads.

Full year revs increased 24% to $479 mm but operating income dropped 38%. On the surface it doesn't make sense, but drill down and see that GWR had to take above-the-line operating credits and charges for assets that changed hands in Australia. A $33 mm charge pushed full-year ops expense up 38% yoy and kicked the reported OR to 90.9 from 81.6 yoy. Back out these items and the adjusted OR – a far better measure of what's really happening -- becomes a more respectable 84.0 for the year and a somewhat high 87.9 for the quarter. I suspect this is largely AUS teething pains like what we've seen as KCS brought the Mex ops to heel.

The cloudy comps put GWR in a difficult situation. Last year at this time they reported their North American rail operations above the line and the Australia results below the line as "equity income" from their WestRail partnership. They dissolved that partnership in mid-2007 (see WIR 7/21/2006) and started reporting "consolidated" results. Consequently the quarterly and full-year comps look a bit odd, with high-double-digit comps in those commodities that came with the AUS deal – farm & food, minerals & stone, and "other" to name three.

In his remarks during the call CEO Mort Fuller said, "Given our strong operating cash flow [$83 mm of which $63 mm went for capex], we plan to continue an active acquisition program and are currently pursuing a number of international and domestic opportunities." I'll say. LTD stands at $245 mm and there's $240 mm of cash in the till. The 12x multiple Fortress coughed up for RRA is bound to up the antes of potential sales. But GWR has a record of paying top multiples and using its contiguous shortline model to reduce the effective multiple by a couple of points at least. Stay tuned.

Continuing the ISA thread, I noted last week that CSXT's ISA Measurement Tool is "first out of the box with something that actually works". Actually, it looks very much like the ISA measurement tool that NS has had in place for some time (WIR 6/10/2005). However, NS has yet to make shortline interchanges part of LOPA whereas CSX has begun the process of making shortline interchanges part of its Industrial Switching Excellence program that measures "the percentage of cars that were switched at industry or interchange according to plan" (WIR 5/3/2003).

Both roads are to be complimented for taking an aggressive stance with ISAs if only because it puts the onus on both parties to comply with the ISAs thus minimizing dwell and keeping the assets moving. However, it still seems there are too many short lines that are not playing the game. Until 100% of short lines are using the ISA tools offered by both roads *all* short lines will be at a disadvantage as being perceived as aloof from the national network. Recall they guy who nearly lost his frozen foods business because nobody could see his interchange. Loads would sit for a week because there was no interchange performance measurement.

Watco and the Washington State Department of Transportation have signed an MOU for the latter to purchase 109 route-miles from Watco's Palouse River & Coulee City Railroad (PCC). The line being sold runs from Coulee City to Cheney. For many years after its startup in 1992, the PCC was profitable, hauling 10,000 carloads of grain, lumber and agricultural products annually. In 2001, the economic climate changed taking most of the business elsewhere.

At that point PCC approached Wash-DOT looking for a solution with the upshot that the latter offered a pubic-private partnership to buy this and two other PCC lines that were also in trouble. Three years later Wash-DOT took the other two lines, leaving the Coulee City-Cheney line in under PCC control. Now, after another three years, we have an MOU under which Watco will run the line through May after which Wash-DOT will look for somebody else to run it.

RailAmerica disappeared from the stock tables this week following its acquisition by "certain private equity funds managed by affiliates of Fortress Investment Group LLC." RRA shareholders will get $16.35 in cash per share held. Holders with physical stock certificates will receive instructions on how and where to forward their certificates for payment. Holders using a "street name" under a broker, bank or other nominee will not need to take any action to have shares converted into cash, as this will be done automatically by the street name.

The $16.35 represents a healthy premium over what RRA had been trading for, in a range between $9 and $13 for some years. That represented an ebitda multiple considerably below the 12x of the Fortress deal (WIR 12/1/2006), though it bodes well for future sellers looking for premiums over the 6-8x typically assigned short lines.

