RAILROAD WEEK IN REVIEW
JULY 21, 2006

"CSX has got to be one of the most shareholder-friendly companies out there." – Jim Cramer on his CNBC "Stop Trading" segment Wednesday following the CSX call.

CSX hit a home run Wednesday morning. Share-holder friendly companies do four things – buy back stock (first base), increase dividends (second), split shares (third) and have pricing power (home). CSX is buying back $500 mm of its own stock (at Wed's close about 8 mm shares), announced a two-for-one stock split (buy by 8/3 to play) and a dime dividend on the split shares, a 54% increase. There, you're rounding third.

As for pricing power, Chief Commercial Officer Clarence Gooden said that half the 2Q06 $255 mm revenue increase (12%) was price, 30% was fuel surcharge and the rest mix. Six of seven merchandise commodity groups posted double-digit RPU increases (emerging markets was still emerging) and the merch group average RPU increased 14%. RPUs for coal (9%) and intermodal (6%) were underwhelming.

After the call some analysts were kvetching that total revenue unit volume was down 1% for the quarter. Maybe so, but look where it's down – phos and ferts (-22%) and forest products (-8%) pushed total merch units down 2% yoy. What happened was that the low-margin short-haul phosphates out of Florida's Bone Valley phosphates hit the skids in Dec and wood pulp is down because the paper business is down.

(Of 22 paper companies listed in the WSJ "paper industry group center" stock prices for ten are down double-digits over five years and the ten include all the major US providers. The double-digit gainers are all off-shore companies like South Africa's Sappi and Aracruz in Brazil. Wood chips and logs are good businesses to be rid of, though many of my shortline friends do not like to hear this.)

CSX held 2Q06 operating expense to a mere 2% increase, powering a 53% operating income gain including a $126 mm credit on insurance recoveries, rightly posted above the line. Even absent that ops income would have been up 23%. GAAP net income was $1.66 vs $0.73 in the prior year, up 129%. The OR came down a very respectable 7.2 points to 73.4 as measurements like on-time arrivals and departures, personal injury rates, system dwell and cars-on-line all improved.

And to cap off what must have been a very good day in Jax, CEO Michael Ward had a very upbeat telephone chat with Jim Cramer on *Mad Money* Wednesday evening. Cramer asked Ward if the relatively small volume increases were a cause for worry. Ward was ready for that one: "No, not at all. Everything in the marketplace indicates that the rail renaissance continues strong. We see tremendous opportunities going forward and are anticipating double-digit figures in revenues over the next five years. We're forecasting growth in the second half in the 4% to 6% range. Our operations are improving and CSX is and is ready to grow in the second half." Cramer wrapped by saying he's bullish on CSX. Nice job, Michael.

Union Pacific scored a number of firsts in its Thursday Call. Freight revenue was an all-time quarterly record at $3.9 bn, up 17% yoy, operating income reached $717 mm, up 53% yoy and the best ever seen on the UP. The operating ratio came down 4.3 points yoy to 81.7, the best seen in more than two years, as ops expense was held to an 11% gain even after a 33% increase in fuel on a burn that was up only 3%.

Total revenue units increased just 5% with coal the best gainer, plus 10%. Auto and IM were tied at 7% with ag, chems and industrial products at +5%, unchanged, and -3% respectively. During the call Chief Commercial Officer Jack Koraleski said that "the shedding of low margin business is intentional," and that shows up in double-digit RPU increases everywhere but coal and intermodal.

Chief Operating Officer Dennis Duffy said that comp and benefits expense rose just 6% yoy even though there are 30% more T&Es than a year ago. UP averaged $2.15 a gallon for diesel fuel vs. $1.67 a year ago and burned 3% more fuel for 1% more GTMs. That the 11% ops increase only produced 5% more revenue units may also represent an opportunity to gain some savings.

It was good to hear that CEO Jim Young is out talking to customers. "Being in front of customers," he said, "tells me there's a pent-up demand for more rail." Moreover, this provides "an upward bias on pricing." With the 17% quarterly revenue gain about evenly split among volume and mix, yield and fuel surcharges, that comes as good news.

For the third quarter and year Young expects revenue growth to continue at the 17% clip, to take another four points off the OR, and to continue the torrid EPS growth rate north of 50% (it was 63% this quarter). As we saw with CSX, the focus is on operating efficiency, asset utilization and yield, and increasing shareholder value. I think they're and a roll and can be all they want to be.

