RAILROAD WEEK IN REVIEW
NOVEMBER 3, 2006

"U.S. operations improved significantly in the quarter, a product of better locomotive utilization, the positive impact of our capacity-enhancing projects, and a sharp focus on operational efficiencies." – Mike Haverty, KCS Chairman and CEO

RailAmerica's third quarter sales increased 12% yoy to $117.3 mm on a 9% increase in freight revenues to $102.6 mm while "other revenues" increased 34% to $14.7 mm on higher demurrage charges plus car hire income. Revenue units were essentially even with 3Q05 at 308,000 net of line sales (Alberta, Colorado, Vancouver Island) and acquisitions (Alcoa, Michigan). "Same Railroad" (lines in operation continuously since 1/1/2005) revenues were up 6% on 2% fewer revenue units.

Lumber, chemicals and metals are the three biggest commodity groups for RRA as a percentage of total freight revenue (all three more than 10%) with RPU all north of $400. Coal is the largest single commodity by revenue units (11%) while "railroad equipment and bridge traffic" is the greatest unit volume (16%). In itself, that can be a bit scary. However, where there are (1) routing protocols like what CN is championing use RRA to short-haul direct Class I routes or (2) commodity-specific overhead moves (autos from Canada to Connecticut via NECR+P&W) it can be quite worth while.

Operating expenses before asset sales credits were up 12% for a 7% gain in operating income for an 89.3 operating ratio, up 50 points yoy. Including asset sales credit the OR was 88.5 vs. 87.8 a year ago. Equipment rents (to which Alcoa contributes more than a $mm a year), depreciation (again an Alcoa effect) and of course fuel were the big gainers. However, during the Q&A Charles Swinburn, CEO, noted that they expect to take a half a point a year off the OR , accelerating as the PIP improvements kick in, such as better asset management processes and the reduction of some 50 clerical and administrative staff positions.

Below the line, interest expense increased $2 mm or 40% and net income from continuing operations was down 5% to $7.1 mm. After adjustments for disc ops the reported EPS was 18 cents, down 12% from 20 cents in 3Q05. There was a $1.8 mm or three cent per chare one-time charge for the final payment to the PIP consultant, and as the pieces are put in place over the next twelve-month RRA anticipates savings in the $10-$15 mm range, worth another couple of dimes in EPS.

CFO Mike Howe told Bear Stearns' Ed Wolfe during the call that CY 2006 eps guidance is for 75-80 cents a share, implying 23 cents minimum for 4Q06 based on the 52 cents reported YTD. I heard no specific guidance for 2007, though when Jason Seidl of Credit Suisse asked Swinburn about his employment contract, the latter remarked that it runs through Aug 2007 and it will be on the table in Dec 2006 when 2007 budgets are discussed.

Swinburn also offered that they are in negotiations on selling three Ohio lines, making good on his remarks during the 2Q06 conference call. Ohio is reducing its operating losses every quarter and has recently signed on North Star and P&G for contracts worth 4000 cpy apiece. Asked whether RRA were for sale, Swinburn simply said "No comment." I can imagine his reluctance to say anything more given the way the rumor mill works. I'm calling RRA a Work in Progress for the nonce and would ask WIR readers to stay tuned.

Genesee & Wyoming reported a net third quarter loss of $12.1 mm (32 cents a share) due mainly to its $33 mm write-down of its assets in Mexico. These and other adjustments relating to the AUS asset sale and litigation settlements cost GWR's Q3 eps 74 cents so a normalized eps from continuing ops would have been closer to 42 cents a share, down 9% from 46 cents reported a year ago, however adding back four cents a share in Mex operations yields a non-GAAP 46 cents a share, even with last year. But it doesn't stop there. Because a loss was reported in 3Q06 the share count has to be increased by 4.6 mm "potential" shares, in effect taking back another three cents so we're looking at 41 cents. Inquiring minds that want the full story are directed to the investors page at www.gwrr.com for the gory details.

Absent these charges net income would have been $21.2 mm, more fully reflecting GWR's business potential. Freight revenues were up 22% yoy to $128.3 mm vs. $105.3 mm a year ago. Of this $23.1 mm increase in revenue, $5.7 mm was from same-railroad growth in the U.S. and Canada, while $20.2 mm was from GWR's South Australia transaction and the Norfolk VA line acquisition partially offset by a $2.8 mm decrease in Mex revenue. The 6% growth in same-railroad NA revenue ex-Mexico was primarily due to revenue gains of $2.0 mm in coal and $1.8 mm in metals. Same-railroad revenue per carload increased by 6.9% (price 4.5%, FSC 3.9%, mix 1.5%).

That's just the carload side. The Rail Link subsidiary works the ports and other industrial locations at 30 locations in 11 states plus 26 smaller shortlines that do not fit GWR's contiguous model. This group is not generally included in the carload stats however 3Q sales were $41.3 mm, up 27.6% yoy, and is posted as "non-freight revenue" on the tables accompanying the earnings release. This little shop thus accounted for 32% of total sales, up from 26% a year ago. I've known the folks running this subsidiary for years and they're some of the best in the business.

Kansas City Southern earnings per share improved to $0.32 per diluted share vs. two cents a share a year ago excluding an adjustment to casualty reserves and a one-time VAT settlement. Operating expenses decreased 3.0% yoy excluding an adjustment to 2005 operating expenses. Revenues increased 8.1% to $415.7 mm as volumes increased 1.9%. Revenue per carload increased 6.3% and the operating ratio was 81.4%.

