

THE RAILROAD WEEK IN REVIEW

JULY 31, 2009

“I have never been a big believer that carloads were a great proxy for revenue performance.” – Canadian National CEO Hunter Harrison

The Second Quarter results are in. That it was one of the worst in years is pretty much a given. As I review the calls and the presentations the signs from road to road are all pretty much the same: double-digit declines in commodity revenues, car counts and revenue ton-miles, system revenue-per-unit generally down in the eight to nine percent range (CN the exception, plus nine percent) and merchandise carloads down across the board from the mid 20 percents to the low thirties.

BNSF, UP, CP and CSX saw operating expense drop at a faster rate than revenues, minimizing the damage to year-over-year operating income and taking a few basis points out of the Operating Ratio in the bargain. Fuel prices dropped by half or more everywhere so it was not surprising to see big drops in operating expense. I backed out fuel expense to see how the roads were doing in controlling expense ex-fuel and found declines in the ten-to-twenty percent range with CN the exception, plus three percent.

But that's just the second quarter of 2009 against the second quarter of 2008. What does it look like across six consecutive quarters? I looked at revenue-unit volumes because how much you move is the biggest determinant of operating income. It's also how most short lines get paid and as volumes go so go they. Taking revenue units posted in the first quarter of 2008 as a base point, I calculated quarterly changes up or down from that base through the second quarter of 2009. (My sample is the Big Six plus KCS, excluding GWR because Australian car counts are included and cloud the North American story.)

In the US West, both BNSF and UNP peaked at plus three percent and plus four percent respectively in the third quarter of 2009, dropping by bigger amounts for the next three quarters, ending the June 2009 quarter down 18 percent and 21 percent respectively. KCS, being between east and west, also peaked in the third quarter of 2008 at plus three percent. Here again it was downhill faster and faster, hitting a car-count that was sixteen percent below that of our start point.

The eastern roads both peaked in the *second* quarter of 2008 though the third quarter was also up but not by as much. But they began their slide in the fourth quarter of 2008, ending the second quarter of 2009 down 19 percent and 23 percent respectively. Moreover, NS handled about 110,000 more revenue units than CSX in the first quarter of 2008 and by the end of 2009's second quarter they were about even.

The eastern Class Is – and their short lines – are in a particularly tight spot. Coal accounted for 28 percent of NS revenues and 31 percent of CSX revenues in the second quarter of 2009. A page B-1 item in Tuesday's *Wall Street Journal* notes that demand for thermal coal from the Powder River Basin is up nearly 30 percent while demand for Central Appalachian thermal coal is off 20 percent and Northern App is off ten percent. It appears the high cost of digging the App coal, a summer season so far devoid of the consecutive days of blistering heat, the low price of natural gas and high stock plies of coal are the culprits.

Canadian National peaked in the third quarter of 2009 and CP hit its high point the quarter before that. Both CN and CP saw business fall by increasing amounts for the ensuing three quarters, ending the second quarter of 2009 down 18 percent and 20 percent respectively.

One final metric of interest is operating expense per million GTM *ex-fuel*. Why ton-miles and not carloads, you ask? I have always felt that a railroad moves tonnage and expenses are incurred by the ton more than anything else. And now, right on cue, comes CN's Hunter Harrison in his opening remarks to last week's call: "I have never been a big believer that car loads were a great proxy for revenue performance. With revenue ton miles you can see that the second quarter, the difference between the car loads at 22% down but the revenue ton miles only about 14%, and I think that you will find over time that it's even a broader spread there." I'm using gross ton-miles because it covers empties as well as loads and every load begins and ends as an empty.

BNSF is the perennial winner, hands down. In the last six quarters it only went above \$8.50 twice, and never as high as nine dollars. UP is next best at ten bucks and change across six quarters. KCS has the widest swings, from a low of \$12 and small change to \$14.35 in the quarter just closed. My suspicion is that the traffic mix and the integration of the Mexican half of the railroad has something to do with it.

