THE RAILROAD WEEK IN REVIEW

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"Short-lines broadly share favorable rail industry characteristics with the Class Is, but have an added bonus in their potential for acquisition-led earnings growth, lower capex requirements, lower labor costs, less regulatory risk, and favorable tax attributes vis-à-vis their Class I peers." -- Bill Greene, Morgan Stanley

Genesee & Wyoming brought up the markers for the third quarter 2011 earnings season with some great corporate numbers. Revenue up 38 percent to $217 million, ops expense up 37 percent to $161 million, ops income up 46 percent to $56 million. There was little noise below the line so share-holders got the benefit of a 33 percent net income gain (after discontinued operations) to $33 million and earnings-per-share grew $0.77, a 30 percent increase. The operating ratio came down to 74.2, a decrease of 1.2 points.

These numbers include activities in North America, Australia and Europe so disaggregating the lot to get at the North America story requires some digging and interpretation. Happily, GWR provides a set of supporting financials that break out the total commodity and operating expense into columns for "North American & (sic) European," "Australian," and "Total." Below-the-line data is for the entire company.

I have not been successful in separating North America from Europe based on public filings. The closest one gets is in the 10-K for 2010: "Genesee & Wyoming Inc. and its subsidiaries currently have interests in 63 railroads, of which 57 are located in the United States, three are located in Canada, two are located in Australia and one is located in the Netherlands." From this one must conclude the Netherlands portion of what's reported as "North America & Europe" is but a small portion of the whole and for that reason WIR will dwell on "North American & Europe" as if it were US and Canada alone.

Putting "North America & Europe" in the context of the whole, one finds the former generated two thirds of 3Q freight sales -- $103 million -- on 79 percent of the revenue units (a container being a revenue unit), 201,253 units. Australia has 100 percent of intermodal revenue, two thirds of farm and food sales, a quarter of the minerals & stone group revenue and 86 percent of metallic ores revenue. Car counts split pretty much along these lines. The North America advantage is its revenue units and car-counts are spread more evenly across all commodity groups, with coal being the largest commodity -- 21 percent of vols. Pulp & paper is second at ten percent and everybody else is in the single digits.

GWR's Rail Link division oversees the port switching, contract switching and short lines that are not part of GWR's six (five if you combine NY/Penna and Ohio) geographic operating regions. Revenues are posted under "non-freight" revenues on the income statement and the actual number of revenue units they handle is excluded from the commodity group comparisons. Total

revenues in this category for NA and Europe increased seven percent year-over-year, bringing total sales ex-Australia to $146 million, up 17 percent, and representing two-thirds of corporate revenue. Operating expenses for North America & Europe -- including Rail Link) increased 18 percent to $108 million, operating income gained 68 percent to $38 million and the operating ratio added less than a point to 74, still a respectable number.

On Tuesday's earnings call GWR said fourth quarter total vols could come down some 13,000 units "due to normal seasonality." In addition, US coal could be off 1,500 on lower steam coal shipments in Utah and Illinois as coal loses out to hydro power and the central Penna coal fields see fewer export coal shipments. The "other" vols on GWR's financials are mainly overhead coal moves for NS in eastern Ohio and could be off another 3,500 units in Q4. Mins & stone units could drift south to the tune of six grand as construction and road building slow for the winter in the cooler climes and non-freight sales may be affected by the seasonal iron ore slowdown in Labrador.

JPM's Tom Wadewitz summarizes the call thus: "GWR's focus on acquisition-driven growth in North America should provide less sensitivity to economic performance in North America compared to other shortline operators. A sharp slowing in the North American economy is the greatest source of risk."

Then on Wednesday, as if to underline Tom's acquisition thread, GWR announced it has an agreement with NS to lease the latter's 56-mile line segment between Albany and Hilton in southwest Georgia. This will be GWR's newest name, the Hilton & Albany Railroad (HAL), and will begin ops January 1, 2012. It's not necessarily new business for GWR in that the branch already interchanges with GWR's Chattahoochee Bay and Chattahoochee Industrial Railroads at Hilton. Another GWR property, the Georgia Southwestern, makes NS interchange Arlington, roughly the midpoint of the HAL.

The new line is expected to handle approximately 12,000 carloads annually, primarily overhead traffic between NS and GWR's Bay Line and its Chattahoochee Bay and Chattahoochee Industrial railroads. In addition, the HAL will serve several local agricultural and aggregate customers in southwest Georgia. Given the nature of the traffic base -- single cars of low-rated ag products, paper-related and aggregates, much of which originates on another GWR property with NS in the middle -- I'm not surprised. And although the HAL is unlikely to provide a meaningful boost to 2012 volumes, GWR's longer length of haul should help operating margins and car-cycle time. I'd just like to know what took them so long.

Canadian Pacific is very much in the news these days as Pershing Square's Bill Ackman accumulates a 12 percent ownership stake in the railroad. The hedge fund's CP position is worth about $1 billion in common shares and options with an average purchase price of $54. Before Ackman's move, CP Rail shares were down slightly over five years vs. NS, up 20 percent, and CN, up 55 percent, for example.

CP trades on a similar valuation to peers, but is significantly less profitable than its closest peer, Canadian National. According to *Market Watch*, "Pershing didn't indicate whether it has any immediate plans to propose to the railroad operator. The hedge fund typically doesn't make hard demands when it first takes a large position in a company. It often tries to work with senior management privately on strategic ideas it believes would improve company operations."

Toronto's *Globe & Mail* says, "Mr. Ackman has a history of working 'inside the tent' with executives and directors to restructure businesses for long-term gains, rather than trying to pressure underperforming companies to enter takeover discussions. Relying on what he has called his 'reputational equity,' Mr. Ackman seeks to win boardroom support for major shifts that can include changes in products, operations and management." Evidently discussions have already begun according to sources familiar with the matter. Concludes the paper, "The move underscores the seriousness with which Mr. Ackman is being taken."

The Wall Street crowd takes a generally positive view, but with reservations. Chris Ceraso at Credit-Suisse suggests CP's getting to an OR of 70 could make the shares worth $80 assuming a "normal-ish rail PE ratio of 14." Ed Wolfe and Scott Group at Wolfe Trahan don't see a CN-like improvement trend "given less strong underlying pricing fundamentals, more debt on the balance sheet and higher capital requirements the next several years." At Morgan Stanley, Bill Greene writes, "Investors worry that CP will have to trade yield for volume in 2012 due to 2011's service challenges." And Jason Seidl at Dahlman & Rose warns, "If [winter] volume growth significantly underperforms the rest of the Class Is... some shareholders may begin to lose patience and be more willing to accept Pershing's intervention." [*I have the complete notes from each, if you're interested. -- rhb*]

And here's a fitting close to this Act I of the play: CFO Kathryn McQuade is scheduled to address the Scotia Capital *Transportation & Aerospace Conference 2011* on November 15 in Toronto. The presentation, according to the advance billing, will provide highlights of CP's current business performance and initiatives. I'm sure the Q&A will be lively.

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