Speaking of multiples, try this one: Cramer noted Tues night that American Standard is spinning off its plumbing division. Home Depot is looking for a buyer for its building and supply division. Lamson and Sessions is in the electrical supply business and trades for ten times trailing earnings. What a great triple-play for a hedge fund that wants to get into supplying the KB Homes and DR Hortons of the world. What's this got to do with short lines? Just this:

Apply the same triple-play concept to three separate but contiguous short line railroads under three different ownerships. Run some sample commodity OD pairs with Mike and Ike's usraildesktop.com and see what's possible. Take the aggressive multiple theme from the RRA-Fortress deal and offer the owners a nice premium to go away and *voila!* a new regional railroad.

Forbes reports that "Rail freight growth is moving faster than Casey Jones' last ride." The recent on-line piece notes that FreightCar America (RAIL) increased 2006 production by 39% yoy, most of which was from OT Hoppers for coal service. NS is a big buyer as are a number of utilities. The stock trades at ten-times trailing earnings, but it may be getting ahead of itself.

First Call's consensus has earnings actually decreasing in 2007 and 2008 and the PEs are increasing accordingly. At $54 RAIL trades at 12x and 15x 2007 and 2008 estimates respectively. Accordingly we're looking at a five-year PEG ratio of 3.9, twice my PEG limit. ARII, the tank-car king, TRN and GBX (which I just sold after hitting my short-squeeze target) look better with reasonable forward PEs and PEGs under two.

Meanwhile, Bear Stearn's Peter Nesvold raised ARII to Outperform, saying it's "time to back up the train." He writes, "We see an improving hopper mix starting in 1Q:07, a doubling of tank car capacity by 2008 and $80mn of capex initiatives in 2007. ARII has a two-year backlog that's holding substantially better than the industry average due to ARII's leverage to the ag and ethanol cycle. We expect ethanol production to increase to 10 bn gallons by 2010 from 5.6 bn and every billion gallons of incremental ethanol requires an incremental 4k tank cars (~25% of industry capacity)."

My revenue vs. contribution thread (WIR 2/9/2007) is getting noticed. Warren Wilson, Senior Director for Rail Line Planning at UP, writes, "Curious about your statement that only two roads measure contribution. As someone just pointed out to me, UP has been doing this for 26 years. I would frankly be quite surprised to hear there is a Class 1 that does not measure, and grade, on contribution - but of course I don't know. I can tell you folks around here do get graded on contribution. Nobody gets promoted for selling dollar bills for a dollar."

Thanks, Warren. I can only tell categorically that a railroad is more interested in measuring contribution than dollars when I get notes such as yours or have chats as I did last week with Art Shoener of KCS. Most often the indication that revenue counts more becomes apparent when a line is up for shortlining. The ops guys are for it because it gives them back power and crews for core ops and spares capex dollars for core route congestion relief. But the market managers hate it because it takes revenue dollars away from them. Who wins this argument depends on whether contribution trumps revenue in the head office.

Another angle comes from a short line operator who has annual carloads well into five figures and knows both sides of the street: "The Class I fixation on contribution can, if one is not careful, decimate a short line's carload business with them. Costing models are not perfect by any means, though inflexibility on specific movements can de-market decent profit margin business.

"Moreover, it can feed on itself and create a nasty downward spiral. If volumes are soft for a given car type then the cost-model output for that car type goes up constraining contribution and causing those cars to be ripe for further de-marketing. This is still a high fixed-cost business and while we never want to go back to the "make it up in volume" days, blind worship of costing models is not the answer either."

Well said. Reminds me of the Class I car management director who told a short-line group that they were getting terrible turn times on Plate C box cars and so were demarketing those lanes. Later in the same presentation he noted that these cars spend a third of their time in class yards *on their railroad*. As it happens, short line customers were crying for the car type and some operators were even considering leasing equipment to capture the traffic. Bottom line: the Class I was long the car type but because of dwell thought it was losing money on the car type so business went begging. Sheesh.

Florida East Coast Industries (NYSE: FLA), parent company of the FEC Railroad, reported earnings for the quarter and year Thursday. Look for my summary and remarks here next week.

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