CSX operating expense ex-fuel per million gross ton-miles over the last six quarters ranged from a low of \$14.50 at the base month to a high of \$16.06 in the first quarter of 2009, drifting back to \$15.24 in the quarter just closed. The shocker is NS where the ops expense less fuel per MGMT consistently runs two bucks more or less ahead of CSX and is clearly the high-cost player among the Class I railroads.

As to what's next, all the presenters said what they could to produce a positive outlook. But I think UP's Jack Koraleski gave the best clues as to what might be in the cards for large preponderance of short lines that depend on the merchandise carload franchise. Here are some excerpts: "The economic outlook appears to have stabilized, but the economy is still somewhat fragile. The fall crops are looking pretty good right now and the harvest should lead to an increase in grain shipments and soybean processing. Ethanol will also benefit from two additional former [Verisun] plants that will resume production here in the third quarter.

"Chemicals will depend heavily on strengthening down stream markets. Liquid, dry and soda ash have both shown some modest improvement here recently and we expect them to kind of retain their current run rates. Fertilizer which has been disappointing both in the fall last year and spring this year could actually be an opportunity for us. In early July [steel] production rate topped 50% for the first time since late last year. We've also seen an increase in brown paper production with additional paper machines being brought back online. We're starting to see some stimulus project activity, but so far it's still hard for us to tell whether it's generating the incremental projects or just shifting the source of funding." And since UP does not exist in a vacuum, what's driving them will no doubt drive the rest of the railroad industry from Maine to Texas across large railroads and small.

Genesee & Wyoming has not been well-represented in the above commentary thanks mainly to the differences in reporting metrics. However, GWR is an excellent a mirror on the shortline community and as such deserves specific comment. Let me start with safety. Through April of this year the GWR reportable injury rate stood at an admirable 0.7 events per 200,000 hours worked. By way of comparison, the Class Is were running at 1.4 events per 200,000 hours, the regionals (DME, FEC, etc.) at 2.9 and short lines as a group stood at 3.2 injuries per 200,000 hours. Besides being able

to send folks home whole every night, a solid safety record pays off in earnings, too, as GWR saw casualty expense drop 24.3 percent or a \$million in the quarter.

Turning to the operating and financial results for the quarter, freight revs from railroads ex-Rail Link dropped \$12.1 million year-over-year even as same railroad sales dipped 21.4 mm offset by \$12.7 mm revs from new railroad acquisitions -- OHCR, etc. Same railroad carloads came down twenty percent with negative showings across all commodity groups but farm & food thanks to a record Australian grain harvest. Non-freight (mainly the "Rail Link Region") sales were off 17 percent mainly on third-party fuel sales and foreign exchange. Revenues from new operations came in at \$2.4 million, handily offsetting the \$1.7 million decline in same railroad revenues.

Reported operating income was \$14.6 million for an OR of 88.7 though backing out one-time expenses relating to the HCRY sale, M&B legal expenses plus the puts and takes from asset sales and insurance recoveries boost effective ops income to \$22.7 million, a 16.5 percent decline from the 2008 quarter and an effective OR of 82.5.

Though GWR does not report GTMs, we can still look at the trends in ops expense less "fuel for own use" and operating ratios. Using 1Q08 as our base, ops expense less fuel has ranged between \$104,000 and \$109,000 with the high in -- you got it -- 3Q08. The present quarter was second highest at \$108,000. The OR started our six-period series at 84.7, got down to 78.4 in 3Q08 only to creep back up to 88.7 in 2Q09 -- 82.5 if you back out the non-GAAP items above.

What's next is more of the same with smart acquisitions offsetting losses from weaker same-railroad properties. A key attribute of the GWR acquisition process is taking a hard look at the competitive advantages of potential customers *vis a vis* their own customers, something TJ Gallagher, CFO, pointed out to me in a phone interview a while ago. Thus it comes as no surprise to hear CEO Jack Hellman say in the warp to last week's presentation, "Supported by the proceeds from our recent equity offering, we continue to evaluate acquisition and investment opportunities in both North America and Australia. With funds available to make opportunistic investments and our increasingly efficient core operations, we believe that we are well positioned to benefit from any improvement in economic conditions."