Canadian National joins the share buy-back and increased dividend parade even as operating income increased 13% on a 6% revenue rise and 1% more ops expense. GAAP will have you believe the net increased 75% to C$729 mm and eps gained 84% to C$1.35 from C$0.73. However, there was a C$250 mm income tax credit so removing that takes the net to C$479, up 15%. Now this is where share buy-backs prove their worth.

CNI had 6% fewer shares outstanding on 6/30/2006 than they did a year ago. As a result, eps increases 22% to C$0.89 whereas an increase or no change in diluted shares would have produced $0.84, four cents less. Over the next year CNI will take the share count down another 28 mm shares or about 5.3%. The six-month cash flow statement shows why this is possible.

CNI generated C$1.0 bn in cash from operations even after a C$700 mm swing in deferred income taxes and receivables. After paying out C$442 mm in capex and $C172 mm in dividends there was C$400 mm in FCF remaining. The $717 mm for the share buy-back took FCF into negative territory, but that was intentional because of the accounts receivable and income tax adjustments above.

Of course, all of this stems from a remarkable operating income story combined with a minimum amount of noise below the line. Here's a transcon railroad reaching three coasts with an OR of 58.6 (down another 2.6 points yoy), a number even the best-run shortlines can have trouble matching. CEO Hunter Harrison, naturally, ascribes it to the *precision railroading* model, saying, "The company's excellent financial performance during the quarter demonstrates the power and value of the model. It's grounded in a solid service plan, the relentless pursuit of asset velocity, and a strong focus on safety."

Total CNI sales increased only 6% yoy compared to twice that at CSX and nearly three times at UNP. Volume growth didn't set any fires, either, up less than 2% (see comps table at end). However, the lowest coal revenue as a percentage of total revenue may be a blessing. CNI is a 71% carload railroad, which provides great opportunities for managing mix, yield and pricing to market. As a result there may be less room for the double-digit RPU increases seen elsewhere.

My suspicion is that CNI is farther down the price elasticity road than either UNP or CSX. The slower rate of RPU gain is one effect. Another is managing ops expense to match the business at hand. Both CSX and UNP increased ops expense at rates greater than the yoy change in revenue units ("ops exp chg/vol chg"). Yet CNI ops expense increased just 1.4% as traffic volume grew 1.7%. Maybe CNI trades at three times book is because *it's worth it*.

John Gallagher writes in Traffic World that a shortline survey by Wall Street's UBS Investment Bank concluded that in the shortlines' view "Class I service needs to improve." Evidently UBS got back 80 completed surveys out of 400 sent out. I think there's less here than meets the eye. If you exclude the S&Ts like the BRC and PTRA, there are still some 500 shortlines in North America. UBS sent inquiries to 80% of them. Of the 500 shortlines about 300 are marginal by my measure, meaning they do less than 4,000 revenue units a year, worth about $1 mm in revenue. It takes about that to run even the smallest shortline given the requirements of manning, managing and marketing.

Let's for the sake of argument say that 80% of the surveys went to 240 of these marginal shortlines and that this group dominated the 40 responses. All shortlines have interchange agreements with their connecting class Is however as a general rule the smaller the shortline the less intense the Class I relationship and the less likely the shortline is up to snuff on their event reporting, meaning the Class I has little idea of where cars are or when they'll be at interchange.

Many smaller lines still want to transact all their business with the Class I by phone or fax rather than the Internet. As a result movement reports, rate requests and equipment orders are delayed or ignored simply because the Class I is no longer equipped to deal with phoned or faxed reports or requests. Ergo the non-Internet shortlines may perceive poor Class I service and that colored their response to the UBS survey.

The Class Is as a group have pushed very hard on shortlines to use the Internet or get left behind. Norfolk Southern's Thoroughbred Operating Plan (TOP), for example, starts with the core railroad and works its way out to the branches in the scheduling process. Core trains are running pretty well and they're working to get the feeder lines (and shortlines) performing to plan.

