THE RAILROAD WEEK IN REVIEW

APRIL 28, 2006

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"We recommend NS or UP as they have more revenue to be re-priced under this new era and therefore more upside in their stocks." – Jim Valentine, Morgan Stanley

The ASLRRA's Annual Meeting in Orlando this week was a rousing success. It was the largest gathering ever, with more than 1,200 attendees representing more than 200 individual shortlines, 100 vendors taking exhibition hall space, and representatives from all the Class Is. The good news is that it was evident from the presentation topics that the shortline community is becoming increasingly sophisticated in its grasp of the hot topics *du jour*.

New this year was an expanded program of break-out sessions covering everything from car supply to event reporting to developing meaningful revenue streams. My only quibble was that the list of presentation topics was long on running trains and short on running a business. And it is here that the shortlines are divided between the haves and have-nots.

The days when one could make a living on short-haul low-rated commodities to multiple Class I destinations are gone. The Class I panel of senior commercial officers made that clear. But it does *not* mean that "all they want is unit trains, intermodal and coal." It means that predictable revenue streams that earn their cost of capital are the first ones in line and the customers (and shortlines) that fill this bill will be the soonest winners. This Annual Meeting did a lot to provide the winning tools. A hearty thanks and a round of applause for all who made it possible.

BNSF reported record first quarter operating income of $792 mm (+25%) on record Q1 freight revenues of $3.4 bn (+16%, a third each on volume, yield and FSC) while holding ops expense to a 14% gain. The OR shed 161 BP to 77.1 from 78.7 a year ago. (BNI says 76.5 based on ops expense less other revenue over freight revs; I use ops expense over total ops revs.) All commodity groups posted double-digit gains in revenues and revenue per unit. As one would expect with BNSF, intermodal led volume growth (+6%) punching total unit gains to 5% yoy.

The Industrial Products was the laggard with loads up only 1% yoy, however the healthy RPU gains show the focus on yield is paying off. The $772 mm in revenue is a record and RTMs are up 6% yoy. Aggregates, forest products, metals, chemicals and petroleum products all clocked double-digit revenue gains. Ag revenues were up 14% on double-digit gains in wheat, corn, ferts and bulk (ethanol mainly) while beans were down 16%.

Performance metrics have slipped a bit – system on-time 78% vs. 80% in 1Q05 – however pushing record volumes across a full system is bound to cause some OT deterioration (see my transcon trip report in WIR 3/31/2006). Since 2003 GTMs are up 24% and unit miles are up 26% even as the railroad has shed mileage to shortlines and transit operators. Velocity in unit miles per day is off 5% in the same period, further demonstrating the need to shed low-speed gathering and distribution to shortlines and focus assets on the core routes.

EPS came in at $1.09 vs. $1.04 the Street estimate. Taking out four cents for the New Mexico line sale puts BNSF a penny ahead of estimates and I suspect this ho-hum number lulled some market managers into thinking BNSF was asleep. *Au contraire*. CSX and UP reported heady gains last week but both are catch-up stories. As an operating guy I can confidently say BNSF is running flat-out and that the well-run railroad has a quality story that will generate gains in high-quality traffic with higher margins. CEO Matt Rose concluded the call saying we should expect EPS growth "in the 20-25% range" which implies revenue gains even better than that.

Elsewhere BNSF is ramping up the Logistics Park concept again, this time in Gardner, KS. Alliance (Fort Worth) and Joliet were the first LPs developed in partnership with third-party developers. The idea is to concentrate development of rail intermodal hub centers and adjacent freight distribution and warehousing centers and motor vehicle distribution facilities.

As we've seen in Joliet in particular, the LP lets BNSF improve carload equipment cycle time by keeping the cars on BNSF, a major consideration when maxizing use of jumbo reefer equipment, for example. The extension of the LP is the "BNSF Premier Transload Network" that Vann Cunningham, AVP-Economic Development introduced at the Oct 2005 shortline meeting in Ft Worth.

By now there are more than 100 Premier Transload facilities in 22 metro areas with one out of every five located on BNSF shortlines. Says Cunningham, "Shortline participation in the Premier Transload network supports the goal of reducing local gathering and distribution with BNSF resources." So shortlines please see the LPs as opportunities, not threats. You will prosper if you do.

Norfolk Southern once again took revenues up (17.4%) at a faster rate than ops expense (12.5%) and thus leveraged a dot-com ops income increase (36.7%). Revenue units increased yoy at a 5% clip, 20 BP better than Friday's updated GDP gain of 4.8% and better than any Class I road. Even Wall Street noticed, stepping back from their eps focus. Bear Stearns' Ed Wolf writes, "We have updated our operating assumptions, including generally stronger revenue growth and better margin improvement." My buddy Tony Hatch adds that NS' results are "further evidence of a secular rather than merely cyclical trend."

Every commodity group but auto posted double-digit revenue gains with the merch group up 17.7%, besting intermodal by three points (sounds of shortlines cheering). Volume increases were nominal but at least positive ex chems and auto while merch RPU was up double-digits in every group; auto again the exception. Chief Commercial Officer Don Seale offered that half the $124 gain in system RPU was from fuel surcharges, however that will change as NS adjusts pricing to reflect higher fuel costs. In his prepared remarks (see www.nscorp.com under investors), Seale said, "In light of what now appears to be permanently higher oil prices, we have reduced the fuel surcharge applicable to our non-Intermodal tariff traffic and will increase the line-haul transportation rates on this traffic."

Record first quarter revenues contributed to an OR of 76.1, a level not seen since the pre-Conrail days, and 337 BP better than 1Q05. Like every other Class I, NS saw fuel prices jump by half yoy to $1.68 a gallon from $1.12. They burned 3% more fuel on 2% more ton-miles, which, when viewed in the context of improved STB Performance Measures, supports a thesis of more merch units moving in faster, shorter hauls than a year ago (more shortline cheering).