Consolidated revenues were $415.7 mm, an increase of $31.1 mm, or 8.1%, compared with $384.6 mm in 3Q05. The gain in revenue units, says KCS, is a "continued recognition of the value of our freight services." All business units, ex-Automotive, recorded strong quarter-over-quarter gains led by Intermodal (24.8%), Paper & Forest Products (10.3%) and Agricultural and Minerals (10.0%). The revenue-unit count was off 2.5% in merch, up 10.3% for IM and 4.0% for coal.

Operating expenses for the third quarter of 2006 were $338.4 mm, a 3.0% reduction from third quarter 2005 expenses of $348.7 mm. A 31.4% reduction in casualties and insurance, excluding the prior year adjustment related to personal injury claims, was a large driver of the substantial reduction in operating costs. Fuel expense in the third quarter 2006 increased 11.4%. Q3 operating income $77.3 mm compared with $35.9 mm, exclusive of the claims reserve adjustment in 3Q05, and an OR of 81.4. Net income available to common shareholders for the third quarter 2006 was $26.4 mm, or $0.32 per diluted share, compared with $1.9 mm, or $0.02 per diluted share, in third quarter 2005, exclusive of the aforementioned non-recurring items.

CEO Mike Haverty credits volume growth, improving overall operations and continued progress in containing costs as major contributors to Q3's success. Quoth he, "After four quarter-over-quarter volume comparisons showing an absence of unit growth, KCS recorded increased volumes in the third quarter of 2006 compared with the previous year, even after accounting for the hurricanes that hit our rail system in 2005. This suggests that the majority of our business rationalization is behind us and much of our lower margin business has been replaced with more profitable traffic."

Drilling down to the numbers, KCS is very much a carload railroad with nearly 80% of total revenues from that group, the highest of any Class I road. As to "more profitable traffic," the merch RPU increased 9.8% thanks to double-digit gains in ag & mineral as well as forest products including paper. Intermodal, though only 15% of revenues, increased RPU by 13.2%.

Looking ahead KCS expects revenue and volume increases to continue at the present rate into the fourth quarter and into 2007 with an OR in the 80-82 range. I get the sense that with the integration of the various pieces now essentially complete, KCS is beginning to realize the kind of growth they anticipated when they began the process. The system map schematic on Slide 29 of the presentation shows where the opportunities lie and virtually every commodity group in included. Mike and his team are to be congratulated for seeing the process through some trying times and for putting KCS in an excellent competitive position for 2007 and beyond.

Florida East Coast Railroad continues to surprise and delight as it pushed the OR back into the 60s. Revenues in Q3 increased 5.8% to $63.4 mm from $59.9 mm in the prior year period, reflecting improved pricing. FSC increased $2.8 mm to $6.3 mm. (FEC gives us what is probably the most straight-forward, least obfuscated FSC explanation. Thanks.)

Freight revenues grew 3.3% yoy on price increases offset by a decrease in volume of 5.1%. Aggregates revenues increased 2.4%, however, volumes were down 3.7% due to a slowdown in the Florida residential market. Vehicle revenues and volumes decreased 3.7% and 16.7%, respectively, primarily due to decreased shipments from the domestic automobile manufacturers. Intermodal revenues including local drayage increased 9.0% yoy, marking IM's 13th consecutive quarter of revenue growth.

FEC's operating income was up 33.7% yoy to $22.1 mm and the operating ratio improved to 65.2% from 72.4% a year ago. When I started this *Week in Review* gig more than 15 years ago FEC always ran ORs in the sub-70 range with only the IC for company. It's good to see the FEC back where it belongs. Then too, FEC runs a hook-and-haul railroad with unit rock trains and IM accounting for 89% of the volume and 76% of the revenues along a straight, flat, 380-mile speedway.

The FEC Industries holco is really a railroad with a realty division attached. Total revenues came to $107 mm of which railway brought in 59%. Operating income was $24.1 mm of which FECR brought in $22 mm. Looking ahead FY 2006 railway ops income will be in the $80 mm range on revs around $270 mm. Full-year capex will run $42-47 mm and includes $7 mm for an 11-mile passing track near Cape Canaveral, roughly the mid-point of the railroad. Sounds good to me.

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Small Class I and Shortline Holding Company Commodity Carload Comps

Quarter ending 9/30/2006

Revenue and income in $millions

Metric	FEC	KCS	GWR	RRA
Railroad revs	$63.3	$415.7	$128.3	$117.3
YOY Pct. Change	5.7%	8.1%	21.9%	11.5%
Carload revs	$32.5	$325.8	$71.4	$87.0
Pct carload	51.3%	78.4%	55.7%	84.8%
Pct Intermodal	46.9%	9.0%	0.4%	0.7%
Pct Coal	0.0%	8.3%	11.7%	7.8%
Mdse Carloads (000)	48.3	275.6	173.0	219.5
Rev/CL	$672.0	$1,182.2	$412.9	$396.5
Operating Expense	$41.3	$338.4	$701.3	$333.0
Operating Income	$22.0	$77.3	-$12.9	$12.6
YOY Pct. Change	33.2%	na	-153.7%	6.7%
RR Operating Ratio	65.3%	81.4%	110.1%	89.3%

Source: Company financials, First Call

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