THE RAILROAD WEEK IN REVIEW

July 27, 2012

"It's very exciting to see the percentage growth in cross-border intermodal carloads nearly double from 56 percent to 106 percent as the base actually gets larger." -- Mike Haverty, KCS

Genesee & Wyoming is to buy RailAmerica under an agreement dated July 23, 2012, whereby, according to the 8-K, RailAmerica entered into a Merger Agreement with GWR and its new subsidiary, Jaguar Acquisition Sub Inc. Each RailAmerica share of common stock "will be converted into the right to receive $27.50 in cash."

The good folks at Wolfe Trahan ran the numbers and concluded the share price represents a multiple of 11 times trailing EBITDA "vs. historical purchase multiples of 8x for short-line acquisitions and 10x for Class I deals, and is below the 11.7x trailing EBITDA that Fortress paid for RA in C06." Still, I'm not surprised because GWR has shown in every acquisition that it can work multiples down by eliminating duplicate fixed overhead expense and sharing resources to lower variable expenses.

Tony Hatch, in his usual baseball vernacular, calls the transaction "a game-changer" with a price tag of roughly $1.4 billion plus $600 million in assumed debt. He concludes,

> The synergies do not include any revenue or shipper effects from "clustering" (a GWR speciality) or from serving shippers on a continental or at least multi-location basis (something Watco has excelled in). The finished product will have 108 SLs – maybe. Perhaps it will involve selling off non-core or non-cluster rails as there is a ready appetite for such sales. Expect another to emerge as a stronger number-two short line holding company over the next few years.

RailAmerica June carloads were 72,820, up 3.7% from 70,238 in June 2011.The Company increased shipments in June, 2012 in seven out of twelve commodity groups compared to June 2011. The largest increases were in Agricultural Products, Other and Motor Vehicles. Agricultural Products volumes were up primarily due to more shipments in the Central and West Regions. Other increased primarily due to higher shipments in the Northeast Region. Motor Vehicles were higher primarily due to increased carloads in the Midwest and Northeast Regions.

The largest declines were in Metallic Ores and Metals and Coal. Metallic Ores and Metals were lower primarily due to reduced shipments in the Northeast Region. Coal decreased primarily due to lower shipments in the Midwest, Central and Northeast Regions. June 2012 carloads include 1,855 carloads from acquisitions. On a "same railroad" basis, carloads increased 1.0%.

For the quarter, loads grew 3.8% yoy; YTD vols increased 3.5%. Sequentially, June carloads slipped 3.4% from May, making June third month this year to be down from the preceding month. Coal appears to be the major culprit, accounting for about 17% of vols. It was down YOY every month but May. On the other hand, seeing RA increase vols at a rate slightly better than GDP is encouraging, especially since it's all carload with no offsets or boosts from intermodal.

GWR June North American carloads came to 58,585 vs. 67,137 a year ago, down 12.7%, making June the sixth consecutive month of North American carload declines. YTD numbers have likewise come down every month to the point that June YTD carloads were off 10.0% and second quarter vols dropped 9.8% YOY. Sequentially, June NA loads were up 0.2% over May. Same-store loads, excluding 1,343 loads from the Arizona and Georgia acquisitions, came in at 57, 252 units, off 14.7% YOY.

Coal remains the elephant in the living room at 25.2% of total volume and it also figures heavily in the "Other" category, mainly overhead NS coal in Ohio. Last year at this time Other was 12.4% of volume; this year it's 4.9% on a 65.5% decrease in units, to 2,875 from 8,323 revenue units. The next largest commodity groups after coal, all at ten percent of total vols, more or less, are STCC 24 and 26 items, metals, mins & stone and chemicals. Together these and coal account for 80.7% of GWR traffic; the metals and STCC 24 groups were the only double-digit downers; chems increased 14.9%.

In the accompanying press release GWR says there were "no overhead coal shipments in GWI's Ohio Region" in June 2012. Farm & food products traffic declined in the Illinois Region primarily due to elevated traffic in 2011 associated with carloads diverted around flooding in the Midwest. Coal & coke traffic decreased 2,189 carloads primarily due to lower shipments in GWI's Illinois and New York/Pennsylvania Regions."

By now all the Class Is have reported second quarter results. I've summarized the key metrics in the table at the end so you can follow along in these observations. CSX led off with total freight revenue, revenue units, revenue ton-miles and system average RPU all flat to down a point or so. NS didn't do much better: revenue, revenue units, RTMs, system RPU essentially unchanged. Merch carloads (ex coal and intermodal but including auto) clustered around zero change. Both barely held the sub-70 operating ratio reported a year ago.

UP saw rail revs rise by 8 percent; KCS was up by two percent, though revenue-unit counts were unchanged and RTMs dipped slightly for both. UP cleaned house in merch carload revs, up 11 percent, to KCS up 3 percent; UP system RPU jumped 6 percent while KCS took a 7 percent hit. Merch carloads were up 7 percent for UP and down a point for KCS. On the other hand, KCS took the operating ratio down nine points to an enviable 62.6 while UP took its OR to a not-too-shabby 67.0, down four points.

