RAILROAD WEEK IN REVIEW
MAY 11, 2007

"Railroad boards and managements should quit looking in the rear-view mirror" – Snehal Amin, Partner, The Children's Investment Fund

Fortress is at is again, having "entered into a definitive merger agreement" with FEC parent Florida East Coast Industries (NYSE: FLA) The official word that Fortress is ponying up $84 a share (13% above Monday's close of $74) came Tuesday just as the Bear Stearns conference (below) was getting under way. The offering price represents a whopping 31% premium to the average closing price over the last 60 trading days. The total value of the transaction including FECI's existing debt is approximately $3.5 billion.

According to a press release, "The merger agreement was unanimously approved by FECI's Board of Directors. The closing of the transaction is subject to customary closing conditions, including receipt of regulatory approvals and the approval of the holders of a majority of the outstanding shares of FECI common stock. The parties presently anticipate consummating the transaction during the *third quarter of 2007* (emphasis added). Upon completion of the transaction, FECI will become a privately held company, and its common stock will no longer be publicly traded."

As for first quarter results, FLA reported total revs of $108 mm vs. $136 mm a year ago with the slippage due mainly to a decrease in land sales of $43.9 mm and a decline in railway revenue of $7.3 mm, partially offset by a $23.1 mm increase in revenues from Flagler's realty rental and services. Consolidated first quarter 2007 net income was $9 mm or $0.26 per diluted share, compared to $19 mm or $0.57 per diluted share (which included $8.6 mm of after-tax profit from land sales) yoy.

Out on the FEC railroad, Q1 revs were off 11% to $59.8 mm from $67.1 mm yoy on a 10% drop in revenue units to 123,800 from 137,600 in 1Q06. Fuel surcharge revs dropped $300,000 to $5 mm as well. Carload shipments declined primarily as a result of softness in the residential construction market in Florida and reduced vehicle traffic. Aggregate revenues (FEC's main merch money-maker) for the quarter decreased 22%, construction materials fell 20% pushing carload revs down 16% on 21% lower volumes. Intermodal revs slid a mere 1% on a 2% volume drop though retail volume increased as a result of new customers added in 4Q06 and 1Q07.

Operating income declined 23% as reductions in comp and fuel partially offset the revenue declines, yet ops expense was down only 5%, creating a negative spread between revs and exp resulting in a four-point OR gain to 76, high for the FEC and certainly an aberration. Fuel surcharges collected dipped to $5 mm from $5.3 mm yoy as FEC moved away from forward hedging with more customers covered by the FSC program. Due to the yoy volume declines during Q1, FEC has initiated certain cost reduction initiatives that are anticipated to result in $4.2 mm of reduced costs for 2007. Such initiatives include, but are not limited to, staff reduction, a reduction of leased rail cars, modifications to the existing train schedule and reduced contract services.

Operating expenses decreased $2.7 mm to $45.5 mm in the first quarter 2007 compared to $48.2 mm in the first quarter 2006. As a result of reduced volumes, transportation labor decreased $0.6 mm. In addition, favorable variable compensation costs (stock compensation costs and bonus) of $1.1 mm further reduced compensation and benefits, which was offset by general wage increases and a severance payout of $0.4 mm, for an overall decrease of $1.3 mm. Fuel decreased $0.8 mm (Price increase - $0.3 mm; Volume decrease - $1.1 mm).

The detail found in the 10-Q is most instructive and it would behoove regional and shortline railroads of all stripes to find parallels with their operations. “Car hire is the net of rents received from foreign rail carriers while the Railway's owned/leased car fleet is on foreign lines offset by rents paid to foreign rail carriers while their fleet is on the Railway's line. Car hire (net) increased $0.3 mm due to the reduction of the Railway's 89 ft. intermodal flat car fleet and the removal of intermodal trash flat cars from service due to obsolescence. This was offset by the reduction of foreign rail cars and rail trailers used on the Railway's line.

“Other expense decreased $0.9 mm. This decrease is a result of a decrease in bad debt expense of $0.4 mm in the first quarter of 2007 versus the first quarter of 2006 and $0.4 mm of Hurricane Wilma related expenses (net of recoveries) included in the first quarter of 2006. The decrease in bad debt expense was primarily the result of the receipt of a bankruptcy payment in first quarter 2007.”

Bear Stearns held its Eighth Annual Transportation Conference in NYC on Tuesday and Wednesday. More than 1500 souls attended from BSC clients to interested parties to speakers. I brought home ten pages of hand-written notes plus reams of BSC research, hand-outs and annual reports. It’ll take months to get through it all, but here are some highlights.

