RAILROAD WEEK IN REVIEW
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"The greatest opportunity facing KCS is in intermodal and the best intermodal opportunity is in Mexico." KCS Chairman Michael Haverty

KCS wrapped up the Class I roads' earnings season with one of the most powerful and engaging presentations of the lot. I had the good fortune to be there in person and it was a sight to behold. The energy was infectious and if I were to sum it up in two words they would be determination and execution. The entire presenting team exuded confidence in the message: Here's where we are, here's how we got here, here's where we're going and here's what we're going to do when we get there.

Fourth quarter revenues were up 14.5% on double-digit gains in carload and coal with IM the laggard at plus 7.6%. RPU was up double-digits everywhere but auto even though in the merch group only chems saw volumes increase, up 12.9%, while ag & minerals and paper & forest prods were off slightly pulling the merch group vols down 0.7% yoy. During the Q&A Art Shoener, President and COO, noted that KCS has instituted a new costing system that can track every expense related to every carload commodity O-D pair, allowing a focus on contribution per move such as the whole industry sorely needs.

KCS is now running ten or more grain shuttles KC to Mexico, up from one or two a year ago. This is putting a lot of pressure – financially and operationally -- on 150 miles of UP trackage rights between Rosenburg and Victoria, TX, via Flatonia. KCS owns the former SP right-of-way between the end points and has begun the process of reconnecting the dots. The end-game here is a 90-mile straight shot of new 136-lb CWR dispatched by KCS. No waiting around for the host railroad to open the gates only to have you follow the local way-freight. Can you say improved cycle times?

It's only fitting as KCS has a higher concentration of merch carload revs than any other class I – 82.5% -- besting second place CN by some 10.2 percentage points. Combining the original KCS plus KCS-Mexico has had a lot to do with it. Whereas before there were essentially two 500-mile regional railroads that made interchange but that was about it, now there is a fully integrated operation a la CN plus IC. It is doubtful we'll ever see another breakout of carloads between the properties as this is now One Railroad.

The benefits are enormous. Take locomotives. KCS is leasing 150 new six-axle AC units from GE in 2007, putting 90 in Mexico and 60 north of the border. Says Shoener, these will replace 220 older SD and GP units with the resultant savings in maintenance costs, fuel consumption, mean time between failures and labor while increasing train-starts per unit per year. More immediately, combining the two roads took the quarterly OR down 7.6 points to a very respectable 80.1, generated an 11% gain in MGTMs on *zero* change in gallons consumed and holding yoy the fuel expense increase to a mere 2%, most of which was price.

EPS for the Q jumped to 41 cents from three cents a year ago and for the year hit $1.08 vs. $0.16 for FY 2005. The killer has been interest expense, hovering around $40 mm for the quarter and four times that for the year. Nearly doubling the operating income for the quarter and year provides much better coverage, especially when interest expense in the year-ago periods ate up most of the ops income.

During the Q&A there was the inevitable question about somebody taking over KCS. Haverty addressed it eloquently and politely, though IMHO this 1000-mle railroad is in no way a take-over candidate and has what may be and certainly can be one of the strongest merch carload and intermodal stories around. Let's watch.

As far as I can tell there are only two railroads in North America that put more emphasis on contribution than revenue. KSC is one (above); the other is Canadian National and the common theme is this: I asked seniors staffers of each whether market managers are graded on revenue or contribution the answer was an unambiguous YES on contribution. No other North American Class I has been as direct as these two, even giving examples of how it works when short line allowances are involved.

I've written in the past that there is an accounting requirement that short line revenues come off the top line. As a result, they come out of the commercial budget and have no effect on ops except to the extent that higher revs against unchanged ops will lower the operating ratio. Only when senior management decrees that contribution, not revenue, is the measure of success will it change. Oh well, two down, five to go.

Tim Eklund, a savvy short line marketer who is also a pretty fair technical analyst, writes, "When trading stocks I like to use Fundamental/Quantitative Analysis to tell me *what* to buy, and Technical Analysis to tell me *when* to buy. Looking at the long-term charts of the Big Six Class Is, one begins to see some very interesting consolidation patterns have emerged over the last 12 months.

