THE RAILROAD WEEK IN REVIEW
APRIL 7, 2006

"The key to this strong performance is that railroads have turned robust demand for their services into price increases on long-term contracts." -- WSJ On-Line, March 22, 2006

First Quarter Earnings reports begin with Union Pacific on 4/19 and conclude the first week of May with KSU (GWR has not yet announced a date). UNP will win the brass ring for greatest yoy improvement as they've gotten costs down nicely. It'll be instructive to see how yoy revenue-unit counts stack up. NSC looks poised to post a solid second place. Anecdotal evidence seems to say they are leaving no revenue stone unturned and STB train speeds show sequential improvement.

Revenues will be up double-digits except for CSX and RRA, up 7.6% and 3.6% respectively (see table at end). KSU and GWR will report large revenue increases on acquisitions, so until the comps catch up keep that in mind. CP and UNP are come-from-behind stories. BNI is flat running the wheels off everything (WIR 3/31).

Full-year earnings-per-share estimates once again show solid gains. UNP is on track to post the best gain and KSU's outsize increase is, I think, a function of getting rid of all the below-the-line noise that went with the TFM transaction. GWR will continue to benefit from its contiguous railroad strategy in North America and as the streamlining of rail ownership in Australia starts to come home.

Valuations appear reasonable with UNP and GWR offering the best bets for further appreciation based on forward Price-Earnings-Growth ratios for the full year. Recall that a price-earnings ratio equal to the growth rate yields a PEG of 1.0 and indicates the name is fully priced; anything under 1.0 is a buy – the lower the better the buy – and anything over one begins to look like a growth stock, though as 2.0 is passed one might consider a short.

Speaking of growth stocks, the yoy earnings gains for the group have that look. Solid double-digits across the board combined with the low PEG ratios make further stock price appreciation a good bet in almost every case. Based on these numbers UNP and CP appear to have the most upside. Bear Stearns recently upgraded CSX – "for the first time we see signs of acceptance of the One Plan throughout the company" – but I feel the stock price has gotten a bit ahead of itself and will remain on the sidelines for now.

BNSF and NS are next on my railroad buy list for my personal retirement account based on what I'm hearing from shippers, shortlines, railroad managements and what I see out on the road. The BNSF focus on velocity (WIR 3/31/2006) and the NS focus on maximizing yield make these the long-term plays. The trends are so strong on both that I'm waiting for a pull-back before diving in.

Stock price gains are fine but there's a caveat. What happens when the Class Is approach parity with "market pricing" and there's little room left for catch up? The full story won't be known until we can compare yoy changes in revenue-unit volume and operating expense. FY 2005 saw a 13% revenue increase on 2% more volume but 8% more operating expense, and that's scary.

What happens when the rate of revenue increase is but a point or two ahead of the rate of volume increase and the expense increase is greater than both? Recall too that maybe four points of the revenue increase is fuel surcharge revenue. The Class Is are moving away from hedging and embracing fuel surcharges as the preferred offset. But as fuel settles in the $55-65 range the rate of yoy fuel cost increases will slow as well, further diminishing the top-line FSC contribution.

The prospect of parity gains in volume, operating expense and revenue does not bode well for continuing double-digit gains in operating income. Worst of all, the carload side of the house will get hit hardest as there is much more room to increase intermodal rates. Perpend: a trucker gets $1.50 a mile to move a box LA to Chicago; BNSF gets 40 cents. Add on a 25-mile dray on each end and give the drayer $3.00 a mile for the short-haul inconvenience and it’s still less than half a buck mile.

The combination of the loss of pricing elasticity, diminishing FSC revenue and increased operating expense will shrink carload margins still further. The most expensive part of the carload trade is gathering and distribution and maintaining the infrastructure to support it. Ergo the faster the Class Is can exit the G&D side of the business the better.

Norfolk Southern has taken another step in this direction with its second in-house shortline. The Delmarva Business Unit (DBU) opened for Business on April 1 with HQ in Wilmington. The stated goal is to improve customer service, increase operating efficiency and develop new business. It is the product of the business model NS successfully created and implemented in North Carolina in 2002 with its East Carolina Business Unit.

As we’ve seen with the ECBU, this business model incorporates the flexibility and local focus of a small railroad, supported by the industrial development and technological resources of a major carrier. And like the ECBU the new DBU has dedicated local management with complete responsibility for managing the railroad, some 191 route-miles of track operated by NS. Its three segments run between Newark, Del. and Edgemoor Yard in Wilmington, Del., between Wilmington and Pocomoke City, Md., and between Harrington and Frankford, Del.

DBU's main terminals are Harrington, Wilmington and Newark and it supports three shortline railroads: The Maryland & Delaware, the Bay Coast RR (formerly the Eastern Shore RR) and the Delaware Coast Line. As an internal unit with its own budget, the DBU has some similarities with a short line railroad but is linked to Norfolk Southern's centralized dispatching, customer service and operating systems. More than 115 Norfolk Southern employees are assigned to the DBU team.