Both the CSX One Plan and the UP Unified Plan are patterned after the TOP. Both are still working on the core system. And both are going to be more insistent that shortlines use the Internet to transact business. The shortlines cited in Gallagher's piece want to see the Class Is "adhering to a consistent operating plan." Doing so mandates that all pieces of the system are visible at all times. That includes the shortline pieces of the system, so there may be some smaller houses to get in order as well.

GWR revenue units for June 2006 were up 6.5% to 72,462 on a consolidated basis. Excluding 10,744 carloads from Genesee & Wyoming Australia which GWR started operating June 1, 2006, same-railroad traffic in June 2006 decreased by 6,292 carloads, or 9.3%. U.S. and Canada same store traffic decreased by a net 6,155 carloads. Roughly half the decrease was the result of declines in Illinois Region coal loadings thanks to recently completed scheduled maintenance at a utility customer. Another third of the decrease was due to lower traffic in the southeast US and in Oregon. North American aggregates and minerals dipped by 961 loads primarily due to maintenance at a NY salt mine. All other U.S. and Canada traffic increased by a net 1,109 carloads.

Elsewhere, GWR's Mexican subsidiary, Compania de Ferrocarriles Chiapas-Mayab, S.A. de C.V. (FCCM), received a letter dated July 12, 2006 from the Ministry of Communications and Transportation (SCT) indicating that the SCT intends to fund 75% of the cost to rebuild a portion of FCCM's rail line in the State of Chiapas. The 175-mile segment of rail line has been inoperable between the town of Tonala and the Guatemalan border since being struck by Hurricane Stan in October 2005.

GWR believes that the cost of reconstruction will be approximately US$20 mm, with the Mexican government expected to fund approximately US$15 million, insurance proceeds expected to fund approximately US$2 mm and GWI expected to fund approximately US$3 mm. The government funding is subject to, among other things, final contractual agreement between the Mexican Government and FCCM. Reconstruction of the rail line is slated to begin prior to year-end 2006.

Trinity Industries Inc. (TRN) has signed a memorandum of understanding to sell its European Rail unit to a Luxembourg company. Timothy R Wallace, Trinity's CEO and President, said, "As we have previously stated, we have been reviewing strategic alternatives for our European rail business. By completing this transaction, it allows us to dedicate more of our resources and assets to the opportunities we have in North America. However, if this transaction does not close as anticipated, we are fully committed to waiting out the recovery of the railcar market in Europe. We have taken steps to reduce our costs and are currently building a better backlog of orders in our European railcar manufacturing business."

Terms of the deal weren't disclosed. TRN says the deal will close within 45 days, and the financial impact of the transaction will be recorded in its third quarter. TRN said it does not expect the deal to have a material financial impact. TRN shares (which I own) have been on steady decline since hitting their high of $47.70 May 10, 2006. With a full order book and the railroad renaissance in full swing, I find it hard to believe the present stock prices fully reflect what TRN is capable of doing. With a 5-year PEG of 0.63, it seems $33 a ticket is a steal.

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Big Six Class I Commodity Carload Comps
Quarter ending 6/30/2006
Revenue and income in $millions

Metric	CN	CSX	UP
Railroad revs (1)	$ 1,946	$ 2,421	$ 3,923
YOY Pct. Change	5.9%	11.8%	17.3%
Revenue Units (000)	1,246	1,870	2,510
YOY Pct. Change	1.7%	0.1%	5.0%
Carload revs (2)	$ 1,387	$ 1,430	$ 2,316
Pct carload	71.3%	59.1%	59.0%
Pct Intermodal	18.8%	14.7%	17.7%
Pct Coal	5.1%	24.5%	18.6%
Mdse Carloads (000)	800	853	1,071
YOY Pct. Change	0.9%	-1.6%	1.2%
Rev/CL x coal, IM	$ 1,734	$ 1,676	$ 2,163
Operating Expense	$ 1,141	$ 1,776	$ 3,206
YOY Pct. Change	1.4%	1.8%	11.5%
Ops exp chg/Vol chg	0.83	34.29	2.29
RR Operating Income	$ 805	$ 645	$ 717
YOY Pct. Change	12.9%	52.8%	53.2%
RR Operating Ratio	58.6%	73.4%	81.7%
YOY Point change	(2.57)	(7.16)	(4.28)
LTD/Capital	37.0%	40.9%	38.1%
Price/Book	3.06	1.92	1.75

Source: Company financials
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