THE RAILROAD WEEK IN REVIEW
OCTOBER 22, 2004

The Norfolk Southern Thoroughbred was first out of the gate for Earnings Week and reported yet another blowout quarter. Once again NSC posted a double-digit revenue increase (16%) while holding operating expense to a single-digit increase (8%), generating a 51% yoy gain. The one unusual item on the expense side was the reorganization that took Conrail Rents & Services down 25% yoy. The effect on railroad results was minimal, though. Even if the item had remained unchanged operating income would have been up 42%, same as in 2Q04. The operating ratio dropped 5.8 points yoy and two points from 2Q04, down 50 BP ex-Conrail.

Below the line, eps came in at 72 cents. Excluding 13 cents from the Conrail transaction, it was still a nickel north of the Street estimate. Of the $158 mm operating income gain, $151 mm made it to the net income line, proving once again the less noise between operating and net incomes the stronger the shareholder return.

In his opening remarks CEO David Goode called it “an exciting quarter driven by strong business demand.” Intermodal coal and merchandise carload revenues were up by 28%, 20%, and 10% respectively while RPU was up 6%, 14% and 6% in the same order. In the carload sector metals/construction and chemical revenues increased 19% and 15% on RPUs up 8% on both.

As for lower-yielding commodity lanes, EVP-Sales and Marketing Don Seale noted that “de-marketing is not in our vocabulary” and NS seeks to “bring business to the railroad at the right value proposition” that is truck-competitive. It must be working as net truck conversions (business won from truck less lost to truck) brought in $42 mm additional revenue in the quarter, 27% of which went to the merchandise carload sector. Shortlines please take note.

Union Pacific’s 3Q04 results showed just the opposite as the 12% operating expense increase overshadowed the 4% operating revenue increase, pushing operating income down 29% to $418 mm. Put in perspective, that’s $58 mm or 11% less than NS generated on 60% of UP’s revenue. Still, the $3.1 bn 3Q operating revenue was a record and it was the second Q in a row to hit the $3 bn mark. Net income dipped 36% to $202 mm taking eps down 34% to $0.77, two cents better than the Street.

CEO Dick Davidson noted during the Q&A that in spite of the service challenges customers continue to support UP in its efforts to improve and that de-marketing some commodity lanes does “permanent damage.” I’m glad to hear that because what I’m hearing from shippers and shortlines goes in another direction. Still, Industrial Products and chemicals contributed 9% and 8% revenue increases respectively on 7% and 1% more units. Coal revenue, units and RPU were essentially unchanged; intermodal got three points in RPU.

Railroad President Jim Young said UP’s “proactive rather than reactive” steps in managing the network include adding more than 4,000 T&E emps (a neat trick when it takes ten interviews to get one hire), encouraging customers to increase load/unload capacity, and using fuel charges more than RCAF adjustments to stay ahead of the pricing curve.

The negative trends in daily cars loaded and velocity reversed in May, though Young thinks velocity will stay at 22 MPH thru Nov. That’s a disappointment as previous reports had led me to believe better velocity was imminent. However, the seven-day rolling average of cars loaded tells a slightly different story, and since it’s revenue-related it’s highly relevant. There were during September alone

13 different days when new records were set, starting at more than 190,000 loads a day and increasing. This is unprecedented.

Looking ahead, UP intends to price to a level that supports reinvestment in the tools required. I take that to mean each commodity group will have to earn its cost of capital. We heard that from BNSF's John Lanigan a year ago, and it's clearly part of Don Seale's "value proposition." UP's Achilles' heel continues to be network integration. Go out on the triple track and it looks like NYC's Broadway Line in terms of traffic density and speed. But shippers and shortlines can document where terminals are still jammed and local managers are making it up as they go along. My take is the communication between Terminal Supes and the Omaha's Harriman Center could be better.

Friday's WSJ ran its monthly short interest scorecard. For the month ending October 15 NSC posted a 9.7% decrease in the number of shares short, meaning fewer people are betting shares are over-priced at current levels. At the other end of the spectrum UNP short interest rose 45.5% in the period and CSX shorts increased 61.6%. Neither of the Canadians nor any of the smaller NYSE railroads were listed indicating relatively small short positions. Interestingly, the technical analysis advocates show CSX and UP as buys based on curve behavior. IMHO, it could be the rising rail tide lifts all names. Be careful out there.

