THE RAILROAD WEEK IN REVIEW

August 3, 2012

"We look upon coal stocks as a long term call on economic activity." -- Dennis Gartman, The Gartman Letter, July 23

RailAmerica's Q2 revenue increased 12.1 percent year-over-year to $156.1 million as freight sales increased 7.6 percent and non-freight sales increased 26.4 percent, chiefly engineering services from the Atlas subsidiary, car repair and switch fees. Revenue units grew 3.6 percent with particular strength in forest products, petroleum and motor vehicles. The RA system average RPU gained 3.8 percent with motor vehicles, waste/scrap, metallic ores and minerals, chemicals and ag products in the lead.

Operating expense increased 10.3 percent for an operating ratio of 78.1, a 128 basis point improvement year-over-year. Net income grew 31.0 percent to $11.4 million. Of particular note, even though revenue units increased, expense lines for labor and diesel fuel decreased as a percent of revenue and equipment rents were unchanged. That tells me RA is increasing car-miles per day, increasing GTMs per gallon of fuel, and generating more RTMs per crew-start.

Coal once again was the blight on the landscape. Revenue was down 4.1 percent in the quarter, vols were off 3.5 percent and RPU was off 0.7 percent to $223, the lowest-rated commodity in the RA franchise. Coal also represents 15.2 percent of vols and just 6.6 percent of revenues. However, as I look down my roster of RA railroad names, I see several places where coal moves in unit trains with Class I power using Class I fuel, so naturally per-car revs will be less than those in mixed-train service. As I've noted here in the past, unit trains like these moving the last few miles over short lines to destination gen plants can be great cash-generators. It's those onesey-twosey industrial coal burners that eat up crew and locomotive time, so kudos to RA for managing its coal franchise so cleanly.

Some of us are in no hurry to write off coal. I've owned Peabody (BTU) from time to time because (a) they'e the biggest and (b) I like the ticker symbol. At the moment shares are trading for under $21 with a book value of nearly $22, 10 times earnings and 0.96 times book, giving it a fair value of $31.83. That tells me one can have BTU for one-third off. Dennis Gartman, he of *The Gartman Letter* out of Suffolk, Va. sees it thus:

> We look upon coal stocks as a long term call on economic activity. Steel will still be produced and that shall still require coal. Electricity will still be produced and that too shall require huge sums of coal, and if the Obama Administration is turned out and the EPA's clout as a result is diminished, then coal's future shall look a great good deal better than its fearsome future appears. [Shares of coal producers represent] a cheap call on economic

growth… and we'd prefer betting on growth over the next decade than we would on weakness.

Genesee & Wyoming total operating revenues for the second quarter increased 3.7 percent to $277.4 million on 232,315 revenue units, down 6.9 percent. The biggest downer was the dramatic fall-off of NS overhead coal in Ohio -- more than 21,000 units. Average same-railroad RPU increased 10.2 percent thanks to a change in mix and fuel surcharge collections. Operating income increased 22.1 percent to $62.5 million; the adjusted operating ratio ex-gains on asset sales and other items was 75.5, down 90 basis points.

The North America/Europe franchise accounted for 76.0 percent of vols and 66.2 percent of revenues, and it is here that we will focus to provide our North American shortline readers some comps for their own Q2 results. Freight revenue for the North American/Europe segment increased 5.6 percent to $102.0 million even as revenue unit dipped 9.8 percent due to a 16.5 percent decline in line-haul coal and a whopping 60.0 drop in overhead vols, mostly that NS coal in Ohio. GWR's largest commodity groups by percent total volumes are minerals and stone (15.2 percent of total, off 3.4 percent), farm & food (12.2 percent, off 13.6 percent), metals (10.3 percent, up 8.2 percent) and pulp & paper (10.1 percent, off 1.4 percent).

Non-freight revenues (Rail Link short lines, terminal operations, etc.) were essentially flat at $43.1 million or 29.7 percent of total revenue, $145.1 million, up 4.1 percent. Operating expense held at no real change; operating income gained 18.3 percent to $39.9 million and the adjusted ops ratio was down 20 basis points to 76.8. Below the line, net income rose 16.8 percent to $36.4 million and per-share earnings grew 15.7 percent to 83 cents from 73 cents a year ago.