"The five- year weekly charts show a classic 'cup and handle' consolidation formation occurring in all of them. UNP has already made its move starting at $90-$92. Some price levels in the other Class Is where breakouts would occur are CSX: $38 - $40, BNI: $83 - $85, CP: $57 - $59, CNI: $48 - $50, NSC: $55 - $57. Given that UNP has already broken out of this upside consolidation pattern would lead me to believe that the others will follow suit shortly confirming a new leg upward in price for the Class 1's."

By way of review, a "cup and handle" formation occurs when a stock heads south for a while and then gradually turns to the upside, usually on light volume, forming a cup. It then turns down for a short time (one to four weeks) forming a handle before heading north for what is usually a longer run on stronger vols. As of this afternoon, all but NSC show signs of resuming their upward trends.

Short lines live or die on performance at the interchange and for too long it's been a crap-shoot whether it takes place on time or even takes place at all. But, like everything else on the railroad, to fix what's broken requires measuring actual performance against a standard. CSX appears to be first out of the box with a tool that really works. Called simply the "ISA Measurement Tool, it's available to CSX shortlines at www.shipcsx.com .

In addition to the basic stuff such as name of road and ISA rules there is an ISA Scorecard graph that shows the interchanges that CSX reported, whether the events met the standards and a listing of the cars actually interchanged. The idea is to provide short lines and CSX with information that can help improve service at interchange points and allow both groups to better understand each other's needs. The tool can be used to improve the operating plan compliance of both rail partners, which will reduce cycle times and improve equipment velocity.

Will it work? Len Kellermann, CSX Director-Regional and Short Line Development. says, "We believe our short line partners will find this on-line tool very useful in improving our mutual interchange performance. It is part of our ongoing effort to improve our collaboration with short line partners, as well as to mutually pursue continued business growth.” And it’s all part of what we’ve already heard at the quarterly earnings conferences about continuous, consistent improvement. To be sure, these metrics are not the be-all and end-all to improved interchange performance, but rather form a foundation on which to build.

CEO Michael Ward concluded his remarks during the Q4 analyst call by citing the need to “leverage better service for profitable growth.” That means on-time arrivals and departures at yards as well as completing the work orders as assigned. OT arrivals and departures in Q4 improved to 75% and 66% respectively from 56% and 43% respectively a year ago. Surely we can sandwich some on-time ISAs in there to help with the OT metrics. I’ll be at the Annual Short Line meeting in Jax in two weeks and look forward to learning about how it’s working.

Canadian National is still talking with the UTU about a possible strike starting at midnight tonight. If it comes off, CN has about 1,000 non-agreement people lined up for T&E strike duty. And while they might be able to cover the jobs short-term, a protracted walkout could do some real harm to CN’s ability to practice Precision Railroading as we have come to know it.

Shortlines with alternative connections may be able to work those alternates and it’s possible that work once moved to the other way out might just stay there. Of course, ISS roads have the most flexibility here and it’s another reason to avoid handling line agreements. And, in Canada at least, members of unions other than the striking union are legally required to cross picket lines and go to work. Thus non-UTU but unionized Canadian shortlines can’t be shut down by secondary boycotts. CN shortlines in the US will be unaffected.

As of noon Friday it appeared that the Canadian UTU had not yet discussed the matter with its parent, UTU International, whose spokesman Frank Wilner said would have to review the matter with the International president, who would then decide whether to authorize the action. Both parties seem not to want to walk, and that’s good. I seem to recall that whenever there’s a strike against CN there are fewer jobs when the strike ends.

FreightCar America (RAIL) reported Q4 sales of $391 mm, up 46% from $267 mm a year ago. Net income for the fourth quarter of 2006 was $34mm vs. $19 mm, up 78% yoy, reflecting increased sales volume, operating leverage attributable to higher volume and improved productivity. Orders for new railcars totaled 2,199 units in the fourth quarter of 2006, compared with 357 units in the third quarter of 2006 and 5,035 units for the fourth quarter of 2005. The backlog of unfilled orders was 9,315 units at December 31, 2006, compared with 12,176 units at September 30, 2006 and 20,729 units at December 31, 2005.

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