The rail industry was well represented with all the Big Six Class Is plus KCS, GWR, and Watco presenting the rail story, with GBX, ARII, WAB and RAIL on the rail equipment side. There were also several airlines, name-brand truckers from ABFS to YRC, TPLPs like HUBG and CHRW, plus representatives of the UTU, the power companies, STB Commissioner Frank Mulvey, and a delegation from Brazil. The format was two days of three panels running simultaneously, each moderated by either BSC lead rail analyst Ed Wolfe or a member of his staff, each with two or three presenters limited to ten minutes and a Q&A period that worked out to roughly ten minutes per presenter. It was intense.

My focus was obviously on the rail side so I will confine my remarks to those presentations. It was fascinating to see how everybody approached the challenge of telling their investment story in ten minutes. Some told a financial story, others described their operating and commercial strengths, some offered a combination of both. Intermodal, coal and to a lesser extent grain got the bulk of attention; the merch biz (which, including ag and auto, makes up more than half the revenue base of all but BNSF) was barely mentioned.

The common threads were that capex continues at record levels, that pricing power remains in favor of the rails and that the rails are less cyclical and more secular thanks to record volumes of bulk and energy products. This is good news for short line operators like Ed Ellis who focus on “agriculture and extraction” and bad news for short lines with customer concentrations in construction materials ex-aggregates and forest products.

The shocker of the day was the keynote address from Snahal Amin, Partner at The Children’s Investment Fund, a $7-billion London-based private-equity firm (“elusive,” according to Wikepedia, with no website) with a significant holding in CSX shares. He opened by saying that RR boards and managements should “quit looking in the rear-view mirror” for volume and revenue growth and stop “being victims of group-think.”

He suggests that a new breed of activist shareholder is going to demand more of “indifferent” boards and management teams and is going to start looking for pricing practices that cover the cost of replacing the wasting asset as well as the avoidable costs of running trains. Closing the gap is “free capacity” and the western roads are closer to it than the western roads. CSX is better positioned than

NS to capitalize on the present positive trends for the rails. But, he warned, three years of rising rates is not going to erase the effects of 25 years of poor railroading absent some serious medicine – more aggressive rate hikes and less "subsidizing the customer," better cost control (why is there a 19-point spread between CN and CSX 2006 ops ratios?), increasing debt/EBITDA multiples to the 5+ range, and firing boards and managements that are not generating max returns with the assets at hand.

Later on some said his remarks were over the top but I found myself thinking there was considerable merit to what he said. Mind you, I'm not looking at the railroad from an analyst's viewpoint of eps as much as from an operating and commercial viewpoint. There is enough anecdotal evidence of operating goofs – missed interchanges, missed paths, not operating to plan, sloppy yard work, etc.— and commercial errors – not calling on the local customers, not pricing to cover costs, "market" pricing that drives high-yield business to truck – that pretty soon one concludes the rails are making money *in spite of* themselves maybe we really *do* need a new breed of activist shareholder.

Watco has purchased the operations of Millennium Rail, Inc. (MRI), a fully-integrated provider of railroad repair and maintenance services including fleet management, general repair and maintenance, specialty freight car manufacturing and program work. Its eight shops are located Pennsylvania, Iowa, Kansas, Texas, Louisiana and Illinois, further expanding Watco's corporate footprint. Of particular interest to Watco is MRI's capabilities in tank car repair to support the growth of the ethanol industry, as well as intermodal and ag covered hopper repair.

The acquisition is a logical one for Watco as car repair was one of its first lines of business, starting with a facility in Coffeyville, Kansas in 1985. Since then Watco has added car repair businesses in Pittsburg, Kansas (and Watco's home city), Jacksonville and Houston. (TX). "This is an acquisition that is a revenue growth platform," says Watco CEO Rick Webb. "Our intention is to improve the business in an orderly, yet aggressive manner. I would expect that we will be hiring additional people at each of the eight shops, making investments to handle the additional work and working with our Customers on a daily basis to meet their needs."

Speaking at the BSC conference Webb noted "the benefits pf staying private" over their 24-year history with revenue since 2003 running at a CAGR of 25%. "We're buyers, not sellers," says Webb, "and we think in decades, not years or quarters. We are disinclined to look off-shore because there's lots to do here." I'll say. WIR readers will recall my recurring too-many-shortlines theme and effective consolidators like Watco can do much to bring order the current chaos in ownership.

End notes: There was so much to cover at the BSC conference I'v ony scratched the surface here. Look for more in coming weeks….The sheer number of vendors' booths at the recent ASLRRA annual meeting is indicative of the intense level of interest in the shortline community. However, as I spoke with the folks in these booths it became clear that many do not really understand the shortline marketplace. Let me modestly suggest that WIR can help fill in the info gaps and help these vendors add significant value to their shortline offerings through a better understanding of who buys what.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $125. Corporate subscriptions $500 per year. A publication of the Blanchard Company, © 2007. Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned here.