THE RAILROAD WEEK IN REVIEW

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"Our regional managers have done an outstanding job of controlling costs and maintaining the safety and operating efficiency of our railroads as traffic levels have improved" -- Jack Hellmann, President and CEO, Genesee & Wyoming

Genesee & Wyoming proves once again how a regional railroad operator with a fairly consistent number of daily train-starts can add volume at little incremental cost. Here's how it works (go to the investor's page at www.gwrr.com, find the slides and scroll down to number 11). Revenue carloads (GWR rolled its intermodal business into "other" a while ago so, like RailAmerica, a car is a car is a car) increased 5.3 percent to 217,029 units with double-digit gains in every commodity group but STCC 26 (pulp & paper), petroleum products and aggregates ("minerals & stone" at GWR).

Here again, some adjustments must be made. GWR put the Huron Central in the disc-ops bucket in last year's second quarter -- backing out its 2,408 carloads brings the carload increase to 16.8, some 31,200 units (and putting the pulp & paper delta back in the plus-column, but barely). Second quarter revenues increased 21.8 percent year-over-year to $158.5 million, up $28.4 million. Operating expense increased 4.5 percent or $5.2 million for an operating ratio of 76.1, a 12.6 point reduction over the 2009 second quarter.

Adding back various adjustments to ops expense for both the current quarter and the 2009 quarter, the adjusted operating expense delta becomes $13.4 million. Now back out the foreign exchange variance of $3.4 million for a true adjusted ops expense of $10.0 million. That's what it cost to bring in the extra $24.2. million in sales (also foreign-exchange adjusted), ergo the incremental operating margin is a laudable 41.4, something every short line or regional railroad ought to be shooting for.

Now apply the adjusted expense delta -- $10.0 million -- to the adjusted revenue carload data and see that the incremental expense per carload was 46 bucks. GWR's average revenue per car (APC) increased 9.6 percent to $462 from $421, meaning every incremental car was worth more than $400 in operating profit. That's what running bigger trains without increasing crew starts can do for one's operating ratio.

To put the quarter's car-counts in context, during the call CEO Jack Hellmann said the quarter's average monthly carloads -- 72,343 -- still lag the Oct 2008 record of 80,528 by 11 percent. Looking back over the quarter, I see each month's carloads up double digits year-over-year against a first quarter that was down four percent year-over-year. Moreover, each month's year-to-date cumulative car count was better than the one before it. I see no reason why this trend should not continue.

One of the finer points about GWR operating improvement came out in the call and Jason Seidl of Dahlman & Rose captured it beautifully: "GWR completed its final round of cost reductions

late in the second quarter of 2009, so the operating ratio for that quarter did not fully reflect the lower cost structure the company has implemented since the trough of the recession. That said, 2Q10 OR represented a 320 basis point improvement from the 79.3 operating ratio reported in 1Q10. These results were achieved as the company was able to leverage its existing operating resources to accommodate higher freight levels."

Below the line, GWR reported $20.7 million net income from continuing operations vs. $8.1 million a year ago with earnings-per-share of $0.50 vs. $0.22, a clear double. Guidance for the year (I normally don't do guidance but in this case it supports the positive carload volume trend story) for revenues in the $610-615 million range vs $585 million a year ago and $602 million in 2008. What's more, we're looking at an annual operating ratio in the high 70s, compared with 81.8 a year ago and 82.1 in 2008. I'm encouraged.

"Coal Pricing Uptick Continues As Inventories Dwindle," writes UBS' analyst Shneur Z. Gershuni, CFA. "Stockpile build in May was negligible compared to the average May build of 5.8 mm tons. Eastern stockpiles are now in y/y deficit as western stockpiles hit a sixth consecutive month of y/y deficit. The resurgence in pricing reflects the inventory draw as six-month Central App and PRB coal futures have increased 50% and 94%, respectively, since April lows.

"Concerns of a premature production ramp-up have been somewhat alleviated as increased regulatory activities have hampered production in the near term. We believe the 2Q10 increase is partly due to the strong market for crossover thermal tons and a decline in producer stockpiles vs. production growth. Additionally, the reversal of fuel switching continued for a fourth consecutive month. We continue to view 2010 as an inventory-cleansing year with year-end inventories expected to be 154 mm tons. Due to improving thermal fundamentals, global thermal spot pricing, and the China-related valuation correction, we anticipate positive traction for thermal coal [producers names] and believe Met [producers] are increasingly attractive."

As for the impact on railroads, "Second quarter 2010 US coal railcar loadings are up 4.8 percent year-over-year yet remain down roughly 1.7 percent year-to-date. Due to steady inventory draw-downs and mild builds earlier in the year, the steep railcar reduction seen in 2009 was unnecessary to rebalance the market in 2010. Barge tonnage continues to show strong data, up 11.2 percent in 1H10 vs. 1H09." I have the full report as a PDF -- just ask.

Dennis Gartman continues his rant in favor of keeping one's investing life simple. Thursday he wrote, "We remain quite bullish of equities generally with -- and we know we are repeating ourselves -- the emphasis on owning basic, very prosaic, dividend-paying companies that produce the most basic commodities: the "Stuff," as we refer to it, that hurts when dropped on one's foot. We wish to own coal, and copper, and steel and fertilizer and ball bearings and the like. These are the things that can be counted and are necessary at the most basic level for economic growth everywhere around the world. These are the dividend payers; these are the companies upon whose collective shoulders the world rests.

"We know, for example, that nothing moves in the world via truck, or rail, or even ships at sea without roller bearings. Hence Timken, the world's largest maker of roller bearings, is at or near

new multi-year highs. This is a simple company, with a product that will hurt when dropped on your foot, but without which nothing moves. Or consider steel, which is perhaps even more basic than are roller bearings. Steel prices have been under pressure all during the recession, but if steel prices move even slightly from their lows, the steel companies will move even more dramatically given their leverage.

"Or consider how important coal is to the firing of the world's power plants. Coal shipments are rising, and coal is cheap on a per BTU basis when compared to nat-gas and crude oil. Arch, Massey or Peabody all supply different types of coal, but on balance all have made what appear to us to be important, multi-month lows. Or consider fertilizers, which have been on a tear to the upside in recent sessions as surrogate grain positions and as bets on future economic growth.

"We wish to keep things simple. If dividends are 3-4 percent of the long term growth of equity investments, we want to own the companies that pay us reasonable, safe, well-protected dividends and whose products are needed at the most basic level." And who gets much of this "stuff" from where it is to where it's needed? Railroads. QED.

Concerning truck capacity, a note from Wolfe Trahan & Co tells us, "Truck tightness remains apparent in the Southwest and certain regions in the Southeast. The West Coast in particular [sees] an increase in transloading from international to domestic boxes onto trucks. Driver shortages have also crimped capacity as carriers can't hire qualified drivers fast enough. Our contact has not encountered any significant rates increases, although he anticipates some modest increases on a lane-by-lane basis. Our contact believes that those shippers who took advantage of carriers last year are likely to see dramatic rate hikes, but this shipper does not anticipate any drastic rates increases as he believes he was relatively fair to his carriers last year."

Department of Corrections. WIR reported last week that second quarter 2010 was the first NS sub-70 operating ratio since the Conrail transaction. Wrong. They did it in the third (69.1) and fourth (67.5) quarters of 2008 as well. Credit the sharp eyes of NS' own John Friedmann with pointing our the error.

Railroad Week in Review is taking a holiday next week as She Who Proofreads has decreed a restorative visit to the Blue Ridge Mountains in Virginia is in order. We will be back at our usual post for the August 20 Letter.

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