The two Canadians did better than the US Class Is as a group. CN revenues increased 13 percent on 4 percent more revenue-units and an 8 percent RTM gain. CP revenue units were off two-tenths of a point and RTMs were up a point. Carload revs were up 11 percent for both, though system RPU was up 8 percent for CP and down a like amount at CN. Merch carloads hovered around the unchanged mark for both. CN once again won the OR brass ring with its 61.3, down less than a point; CP remains stubbornly stuck north of 80 -- I will say no more.

Below the line, the common thread is smallish -- almost flat -- net earnings with mid-single-digit percentage eps gains propelled by share buy-backs. My sense is the trend will continue as long as we see inflation-plus price increases on small volume deltas, tight expense control and unexciting ops income gains. Even at today's ho-hum levels, year-to-date cash flow from operations remains well above net income (only CN stumbled momentarily here), in turn fueling capex, divs, *and share buy-backs*. Consequently, railroad earnings going forward will look more and more like utilities only with smaller div yields and more aggressive share repurchases.

Partly because of this utility-like scenario, Class II and III railroads that play mostly in the single-car sand box look more like drayage firms than railroads. A shipment arrives at the ramp, the drayman goes there, picks up the box and delivers it to the end user, or the reverse. He's paid a flat fee and has little or no pricing power. To be sure, the short line has a competitive advantage in its ability to solicit new biz from a local angle. But then, the new biz only moves if the Class I will allow it. The drayman parallel remains valid.

The Captive Shipper Question is now generating some ink at the STB. This week the Board proposed new rules that adjust the procedures and damage thresholds yet leave railroads' right to revenue adequacy intact. A note from RW Baird suggests "the proposed changes would increase the potential number of captive shipper rate challenges as the STB begins proceedings to study potential for competitive switching rules among rails."

Chris Ceraso at Credit Suisse says "the Board was not fully able to gauge the proposal's potential impact on either the railroads or the broader shipping community" and gives this example:

> § If Railroad A was the original carrier taking Shipper's freight from origin to destination, but under the new rules, Railroad B (with an interchange within 30 miles of the origin) may now also bid for the freight and the Board needs a method to determine how much Railroad B has to pay Railroad A for access to A's line (say, for the 30 miles).

Ceraso makes a useful point. I see short lines getting caught up in this where a customer buying in bulk (utilities, feed mills, etc.) is on a short line interchanging with two class I roads. Or even where the short line has only one class I but the latter doesn't want to pay the former and prefers to control first-mile/last-mile himself. Think frac sand, crude oil.

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Class I Commodity Carload Comps						
Quarter ending	6/30/12					
Revenue and income in $millions						
Metric	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 2,543	$ 1,366	$ 3,012	$ 545	$ 2,874	$ 5,221
YOY Pct. Change	12.5%	8.0%	-0.2%	1.9%	0.3%	7.5%
Revenue Units (000)	1,286	646	1,640	520	1,799	2,258
YOY Pct. Change	4.2%	-0.2%	-0.4%	4.0%	0.7%	0.5%
RTMs	50,324	32,559	57,200	10,906	47,200	126,629
YOY Pct. Change	7.8%	1.0%	-1.9%	-6.3%	-2.7%	-4.2%
Carload revs (2)	$ 1,561	$ 853	$ 1,711	$ 397	$ 1,556	$ 3,041
YOY Pct. Change	11.5%	11.2%	6.1%	2.2%	8.6%	11.1%
System RPU Pct Chg.	-7.6%	8.2%	0.1%	-2.5%	-0.4%	6.4%
Pct carload	68.6%	64.0%	56.8%	72.7%	54.1%	58.2%
Pct Intermodal	23.1%	24.8%	13.5%	14.0%	19.6%	19.2%
Pct Coal	8.0%	11.1%	27.2%	9.6%	26.3%	16.6%
Mdse Carloads (000)	726	316	680	234	604	1,000
YOY Pct. Change	0.7%	-0.3%	0.4%	-1.3%	3.7%	7.3%
Rev/CL x coal, IM	$ 2,150	$ 2,699	$ 2,516	$ 1,695	$ 2,576	$ 3,041
YOY Pct. Change	10.7%	11.6%	5.7%	3.6%	4.7%	3.6%
Operating Expense	$ 1,558	$ 1,127	$ 2,069	$ 342	$ 1,940	$ 3,497
YOY Pct. Change	12.4%	9.0%	-1.1%	-10.9%	-2.6%	0.9%
RR Operating Income	$ 985	$ 239	$ 943	$ 204	$ 934	$ 1,724
YOY Pct. Change	12.7%	3.5%	1.8%	34.4%	6.7%	23.9%
RR Operating Ratio	61.3%	82.5%	68.7%	62.6%	67.5%	67.0%
YOY Point change	(0.06)	0.76	(0.64)	(9.03)	(1.97)	(4.37)

(1) CN, CP in $Canadian
Source: Company Financials