RAILROAD WEEK IN REVIEW

NOVEMBER 30, 2007

"Building relationships is the key differentiator for Watco." -- Watco CEO Rick Webb

Watco held its 2007 Business Update meeting in Houston last week. Those of us who were not able to attend in person got to participate over a hot phone line, meaning we could ask questions at the moment just like those in the room, and we did. I thought they did a great job of telling their story, anticipating listeners' concerns and positioning Watco positive, up-beat way. Like CSX and CP (the best of show in analyst presentations, IMHO), Watco put the emphasis on what they're *going to do* and used what they *have done* as background and to set the stage.

There were lots of take-aways in terms of best practices for short lines. Without going into details with names and numbers, suffice to day that Watco has zeroed in on what they can do internally to improve margins and externally to improve returns. It's important to keep in mind that Watco's three "Foundation Principles" – Improve customer satisfaction, Improve profitability, Do both over the long term -- were very much in evidence throughout the day.

Perhaps the biggest change is Watco's shift to an Economic Value Added model that measures the expected and realized return from every initiative. Simply put, EVA is the net after-tax operating profit of the activity less an internal charge for the capital committed. In his presentation, Watco CEO Rick Webb put up half a dozen internal projects from tax-credit renewal to generating more revenue with no GS&A increase to reducing accounts receivable days outstanding. Then there were six external projects ranging from maximizing returns on the new Michgan Central JV with Norfolk Southern to expanding share in the car repair market. With out getting specific, suffice to say we're talking total EVA numbers comfortably into eight figures.

Terry Towner, President and COO, went into some detail on operations initiatives, the sorts of things that ought to be second-nature to short line owners but too often are not. Take locomotive leasing: you can lease power for less money down than writing a check for a new (used) one but, Terry asks, what's the NPV of lease terms vs. ownership? How much fuel is the right amount of fuel for a given loco on a given job; are all locos equally good at handling every assignment? What's the cost-benefit of more AEI readers in terms of people-productivity and accuracy of event-reporting?

And though Terry didn't make the specific link, it was clear to me that paying closer attention to details in the field makes for a safer operating environment. The percent change improvement in all metrics was well into double-digits 2007 vs 2006. As we've noted before, a safer railroad is a more efficient railroad if only because man-hours lost as well casualty and insurance expense are driven down. Paying attention to detail makes it happen.

CFO Rick Baden then walked us through the financials. The numbers made it clear than the EVA focus and operating efficiencies s are having the desired effect. Revenue and EBITDA are both up double-digits YTD 2006-2007 and revenues were up. If there were one quibble, it is that a revenue-unit count would have been helpful. We know from RMI's RailConnect Index that yoy shortline revenue units were off nearly 6% through 3Q07; how did Watco do in both total units and same-store units? Still, I think Team Watco did a marvelous job telling their story. I look forward to the next event when they tell us how much better they did than the projections presented here.

I've tried to get a handle on the foreign exchange matter as to how it affects short lines doing business with CP and how to compare yoy revenue figures. My interest is in tracking yoy changes in pure numbers -- revenues and revenue units. I'm not concerned with earnings for WIR, just the yoy changes that will have an effect on short lines. The FX discussion in CP's 2006 Annual Report just says "more revenues than expenses are generated in US dollars," and that doesn't quite get me there. So I dropped a note to Janet Weiss, AVP for Investor Relations.

The question is whether one should be looking at pre-FX or post-FX numbers such as one sees on Marcella Szel's slide 9 in the 3Q07 presentation. To which Janet responds, "Nothing like foreign exchange to keep your pencil sharp! If you are looking at shortlines, the majority of short lines are located within the US and generally earn revenue in US $ and incur 100% of expenses in the same currency so I would go with the 'pre-FX' revenues and expenses. Marcella's slide 9 presentation that expressed revenue growth prior to the impact of foreign exchange is correct for a directional assessment of shortline revenues.

"With respect to our summary of rail data, foreign exchange implications are carried WITHIN each line item. Our revenue line includes FX impacts etc in that we translate all currency back to Cdn and report. The same is true with each expense line item. The only place where FX is isolated is the foreign exchange impact on long-term debt. This is a mark-market issue. As such we re-state long-term debt (about 75% is US) based on the FX rate at the end of the reporting period." Thanks, Janet.

