THE RAILROAD WEEK IN REVIEW
JULY 15, 2005

"Since 1971, every recession has been preceded by an increase in the fed funds rate and a spike in oil." Richard Yamarone, chief economist at Argus Research Corp, quoted in Barron's On Line.

Rail traffic for Week 27 (July 9) was up a point over all over 2004's Week 27, up 2% in the past four weeks and 3% YTD. Intermodal continues to be the driver, up 4.1%, 4.3% and 5.9% for the three periods yoy. Commodity carloads were down a point, decreasing from up four-tenths of a point over four weeks and up 1.4% YTD. Motor vehicles, metals, coke and nonmetallic minerals all took double-digit hits.

Among the railroads themselves Week 27 was a study in contrasts. In the east NS was up 3% with coal and intermodal up 7% and 9% respectively while CSX traffic dropped 5% with coal and intermodal – half its volume – off by 3% and 2% respectively. North of the border CN rang up a 7% volume gain to CP's 6% decline in loadings. Out west the contrast was somewhat less severe, both bracketing a plus 2%: UP 1.7% to BNSF 2.4% with the former taking the bigger grain hit.

The AAR performance measures use a week ending 7/8 (you'd think the two departments would use the same cut dates) and there's not much improvement over the "historical 3Q04 average." BNSF and UP both slowed down a bit yet UP's average 30-hour yard dwell pales before BNSF's average dwell of a mere 10 hours, best in the business.

NS and CSX also slowed somewhat though with NS besting CSX by a consistent 7 hours in yard dwell (24 to 31) so we can see where the better transit times are to be had. The CN-CP dwell spread score is 12 to 23 in favor of the former and CN was the only RR to increase average speed by more than 1 MPH, now leading the pack at 26.7 MPH.

Herein lies proof that the faster railroad costs less to run. BNSF, CN and NS continue to best their regional competitors in operating ratios and spreads between revenue and operating income increases. All three maintain active fuel hedge programs and have low injury rates in reportables per employee-hour worked. Look for this thread to be repeated over the next two weeks of 2Q05 earnings reports.

Norfolk Southern turned the tech corner this week, advancing to Long/Strong Buy from Avoid after a short stop at Neutral. NSC broke through the 50-day SMA at $32 on 7/8 and hasn't looked back; the 10-day average crossed the 20-day line from below on Thursday further strengthening the upward move. Late Friday, however, the stock was beginning to look a tad oversold north of $33.

Elsewhere, the tech signs look pretty good for our favorite industry. Among carriers BNI, CNI and UNP are the only neutrals while six of other seven are Long/Buys. Only CP ranks an Avoid on a weak downward trend within the $34-$36 trading range set up over the past four months. Please keep in mind the tech side measures how the investment community feels about each name's prospects. Good performance measures are one thing; how The Street perceives earnings momentum going forward is another. That said…

JP Morgan on Friday initiated coverage of The Big Six with Neutrals on CNI, CP and BNSF, Overweight on CSX and NSC and Underweight on UNP. The author is none other than Tom Wadewitz, who came over from Bear Stearns last month to run not only JPM's rail desk but also to cover airfreight and truck transportation names as well.

We had a chance to chat briefly Friday about what he sees going forward and the rationale behind his rankings. His so-called "initial reports" weigh in at 30+ pages each and include an investment thesis, key points to support same, a valuation and rating analysis, and a statement of risks to the rating. Re CSX, for example, Tom writes, "In our view, CSX has entered the sweet spot of operating margin improvement and EPS performance…. Our June survey of industrial shippers provides an indication that shippers expect rail pricing to remain strong in 2005 and accelerate in 2006…. The first risk to our rating is deterioration in revenue growth for CSX if coal volume growth falls or if industrial volumes fall particularly sharply."

I've always enjoyed Tom's approach to the rail industry. He's an excellent student and a fine writer. Best wishes, friend, and keep those reports coming.

Florida East Coast Industries (NYSE: FLA) CEO and President Aldolfo Henriques has been tapped to join the Board of Directors of U.S. Century Bank, a relatively small enterprise with $450 mm in assets and ten branches in Miami-Dade ad Broward Counties. Prior to joining FLA last February Henriques had been Union Planters' top South Florida executive since 1998 and before that spent six years as NationsBank (now BAC) CEO for South Florida. Coincidentally, Union Planters was bought last Jan by Regions Bank, a major player in shortline financing and lending.

Genesee & Wyoming North American traffic in June 2005 increased more than 16,000 revenue units or 32.8% yoy including more than 12,000 from acquisitions over the TTM period. Total volume reached 67,000 revenue units, up from just over 50,000 in June 2004. June carloads from the former Rail Management Corp. railroads do not include shipments at the Port of Galveston and the Port of Wilmington, posted as switching revenues (non-freight) along with GWR's other port operations.

