

THE RAILROAD WEEK IN REVIEW

August 5, 2011

“Second quarter revenue increased 32% to \$210 million and operating income increased 35% to \$51 million, Company records.” -- Jack Hellmann, President and CEO, Genesee & Wyoming

The Genesee & Wyoming second quarter earnings call brought up the markers for this round of earnings announcements. Total revenue was just under \$210 million, up 32%, on nearly 250,000 revenue-units, up 15%. Operating income was \$51.2 million, up 31%; the operating ratio was 76.6 adjusted for non-ops puts and takes. Below the line, net income jumped 52% year-over-year to \$31.1 million from \$20.6 million and earnings-per-share rose a respectable 47% to \$0.78 from \$0.53, even though the diluted-share count increased 3%.

Australia accounts for 34% of total freight revenue on 22% of total revenue-units with three commodity groups -- intermodal, farm & food, and metallic ores bringing in 92% of AUS sales. These three also account for just 72% of AUS revenue units with average revenue per unit of \$932, roughly 1.5 times the North American Average. The 15% revenue-unit delta is largely attributable to GWR's FreightLink acquisition with a jump to more than 15,000 units from fewer than a thousand units a year ago.

Back out 18,000 “farm & food” carloads and another 5,900 load of metallic ores and and see that North American carloads increased 5% year over year with gains in coal, the STCC 26 paper-related group, chemicals, petroleum products and overhead coal for NS on the former Ohio Central lines. Non-freight sales increased 8% to \$58 million, of which \$43 million was from the North American operations that include a number of smaller short lines plus ports and contract switching assignments.

Total same-railroad (adjusted for Huron Central) revenue-units gained 4% or some 8,000 units. Leaders were coal, up 3,500 units on export met and steam, farm & food up 2,700 cars in Illinois and Australia and 1,500 loads of export coal haulage and waste. The big laggard was the metals group, off 3,500 cars due to problems with a plant start-up.

GWR continues its safety leadership with only zero-point-five reportable injuries per 200,000 hours worked through May. That's one-seventh the FRA Group 3 (practically all US short lines) rate of 3.4 reportables per 200,000 hours. Moreover, GWR's 50-plus shortline names represent roughly 10% of all short lines, so if you back out the GWR names the Group 3 number might just drift higher. But then, the GWR focus begins at the top with CEO Jack Hellmann himself (see my GWR story in the June, 2010 *Trains*, Hellmann quote page 45: “Management's job is to foster a culture in which safety is paramount.”)

The Arizona Eastern Railroad (AZER) figures prominently in the GWR earnings story. On Monday GWR and AZER announced a transaction in which the former will acquire the latter for \$90 million in cash with closing expected in the next two months. Headquartered near Miami, Arizona, AZER is composed of two rail lines operating over 200 track miles in southeast Arizona

and southwest New Mexico that are connected by 52 miles of trackage rights over the Union Pacific Railroad. The largest customer on AZER is Freeport-McMoRan Copper & Gold Inc, the world's largest publicly traded copper producer, making this acquisition a perfect fit for GWR's stated objective to do more in the "natural resources" space.

AZER primarily provides rail service to Freeport-McMoRan's largest North American copper mine and its North American smelter, hauling copper concentrate, copper anode, copper rod and sulfuric acid. In conjunction with the transaction, AZER and Freeport-McMoRan have entered into a long term agreement whereby AZER will provide specific service and track upgrades, and Freeport-McMoRan will provide AZER with certain guarantees. In addition, AZER serves other local customers, predominantly in the mineral, agricultural and forest product sectors.

I spoke with my good friend Ed Ellis, President of Iowa Pacific Holdings and owner of AZER, early Monday morning and he reminded me of two key aspects of this sale. First, that this is the first property IPH has ever sold, and second, that the success of the AZER (see also my "Great Recession" story, *Trains*, June, 2011, page 41) bears out the IPH positioning as "the work-out" guys who take smallish roads and make something out of them. In this case, buying a line for \$20 million plus with 5,000 annual carloads seven years ago and turning it into this.

Says a note from Wolfe Trahan & Co., "We roughly estimate \$0.11 of annual EPS accretion for GWR. The company has \$300 million of borrowing capacity and management seems increasingly upbeat that acquisition and other growth opportunities should emerge in the near to medium term." But there's a caveat. "GWR has a strong growth story outside of the North American economy, and its acquisition outlook seems to be improving. However, we see *less upside in its core U.S. business* with lower end pricing than the large-cap rails. [*Italics added*]

The economy continues to grab headlines, with the Markets in full correction mode. The Dow dropped another 500 points Thursday, having closed down every day since July 22. As if one needed more proof that the economy is in a funk, one need only dust off the 100-year-old "Dow Theory" positing that trends are confirmed if the DJIA and the Transports are moving in the same direction. The idea is that the Industrials mirror the health of companies making goods and the Transports mirror the health of companies moving goods.

Here's how Rick Paterson at UBS puts it: "We raised a yellow flag back in May after Q2 US rail carloads linked to the industrial economy sank 0.6% y/y, and this week the ISM data has us reaching for our caution flags again. Slowing orders and bloated inventories can be a recipe for disaster for the economy and transportation stocks. If the negative spread between new orders and inventories persists, or worse, if it begins to grow like a weed, we'll have to consider packing up and finding our way to the recession camp with the other bears."

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