Amtrak is looking for a few good men and women to participate in the Presidential Passenger Push. Paul Vilter writes, "I'm currently advertising for two new positions, and have attached both of the job postings from Amtrak's web site. [I have the attachments if interested. -- rhb]"

"The two Acts mentioned in the job postings, the "Passenger Rail Investment and Infrastructure Act of 2008" and the "American Recovery and Reinvestment Act of 2009" which as you know are the federal laws that together are channeling \$8 billion of federal stimulus money into intercity passenger rail over the next few years.

"These Amtrak positions are about structuring and managing agreements with the host railroads whose tracks Amtrak uses, and with Amtrak's state partners, to ensure that the portion of the \$8 billion that will be invested in host railroads is spent wisely and will generate the intended passenger rail benefits. It's potentially game-changing stuff. These are regular, ongoing, full-time positions.

"One position is somewhat more junior and analytically focused (the "Sr. Officer" position in Amtrak lingo), and one is somewhat more senior and negotiation/contract focused (the "Principal" position). There is the possibility of a second Principal position as well. Please note that the initial listing of these jobs on Amtrak's web site shows them located in Washington, DC .

“However, if you read the actual postings you’ll see they can be based either in Washington , DC (at Union Station) or in Philadelphia (at 30th Street Station). The Principal job also offers relocation benefits for candidates from outside the area. Anyone interested in applying should go to Amtrak’s web site, www.amtrak.com , and follow the procedures listed there. The last day to apply is August 11 Hopefully each of these jobs will make a good fit for someone!” Thanks, Paul.

RailAmerica is returning to the fold as a public company. A short announcement says the \$300 mm IPO will get the company listed once again on the NYSE, only this time under RA. JPMorgan, Citi, Deutsche Bank and Morgan Stanley are serving as underwriters. **Fortress Investment Group** took the company private in 2007 for \$1.1 billion, including \$450 million in equity. There has been no formal press release from RailAmerica and those making inquiry are being asked to see the registration statement. This I will do and offer my observations anon. Congratulations are in order for John Giles and his team for this successful and rapid turnaround.

The vacation was a delightful mix of of exploring new (to us) bits of Pennsylvania History from the Pinchot mansion “Grey Towers” in Milford to the Lumber Museum between Galeton and Coudersport. We also did a bit of “forensic railroading” – trying to find traces of once extant but now extinct rail lines. The Wellsville Addison & Galeton holds a particular fascination because (a) it didn’t last long and (b) could have been useful in the present Marcellus shale push. Any comments, observations or experiences on the WAG would be welcome.

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Class I Commodity Carload Comps
Quarter ending 6/30/09
Revenue and income in \$millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	\$ 3,316	\$ 1,781	\$ 1,022	\$ 2,185	\$ 341	\$ 1,857	\$ 3,303
YOY Pct. Change	-25.9%	-15.1%	-21.5%	-24.8%	-29.8%	-32.8%	-27.7%
Revenue Units (000)	2,041	928	564	1,411	378	1,412	1,852
YOY Pct. Change	-18.7%	-21.9%	-24.3%	-20.5%	-18.8%	-25.7%	-21.9%
RTMs	143,703	38,865	25,532	52,000		37,500	113,234
YOY Pct. Change	-12.6%	-14.1%	-25.7%	-19.0%		-26.5%	-19.7%
Carload revs (2)	\$ 1,386	\$ 1,172	\$ 603	\$ 1,174	\$ 250	\$ 978	\$ 1,811
YOY Pct. Change	-31.3%	-14.8%	-19.4%	-28.3%	-34.8%	-32.9%	-31.9%
System RPU Pct Chg.	-9.1%	9.3%	0.8%	-5.4%	-15.2%	-9.6%	-8.1%
Pct carload	41.8%	65.8%	62.0%	53.7%	73.3%	52.7%	54.8%
Pct Intermodal	28.8%	17.9%	28.2%	13.3%	9.4%	19.8%	18.0%
Pct Coal	26.4%	5.1%	9.8%	30.3%	12.5%	27.5%	21.6%
Mdse Carloads (000)	727	521	260	579	191	468	713
YOY Pct. Change	-28.7%	-30.5%	-24.1%	-24.6%	-29.2%	-32.2%	-28.6%
Rev/CL x coal, IM	\$ 2,676	\$ 2,250	\$ 2,321	\$ 2,028	\$ 1,311	\$ 2,092	\$ 2,540
YOY Pct. Change	-3.6%	22.6%	6.2%	-4.9%	-8.0%	-1.1%	-4.6%
Operating Expense	\$ 2,519	\$ 1,198	\$ 797	\$ 1,603	\$ 298	\$ 1,389	\$ 2,552
YOY Pct. Change	-33.1%	-13.9%	-22.6%	-26.8%	-21.9%	-29.3%	-29.8%
RR Operating Income	\$ 797	\$ 583	\$ 226	\$ 582	\$ 43	\$ 468	\$ 751
YOY Pct. Change	11.6%	-17.5%	-17.1%	-18.8%	-58.5%	-41.4%	-19.3%
RR Operating Ratio	76.0%	67.3%	77.9%	73.4%	87.3%	74.8%	77.3%
YOY Point change	(8.09)	0.96	(1.17)	(1.97)	8.80	3.69	(2.36)