Providence & Worcester reported 3Q07 net income of $181,000, down 90% yoy from the $909,000 mm reported a year ago. EPS dropped 80% to four cents from twenty cents a year ago. As usual when we see wide swings like this part of the reason is a half a $million more in property sales a year ago vs. the present quarter. Above the line, operating income skidded 81% to $122,000 from $652,000 as ops expense remained essentially unchanged while operating revenues dropped $490,000. Total operating revenues were down 6% to $7.3 mm.

Adding insult to injury, P&W had to restate its 3Q06 results, adjusting comp and benefits upward by $28,000 in the Q for a liability for accrued compensated time off and related payroll taxes. As a result, comp and benefits took 48% of revenues last year and 53% this year, both high for a regional railroad where the norm is in the range of 30-35% of total operating revenue. The OR for 3Q07 came in at 98.3, up 670 basis points yoy.

The 46% drop in intermodal sales ($456,000) arose chiefly from the loss of west-coast container traffic that has shifted to all-water routes to the east coast. Volumes were nearly cut in half, to 9,000 units from well over 17,000 in 3Q06. Merch carloads dipped 3% as P&W suffered the traffic downturn along with everybody else. The good news is that low-rated aggregate volume declines were partially offset by the new auto and ethanol business so RPU actually went up 3%.

The balance sheet, while LTD-free, is troubling. P&W has a current ratio of 0.95 and shows working capital at ($326,000). Shareholders' equity decreased $813,000 since the 12/31/06 balance sheet. The YTD capex figure is $3.7 mm, 19% of revenues – reasonable but toward the high end – against cash from operations of just $1.4 mm. Cash and equivalents dove 93% from just under $2 mm to $135,000.

The story remains constant: P&W makes money when it has property to sell. Recall that in 1H06 the company issued 13,000 shares of stock to raise $211,000 to fund its 2005 profit-sharing contribution. The comp and benefits restatement pushed that line to more than 50% of sales; were it closer to the norm that would mean a $1.3 mm boost to ops income and an OR closer to 80. This is a great little property and deserves better.

Bear Stearns' *Friday Freight* letter is a great source of insights as to what people are saying about our favorite industry. The Nov 23 note provides some shipper observations on "recent trends in export and domestic coal demand." As to the first, the cheap dollar makes US coal more attractive to European users, creating the first up-tick in that sector for years, and export met coal is up 25% yoy. On the domestic side, larger producers will have economies-of-scale advantages over the mom-and-pop mines and will increasingly prevail. Moreover, higher coal freight rates may lessen the appeal of PRB coal in the east.

To drill down a little deeper, I spoke with a short line operator in the east who serves some smaller mines for both met and steam markets. He says that he too has seen an up-tick in met coal and thinks that equipment turn-times a deterrent for western coal in the east, though there have been no significant changes in coal sourcing patterns in his area of influence.

In a similar vein, a *Wall Street Journal* piece the same day suggested that copper futures may remain weak for some time. Another item cited Deere's 52% yoy gain in North American Sales. To check these out I e-mailed both pieces to a short line operator with significant interests in both. He's not worried about copper because even at today's lows, it's still way ahead of where it was when he entered the market two years ago and the demand is still there. Look at the Freeport acquisition of Phelps-Dodge, for example. The Deere sales jump "has changed everybody's perception about farming" which is fine for his ag-based properties.

What do paper barriers and American Airlines have in common? How about the news that AA may spin off its American Eagle regional carrier? If it does, the smaller carrier could conceivably start selling connections on airlines other than American, though careful selection of the buyer could limit this eventuality. And undoubtedly the more freedom to make other alliances, the higher the price. That has a familiar ring because the railroad paper barrier argument is that by limiting foreign road connections the seller can live with a lower price, making the line affordable to more bidders.

In its press release AMR said that "the divestiture of American Eagle and the regional airline's ability to provide quality feed at competitive rates to other carriers, as well as American, will better position American Eagle to compete for new customers and growth opportunities in the future." Putting that in railroad terms, "The Fallen Flag & Eastern's ability to provide quality local freight services at competitive rates to other carriers, as well as Big Railroad, will better position FFE to compete for growth opportunities in the future."

Perhaps the best way to eliminate the paper barrier problem altogether is to sell branch lines with no strings attached a la AMR's comment. I mean, if the Big Railroad has decided it does not want to serve a particular market, let it exit that market and sell the franchise lock, stock and barrel to somebody else who does. And let it go with the requirement that the buyer be an ISS road so there are no handling fees or switch allowances and the new short line can participate in rate increases as they occur. That ought to settle everybody's hash.

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 are $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.