NS has put the DBU under the same leadership team as the ECBU so that what was learned on the ECBU can be immediately applied here. No sense going up the same learning curve twice. After spending about four hours on the phone Tuesday talking with NS staffers, shortline owners, and other interested parties I come away convinced this is a watershed moment for NS with more to come sooner rather than later.

Elsewhere, Don Seale moves up to EVP Marketing and Chief Commercial Officer as Vice Chair Ike Prillaman takes his retirement. Seale joined Norfolk Southern in 1976 and served in a number of sales and marketing positions before being named EVP sales and marketing in 2004. Jim Squires steps up to SVP financial planning, reporting to Hank Wolf, vice chair and CFO, and Bill Galanko moves to VP-Law reporting to Jim Hixon, EVP-Law and corporate relations.

Squires joined NS in 1992 as an attorney and served in positions of increasing responsibility before being named senior vice president law, his most recent position, in 2004. Galanko joined Norfolk Southern in 1990 as general tax attorney and was named vice president taxation in 1999. He was named vice president financial planning, his most recent position, in 2005.

Rounding out the Paper Barriers thread, let the record show that were it not for mercantilism the colonies never would have been formed. And were it not for Class Is wanting to shed marginal gathering and distribution activities while preserving at least some of the revenue stream we never would have seen shortlines springing up like weeds post-Staggers.

The ASLRRA is pro-paper barriers, and for two very good reasons. First, paper barriers make line transfers more palatable to Class I commercial types. Second, the top third of all shortline operators (see “The Value-Added Shortline,” www.rblanchard.com/resources) are the most likely winners in Class I line transfers and they have learned to live with paper barriers. I know for a fact that both BNSF and NS will rely on paper barriers in future transactions; readers tell me UP is of the same mind. This it appears that without paper barriers there will be no transfers. That’s not what the ASLRRA, the RIA and the RIWG are about.

A shortline owner intimately involved with all three writes, “The key here is that many line spin-offs are done for little or no cash. Look at the Missouri & North Arkansas, a railroad that is the focus of the WCTL petition. In its submission to the STB, UP noted that it leased this 389-mile asset since 1989 ‘without receiving a dime’ in lease payments from the M&NA. UP's only return on the asset comes from traffic generated by the M&NA (particularly unit coal trains).”

He goes on to warn that if there were no conditional leases and open-access line sales were the only transfer option shortlines “would have to leverage themselves even further or raise additional capital through equity sales.” Players like RRA, GWR, Watco, and OmniTrax come to mind. Writing in *Railway Age* (October, 2005), LAL Board member Gene Blabey observes that “that the explosive growth in the shortline industry in the last 20 years has been due primarily to paper barriers.” That’s a definite positive. A line preserved with paper barriers has got to be better than a line abandoned for failure to meet the owning Class I’s internal hurdle rates.

An attorney who’s put in his share of hours on paper barriers offers this observation: “The sale/lease of a marginal branch line to a shortline operator is simply a way for a Class I to extend the useful traffic life of a marginal line by [transferring it to a shortline] operator… [The STB has a] congressional mandate to preserve, maintain and promote an integrated privately funded national rail transportation system, [and] all railroad service, like all politics, is local.

“What may be a very good competitive solution in one situation may be completely inappropriate in another. Thus, the position of the AAR and the [ASLRRA], which permits negotiated private settlements through the Rail Industry [Working Group], enables the parties to focus on individual situations and is far superior to the blanket elimination of paper barriers.”

For the final word, let me turn to my good friend and fellow pundit, Larry Kaufman: “I would not be surprised if you had said the letters you quoted all came from rail shippers. As I have said before, I must have missed the picture of the Class 1 CEO holding a gun to the head of the would-be shortline operator forcing him to take over the line that otherwise probably would be abandoned. I am sick and tired of customers who always have a bitch about the railroads. It falls in the category of ‘watch what you ask for, because you might just get it.’ If the complainants had their way, a lot of miles would be abandoned, and/or they would be back in the regulatory soup, and I don't recall that the shippers benefited any more from that than did the carriers.” Thanks, Larry.

Shoes Redux. Last week I ran a very thoughtful note from a railroad investment professional on the need for the railroad industry to do more to promote itself to the general public. Now let me don my old ad sales hat and offer some specifics on what’s being done and what can be done. But first, a couple of take-aways from Advertising 101: You need to reach the target audience with a frequency of placements sufficient to enhance recall of the message.

Media owners make their money selling ads, not subscriptions. Ad rates are based on readership or TV households tuning in as measured by any number of syndicated services. Tales of death and destruction will do more to boost readership and ratings than all the motherhood-and-apple-pie stories anybody can dream up. Ergo there's a lot of competition for eyeballs and D&D works best.

Thirty years ago when the AAR had a $2 mm ad budget they were advised that advertising requires continuity. As one pro put it, "If you're going to turn the faucet on and off, don't turn it on in the first place because you'll only be wasting your money." Unfortunately for the ad budget, Staggars came along, the faucet was never turned on and today we're left with the History Channel.