Last week I visited the RailAmerica headquarters in Boca Raton for a look behind the scenes at the "above the line" activities. For openers, COO Joe Conklin and his staff took me through their centrally-supported approach to everything from track maintenance to locomotive management to purchasing. We talked about safety, independent operating centers (IOCs), mean time between loco failures, best practices in engineering, and RRA's vision for line sales and acquisitions. It was a day delightfully free of analyst-speak and I came away with a more accurate picture of what RRA does and why.

<u>Operations</u>. RRA anticipates 2004 sales of $385 mm on 46 railroads covering 9,000 route miles in 26 states and six provinces with 1900 employees, about half of whom belong to a railroad union. Shortlines are arrayed in east and west corridors of four regions each and with the Miss River the dividing line. Each shortline has its own P&L with support functions centralized in Boca. Properties range from 13 miles/5,000 carloads to 692 miles/114,000 carloads. RRA's 2003 North American operating ratio was 77.3, seven points better than 1999, and beating all the Class Is but CN.

<u>Mechanical</u>. RRA operates a fleet of 489 units, with 387 currently in use. Of these, 80% are leased long term. RRA also has 57 units for sale. The leased units were leased long enough ago to enjoy a daily rate about a third of the going rate today. The fleet is managed to provide maximum HP per unit with a Uniform Preventive maintenance program across all railroads. Local GMs expense all but a dozen items that are capex and controlled by Boca. The payoff is a 91% of available HP availability rate. I have no doubt this is sustainable with RRA's program to right-size and upgrade the fleet, now mostly EMD dash-two with several aftermarket dash-three units and three SD 70's. Four-axle power is preferred, though as lines lengthen and trains get heavier, newer six-axle units will be the order of the day.

<u>Maintenance of Way</u>. A systems approach of maintaining track to the service level required is in its third year on RRA. This replaces the method of developing the capital plan on an individual-railroad basis that was largely dependent on what the P&L could afford. Track spend is 54% ties and surfacing, 13% bridges, and 5% out-of-face rail replacement. With tie prices up double-digits for 2005 RRA has pre-bought thus avoiding the as-needed local buys. My $5,000 per mile per year rule is alive and well here.

Purchasing. Three years ago RRA was doing business with 16,000 vendor reps to support its 37 railroads. Purchasing cards were popular, accounting for 75% of buys. Suppliers had a field day – “divide and conquer” was the norm. Now RRA does business with just 105 vendors and sponsors annual supplier conferences to tell the RRA story and get vendor managements on board. At last count 125 companies send reps to the annual. And well they should. RRA is pre-positioning more supplies in its regions and looks for vendor support in this program.

Marketing and Sales. RRA has the most systematic approach to market development I’ve even seen in the shortline sector. Their premise is the best prospect for new business is the existing customer and has developed a three-part process to track and develop same. Using RRA’s proprietary internet-based tool any manager can track customers, markets and projects by railroad, by system or commodity group. At this moment, for example, RRA has more than 1,400 customer profiles, market share summaries on 75% of them and more than 500 active BD projects.

An eye-opener was bridge traffic. I had always thought bridge traffic was fragile and highly vulnerable to diversion. Such is not always the case. For example, the Ottawa Valley Railroad offers CP an alternative east-west route that saves about 200 miles. In most cases the RRA service is a specific product designed by lane to provide maximum value to the Class I customer in terms of reducing car cycle time, transit times, and congestion. Bridge Traffic shows up on the commodity project list along with everything from aggregates to warehousing.

Acquisitions and Line Sales. No more "any-rail-any-place" acquisitions was a recurring theme throughout the day, and particularly over lunch with President Don Redfearn and CEO Charlie Swinburn. Where ROIC (income plus local taxes over equity) falls below target, the railroad is toast. See the E&N, for example. On the acquisition trail RRA looks for lines that have synergies with existing properties. Moreover, they’re not out there paying significant EBITDA multiples unless there’s an opportunity to shed operating costs and lower the effective multiple. One can see where this program will lead to even lower operating ratios in the future.

Outlook. The focus is on accretive acquisitions, ROIC by property, cash flow, and system-wide engineering and mechanical priorities, all in support of growing the top line. After the six-hour look at what makes the “new” RRA tick I came away with the impression of a growth-driven company. The operating and commercial resources are in place. There will be opportunities to shed non-performing shortlines and use the proceeds to enhance and expand the top performers. Just as Class Is continually evaluate branch line performance, so it goes with RRA. The industry can only be stronger for it.

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