Below the line NS rang up a 53% gain in eps to $0.72 against a Wall Street consensus of $0.68 including $27 mm in accelerated options expensing related to the new FAS 123. Bear Stearns, Morgan Stanley and Credit Suisse have all issued glowing reports on this quarter as well as sustained Overweight and Outperform ratings. Zack's reports that NS has beat estimates nine out of ten years, has grown eps at 32% over five years and analysts have been revising estimates upwards. Out on the railroad I see a fast, safe operation under the leadership of some very bright and dedicated people. The momentum is there.

Canadian Pacific first quarter operating income rose 28% yoy to C$229 mm thanks to a 9% gain in revenue and a 6% gain in ops expense. Freight revenues however increased 8% to C$1067 with the other point coming from a doubling of “other income” to C$43 mm. Foreign exchange and fewer carload of coal and potash took freight revenues down 8% yoy though other volume, mix and FSC generated the net eight percent gain. Total revenue units were essentially unchanged yoy, GTMs were off 2% and CP cut fuel burn by 3%. The OR dropped three more points to 79. Below the line eps gained 36% to C$0.69 against a consensus of C$0.63. Excluding the FX loss the gap narrows.

Recall that CP took the refrigerated box car business out of carload and put it in intermodal, so we’re not looking at clear yoy comps. That said, the significant commodity revenue gainers included grain (+28%), industrial (+13%) and intermodal (+13%). Grain vols were up almost as much so the percent change in RPU was middling. IP gained 16% in RPU even though carloads were off 2%. Coal loadings were down 8% yet held a 6% RPU hike.

The decline in potash and ferts appears to be a function of soft Asian potash demand and a general weakness in the ferts market. Coal is off because the demand for met coal in Asia is off. During the call CP management suggested coal vols are likely to remain depressed though the projections for grain, ferts, IP and IM are good.

RailAmerica increased first quarter operating income a respectable 44% to $14.3 mm thanks to a 13% gain in freight and other revenues while holding the operating expense delta to 10%, bringing the OR down 2.70 points to 87.3, still high by Class I standards but comparable to the larger community of independent shortlines where ORs range from the high 80s to north of 100. Recall that RRA still struggles with the RailTex “any railroad any place” syndrome and lacks the economies of scale that contiguity creates – see GWR’s map, e.g. In that context an 87 is not bad.

Ops expenses came down save for fuel and depreciation, which is as is should be. CEO Charlie Swinburn noted in his remarks that RRA compensation and purchased services remain pretty much constant regardless of volume and car hire came down a bit due to the changed equipment mix with the line sales and the Alcoa acquisition. Below the line, RRA earned $0.17 a share from continuing operations, up 34% yoy. Discontinued operations added $8 mm or 22 cents a diluted share to the reported net.

RPU was up double-digits in six of 15 commodity groups as RRA gained “pricing power” in a third of their lanes, up from 25% a year ago. The down side is that most RRA properties are paid carload allowances rather than classic “divisions” and so will not see the double-digit rate increases so prevalent on the Class Is. Acquisitions accounted for 6% of the yoy revenue gain with the rest from yield (3%), fuel surcharges (2%), foreign exchange and non-freight a point each. Same railroad revenues increased 7.25% on flat volumes, though a work stoppage at a major customer cost RRA a point here. Losses on the Ohio operation were cut to a $million from two $million a year ago and Swinburn said if it isn’t turned around completely in short order they will look at their options.

Two items of particular note: the Process Improvement Project (PIP) and the highly effective safety program. The PIP was initiated recently to improve organizational effectiveness by reshaping the way they do things and to generate procurement savings. Economies from the 10-month process will start showing up in 2007 and are expected to lower costs by some $10-15 mm -- two-thirds from lower ops expense and a third from a reordering of capex items.

The safety initiative has paid off handsomely. Injuries per 200,000 hours dropped to 1.51 from 3.49 a year ago. There were just 16 reportable train incidents vs. 25 a year ago; personal injuries came down to *seven* from 16. This takes leadership and attention to detail and the payoff for RRA was a 25% reduction in casualties and insurance expense. And every nickel taken out of ops expense is another nickel for paying down debt. RRA’s debt/capitalization is now 46.8% vs. 49.3% as of 12/31/2005.

Elsewhere, RRA's New England Central Railroad (NECR) has signed an agreement with the BLET to represent certain of its employees. In a press release dated April 17 the BLET said the agreement provides wage increases of 12% over the life of the contract with 50 of 75 voting in favor. As we saw in the BLET announcement regarding the Jan 2006 win on OmniTrax' Panhandle Northern, there's a fair amount of copy telling us how bad it was on the NECR.

If one were to take the BLET notice at face value one might conclude that in some ways the agreement seems to amount to a step backward for the shortline. Shortline employment has the ability to keep people employed by adding continuously to their skill sets. The BLET appears to take away this learning opportunity by enforcing the Locomotive Engineer and Conductor labels. Typically, everybody in T&E service on a shortline is an FRA-certified Locomotive Engineer, meaning they're employable any place they go.

As it turns out, the agreement is a lot more flexible than the release makes out, and that's to the good. A manager's first responsibility is to keep his employees *employable*, not merely *employed*. From what I've seen out on the railroad and heard from RRA senior management RRA seeks to do just that. The adversarial hype in the union's press release is an ill wind that blows nobody any good.

Post Script. Florida East Coast (FLA), L. B. Foster (FSTR) and GATX (GMT) all reported Thursday. Look for those results here next week.