One of the virtues of print media is you can match the medium to the message. WIR devoted most of its Sep 16, 2005 (www.rblanchard.com/week_in_review) letter to the way NS got its Lake Pontchartrain bridge back in service following Katrina's devastation. I also ran a web page (www.rblanchard.com/katrina2) with photos and had a link to it in WIR. Too bad the mainstream media didn't pick it up, but NS surely did its part in getting the message out.

Recall too that CEO Wick Moorman told the Katrina story at the September 2005 Lexington Group meeting (WIR 10/7/2005) and that this august crowd is composed strictly of railroad writers, publishers, photographers, and historians. NS is going for reach and frequency, too. Wick Moorman copped the title story in the Feb 2006 *Forbes* and NS has a new ad campaign planned for the season. And NS has included a DVD in its 2005 Annual Report, this one describing the Katrina recovery.

And let's give credit for the job BNSF is doing with its press trips (WIR 3/31/2006). You can see Dan Machalaba's take on the trip in Tuesday's *WSJ* (4/4). Also on the trip were *Trains* Editor Jim Wrinn, Don Phillips of the *International Herald Tribune* and long-time *Trains* contributor, Bloomberg's Rip Watson, *Progressive Railroading* Editor Pat Foran plus writers representing a number of newspapers from towns along the line.

The rails have two target audiences: shippers and investors. CP advertises in *Logistics Today* and they need company. Both *Railway Age* and *Progressive Railroading* have substantial shipper readerships. CNBC, Bloomberg, and the WSJ cover both targets and I've seen NS ads in two of the three. *Trains* has a happy mix of shippers, investors and an involved public. My ad buy: Thirteen weeks of Squawk Box 30s, six BW half pages in WSJ and quarterly BW quarter pages in the four mags.

On stock purchases. If Jim Cramer can hold "best of breed" in his Charitable Trust and talk about others in the same space on "Mad Money," and if the Motley Fool columnists can invest in what they write about, then so should I be able to invest in what I write about. I'm not a CFA working for a Big Firm issuing buy and sell recommendations; I'm an observer of the passing scene who is passionate about railroads and who has done some investing in what he believes in.

My commitment to you is that I'll announce any buy or sell decision at least ten days before I pull the trigger. I don't short as a general rule, though I will write covered calls to generate income on a slow-moving stock.

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Ticker	**BNI**	**CNI**	**CP**	**CSX**	**GWR**	**KSU**	**NSC**	**RRA**	**UNP**
Reports	25-Apr	20-Apr	25-Apr	19-Apr	na	2-May	26-Apr	27-Apr	20-Apr
1Q06									
EPS									
2006e	$ 1.04	$ 0.51	$ 0.54	$ 0.85	$ 0.33	$ 0.10	$ 0.67	$ 0.17	1.08
2005a	$ 0.83	$ 0.43	$ 0.43	$ 0.68	$ 0.26	$ 0.09	$ 0.47	$ 0.16	0.48
Change	25.3%	18.6%	25.6%	25.0%	26.9%	11.1%	42.6%	6.3%	125.0%
Revs (mm)									
2006e	$ 3,460	$ 1,560	$ 995	$ 2,260	$ 106	$ 401	$ 220	$ 114	$ 3,670
2005a	$ 2,980	$ 1,390	$ 828	$ 2,100	$ 84	$ 198	$ 196	$ 110	$ 3,150
Change	16.1%	12.2%	20.2%	7.6%	26.7%	102.5%	12.2%	3.6%	16.5%
Full Year	**BNI**	**CNI**	**CP**	**CSX**	**GWR**	**KSU**	**NSC**	**RRA**	**UNP**
EPS									
2006e	$ 4.80	$ 2.69	$ 3.21	$ 3.76	$ 1.48	$ 0.58	$ 3.30	$ 0.85	5.09
2005a	$ 4.13	$ 2.30	$ 2.73	$ 3.34	$ 1.13	$ 0.07	$ 2.82	$ 0.83	3.41
Change	16.2%	17.0%	17.6%	12.6%	31.0%	728.6%	17.0%	2.4%	49.3%
Price 3/31	$ 83.33	$ 45.28	$ 49.97	$ 59.80	$ 30.68	$ 24.70	$ 54.07	$ 10.66	$ 93.35
PE	17.36	16.83	15.57	15.90	20.73	42.59	16.38	12.54	18.34
PEG	1.07	0.99	0.89	1.26	0.67	0.06	0.96	5.20	0.37
Price 3/31/05*	$ 53.93	$ 31.66	$ 35.97	$ 41.65	$ 17.27	$ 19.26	$ 37.05	$ 12.48	$ 69.70
YOY Chg	54.5%	43.0%	38.9%	43.6%	77.6%	28.2%	45.9%	-14.6%	33.9%

*split-adljusted

Sources: First Call, company reports, WSJ.com for 1Q05 stock prices

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