In 2Q05 GWR revenue units were up 15.4% yoy -- more than 24,000 units, of which 19,000 came from acquisitions. The same-store increase was primarily due to a 2,596 carload increase in lumber & forest products traffic and a 1,998 carload increase in pulp & paper traffic. Australia did not fare quite so well as counts for June and the quarter were off 2.9% and 4.2% respectively.

Observes Bear Stearns' Greg Ryan, "Australian (ARG) volumes were in-line with our expectations, down 2.9% in June, modestly improved vs. declines of 4.3% and 5.5% in the prior two months. ARG's volumes declined 4.2% for the quarter, compared with a 3.9% decline in 1Q and roughly in line with our 2Q forecast of 3.2% contraction. Grain volumes, down 44.8% in June, remained particularly soft versus a difficult comp."

Kansas City Southern negotiations with TFM and the Mexican government seem to be moving toward resolution in 3Q03. The stock, trading at 30.4 times the 2005 estimate as Friday's close of $21.56, carries a valuation more than double what one would expect for a railroad. There are some who say KCS+TFM might be a tempting acquisition (please fill in the blanks).

The unknown is the combined value of the Value-Added Tax (VAT) the Mexican government owes KCS plus the value of the put option the Mexican government holds on the 24% of TFM that KCS does not already own. Bear Stearns estimates the VAT is worth about $1.1 bn in face value plus interest and inflation, though after taxes and the government stake it'll be closer to $642 mm.

The put falls someplace between between $346 and $500 mm (depending on how one figures it). Net-net if KCS collects the VAT and the put option is exercised KCS still comes out $142 mm to $296 mm ahead and gets 100% of TFM. Bear Stearns reckons combined EBITDAs for 2005 and 2006 run to $418 mm and $473 mm respectively. Combined enterprise values (EV) ring in at $4.6 bn each year, indicating EV/EBITDA multiples of 11.0 for 2005 and 9.7 for 2006. Not too shabby when you recall the entire Class I universe is trading at multiples of 7.6 and 6.9 respectively. Kudos to Greg Ryan and the guys at Bear for helping to make sense out of all this.

The Rule of 100 holds that a shortline needs 100 revenue carloads per year per route mile of track (CPYPM) to be profitable (see http://www.rblanchard.com/resources/texts/rule100.htm). Yet some shortlines use track owned by various local authorities that also pay for some or even all the annual track maintenance costs as well as capital upgrades. What happens to the 100-car rule here?

Using the same assumptions as the above link, relieving a 60-mile shortline of all track expense drops CPYPM to 55 from 100 based on total operating expense divided by a nominal handling fee of $250. Of course your mileage may vary depending on RPC. Still, it's an argument for going with fewer carloads per mile when somebody else is footing the track bill.

More on the *Kelo* property ownership question. Marybeth Luczac, Executive Editor at *Railway Age*, did some asking around about the impact of the Supreme's property-taking decision (WIR 6/24/2005). She writes, "I've finally tracked down and talked to both AAR and ASLRRA about the Supreme Court's recent ruling that local governments can seize people's homes and businesses -- even against their will -- for private economic development.

"Both associations said that there is no concern in the industry at this point. As AAR's Tom White summed up: 'Our lawyers don't really see it as having much impact on railroads. Even if a city tried to exercise eminent domain to seize a rail line, it would still have to get STB approval which it would have a hard time getting if the line was deemed essential for interstate commerce.'" Thanks, Marybeth. May the Providence & Worcester sleep more soundly on its New London waterfront holdings.

As we continue to wring our hands over rising fuel costs, take heart. There are folks out there who are lowering fuel costs even as traffic increases. Consider Southwest Air (ticker symbol LUV). The quarter just ended was Number 57 in a consecutive string of profitable quarters. Ops revs were up 13.3% to $1.94 bn, ops income increased 40.6% to $277 for a railroad-equivalent OR of 85.7.

Now here's the kicker: Ops exp increased just 9.7% thanks in part to the fuel hedge program that saved $196 mm in 2Q05. LUV remains approximately 85% hedged for 2H05 at $26 per barrel; approximately 65% in 2006 at $32 per barrel; over 45% in 2007 at $31 per barrel; 30% in 2008 at $33 per barrel; and more than 25% in 2009 at $35 per barrel.

And yet we see certain railroads hedged not at all or now hedging their bets. How can this be when the results of an aggressive fuel hedge can be so dramatic? Anybody? (Full disclosure: I am long LUV, selling 15 calls 45-60 days out for a buy-write that keeps on giving as long as LUV stays in the $13.50 - $14.50 range.)

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