Class I Commodity Carload Comps
YTD through 6/30/09
Revenue and income in \$millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	\$ 6,836	\$ 3,640	\$ 2,093	\$ 4,432	\$ 687	\$ 3,800	\$ 6,718
YOY Pct. Change	-21.8%	-9.6%	-17.2%	-21.1%	-26.6%	-27.8%	-24.0%
Revenue Units	4,169	1,882	1,141	2,830	762	2,868	3,699
YOY Pct. Change	-16.5%	-18.9%	-21.5%	-19.0%	-17.0%	-23.1%	-21.4%
Avg RPU change	-6.5%	11.8%	4.0%	-3.3%	-13.1%	-6.2%	-3.8%
Mdse Carload revs (2)	\$ 2,858	\$ 2,446	\$ 1,259	\$ 2,344	\$ 499	\$ 1,953	\$ 3,693
YOY Pct. Change	-27.7%	-8.9%	-23.1%	-26.3%	-31.8%	-30.5%	-28.4%
MGTM	485,384	148,113	100,568	190,100	17,956	70,500	407,432
YOY Pct. Change	-13.6%	-13.7%	-21.9%	-17.3%	-18.9%	-24.8%	-20.8%
Pct carload	41.8%	67.2%	60.2%	52.9%	72.5%	51.4%	55.0%
Pct Intermodal	28.3%	17.5%	27.3%	12.7%	9.1%	19.3%	17.1%
Pct Coal	26.8%	5.9%	10.5%	31.7%	13.1%	29.3%	22.7%
Mdse Carloads (000)	1,064	1,093	521	1,127	385	936	1,424
YOY Pct. Change	-26.8%	-25.5%	-23.1%	-25.6%	-26.6%	-30.7%	-27.2%
Rev/CL x coal, IM	\$ 2,686	\$ 2,238	\$ 2,415	\$ 2,080	\$ 1,294	\$ 2,087	\$ 2,593
YOY Pct. Change	-1.2%	22.3%	10.4%	-1.0%	-7.2%	0.3%	-1.6%
Operating Expense	\$ 5,274	\$ 2,576	\$ 1,728	\$ 3,328	\$ 595	\$ 2,949	\$ 5,295
YOY Pct. Change	-26.2%	-7.8%	-15.3%	-22.2%	-20.5%	-24.2%	-25.6%
RR Operating Income	\$ 1,466	\$ 1,064	\$ 365	\$ 1,104	\$ 92	\$ 851	\$ 1,423
YOY Pct. Change	-7.7%	-13.5%	-25.2%	-17.8%	-51.1%	-38.2%	-17.2%
RR Operating Ratio	77.2%	70.8%	82.6%	75.1%	86.6%	77.6%	78.8%

(1) CN, CP in \$Canadian

(2) Excludes coal, intermodal

Source: company financials

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