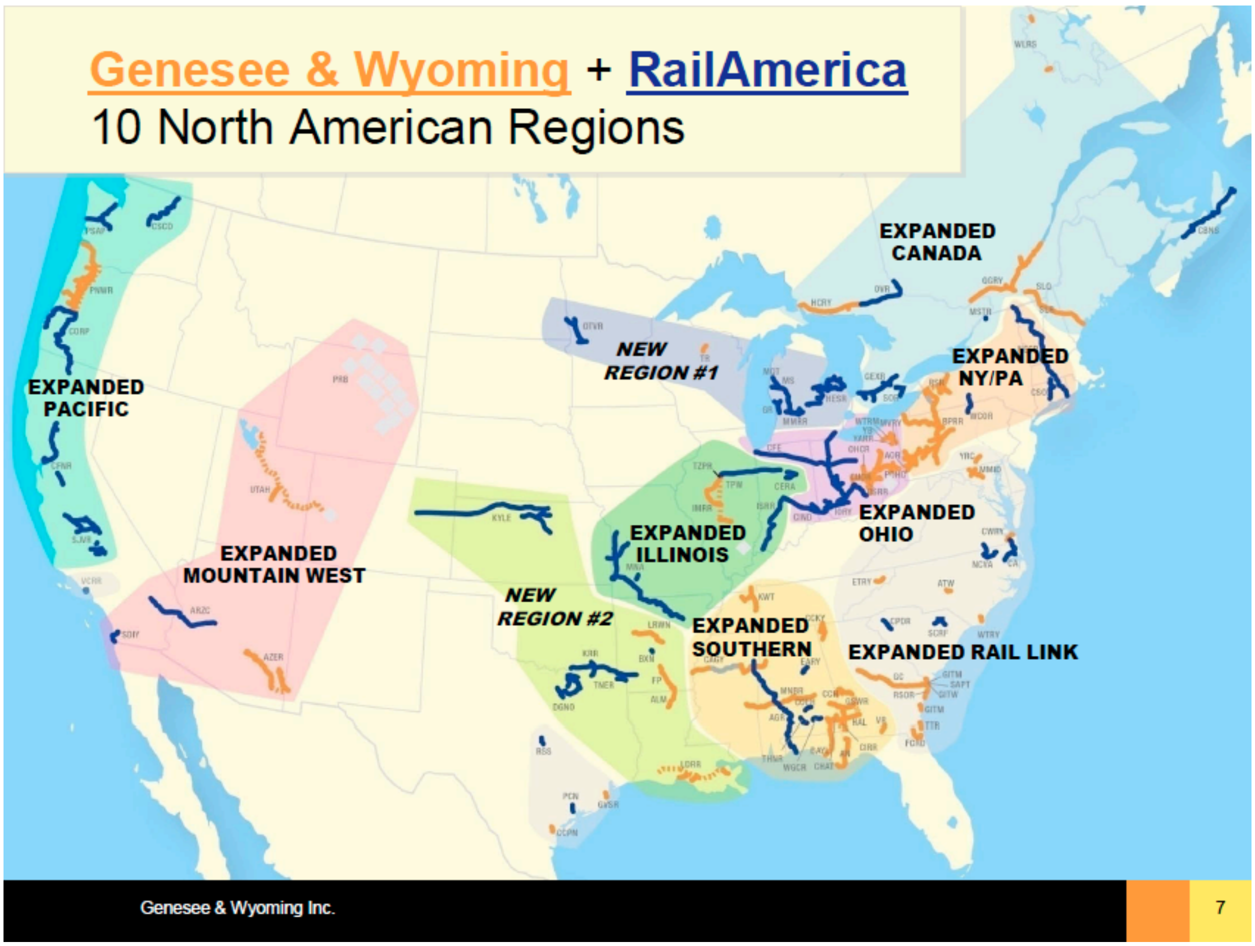
In addition to the the RailAmerica transaction (more on that anon), GWR announced two more variations on the natural resources theme: a new iron ore service in Canada and major expansion of the Australian iron ore trade. The first, a new G&W subsidiary serving Tata Steel Minerals Canada, is a new 13-mile line off the Tshieutin Railroad with interchange near Schefferville, Quebec. Construction of the $26 million line is expected to begin in the current quarter with service starting in three to six months.

In Australia, the railroad has struck two new iron ore rail haulage agreements with Arrium, an Australia-based international mining and materials company with $7.1 billion in annual sales revenue that was spun out from BHP in 2000. One is for 3.8 million annual tons over a standard gauge line from Wirrida to to Whyalla for export to Asia, for which GW Australia has bought nine locomotives and made capital investments of some A$67 million. The other is for expanding a narrow gauge iron ore feeder service to handle eight million tons a year, up from six, and requiring a GWA investment of A$60 million for infrastructure upgrades.

As an aside, let me share an observation on GWR's focus on natural resources. The coming scarcity thereof is the theme of Jeremy Grantham's July Letter:

The portfolio investment implications are that investors should expect resource stocks – those with resources in the ground – to outperform over the next several decades as real prices of the resources rise. Serious long-term investors should have a very substantial overweighting in a resource package. I suggest for long-term investors a resource position of at least 30%. Resources are a smaller fraction of final sales than average and higher profit margins make them more resilient to margin pressures.

The RailAmerica transaction, said CEO Jack Hellman on Thursday's call, is "contingent on approval of a voting trust or approval of GWR's control application for RailAmerica," and they expect to file for both in a matter of days. The closing into a voting trust using the equity method of accounting could come as soon as next month. Full integration of RailAmerica requires approval and that could be any time from December 2012 into 3Q2013.



Source: GWR presentation at www.gwrr.com

This map is from a slide deck at gwrr.com explaining the details. As you can see, the RailAmerica lines fill in strategic gaps creating nearly through-services line-haul offerings for GWR between western NY and central Illinois, between northern Mississippi and southern Georgia, and along the I-5 corridor in California. On the other hand, the New Region 2, Expanded Mountain West and the southeast coastal states remain disconnected and non-core. Let's see how this all shakes out in the next two or three years.

The Graham Number (WIR 6/15/2012) pops up again as I review valuations of our favorite Class I rails. My Value Screen looks for good businesses selling at a discount to fair value (the Graham Number) and weighs as well dividends, earnings yield (eps as a percent of share price). CN popped up as the most over-valued rail at $88 and change, 1.55 times my fair value number. Moreover, the earnings yield is 6.4 percent and the dividend yield 1.6 percent -- 8.0 percent for both -- against my threshold of 10.0 percent. (By way of comparison, NS total yield is 10.3 percent and CSX is 10.6 percent: UP and CP are both sub-seven.)

I had suspected CN would have a run like this two months ago and sold August $80 calls against it. Yeah, I got called away short of the present number, but I'm out and pocketed my premium. And it turns out I'm not alone in my "over-valued" thesis. Cherilyn Radbourne at TD Newcrest in Toronto is having second thoughts, too:

> We are reducing our rating on CN to HOLD from Buy. Our target price is unchanged at $100.00. The rating change is predicated largely on the stock's *recent strength and relative valuation.* [*Emphasis mine --rhb*]. We continue to believe that CN offers attractive offensive and defensive qualities and -- in our view -- the company's Q2/12 earnings evidenced tremendous underlying strength, with notable growth in long-haul traffic.
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> That being said, CN has raised its 2012 EPS guidance twice; our estimate and the consensus forecast are running somewhat ahead of the company's guidance and, from that starting point - with an uncertain economy - we believe that the company will have a harder time surprising relative to expectations. CN is trading at 14.7x our FTM EPS estimate, which we would characterize as fair -- not expensive -- but we believe that the U.S. rails offer better relative value from current levels -- particularly CSX and NS. [*both a more reasonable 1.2x fair value -- rhb*]

I got some push-back on my short line-drayman comparison last week. There are those who say I gave short shrift to the short lines' ability to generate new business -- business the Class Is would never even see were it not for the short lines. The fact that short lines are growing year-over-year car counts at a faster pace than some Class Is is one indicator.

Point well taken. However, the number of short lines really beating on the doors and bringing on profitable new Class I carloads is a small percentage of the total number of Class II and III lines out there. That percentage must grow or they'll all be perceived as draymen and not much more.