THE RAILROAD WEEK IN REVIEW
MARCH 25, 2005

As we discovered with our recent CSX shortline story, coal plays a bigger part in the Class III railroad community than is generally surmised. Thus it is with more than passing interest that AG Edwards bumped Arch Coal (NYSE: ACI) up to a BUY, target $52 from the present $43 based on more volume, less cost and demand-supported price increases. The house believes an improved financial outlook is a function of increased production volumes, higher sales price realizations and lower operating costs per ton.

ACI's Yahoo profile notes that its 27 mines are primarily located in the Powder River Basin, Central Appalachia and Western Bituminous regions of the US and sold about 1.3 mm carloads worth of coal in 2004. Check your maps and see it you can play. The fundamental outlook for the coal sector is favorable with a strong coal-pricing environment supporting earnings growth.

Elsewhere on the coal scene Peabody Energy (NYSE: BTU) bought selected assets from Lexington Coal Company for $61 mm in cash citing strong growth and long-term demand for Illinois Basin coal and increased investments in technologies. Purchased assets include some 10 mm tons of reserves and facilities near Coulterville IL (CN-IC), 40 mm tons of reserves and facilities in Knox County, IN (CSX, Indiana Southern, NS) and 20 mm tons and reserves and mining assets in Sullivan County IN (CSX, Indiana RR). The transaction is expected to be accretive to earnings in 2006.

Wall Street pundit James Cramer thinks the time is right to invest in the rails. In a subscription blurb for his Real Money letter at thestreet.com he writes, "The railroad companies are clearly benefiting from the weaker dollar and rising oil prices. The weak dollar makes our commodities prices competitive vs. so many other foreign players, and commodities ship by rail. Plus, the transports get to pass on the rising cost of fuel in the form of fuel surcharges. After years of missed estimates and botched predictions, particularly from CSX and Union Pacific, the majors finally look like they've got it together. Rails like CSX, Norfolk Southern, Burlington Northern Santa Fe and Union Pacific will remain in terrific shape as long as the dollar stays weak and oil stays high."

And Tuesday's WSJ summary of current NYSE shorts shows 12% and 43% declines in short interest for CSX and UP respectively. CSX on Tuesday was 50% above its 52-week low and UP was 28% above it. Another sign is how far they are ahead of their 50-day moving averages: CSX +7%; UP + 11%. Putting that in perspective, NS and BNI are trading at 80+% over 52-week lows and 7% and 13% respectively above the SMA-50s. I'd say there's still for significant price appreciation on CSX and UP, at least from a technical view-point.

On the other hand, Avondale Partners' Jason Seidl has marked down NS to Market Perform from Outperform. He writes, "Given the underlying strength at NSC (along with the entire rail sector), we have increased our 2005 EPS estimate from $2.45 to $2.50" and $2.75 for 2006, unchanged, on higher fuel costs. He bumped NS his share price target two bucks to $40, just 5% ahead of Friday's close about what the pundits expect from the broader market.

Jim Valentine of Morgan Stanley takes the other side of the bet, maintaining an Overweight and citing "sequential improvement in NS operating metrics." Well, maybe. Week 11 train speed is down yoy but about where it was Jan 1. Terminal Dwell at 24 hours is where it was in '03 and 4% worse than '04. Cars-on-line have climbed steadily since last summer's low of 180,000 to more than 195,000.

Union Pacific was very much in the news this week as it increased 1Q05 earnings guidance 72% to 43 cents from two bits on the low end. Revenue growth has been running at about 8% yoy and stronger than expected. Revenue units (UP says carloads but since that includes intermodal boxes units is the more precise term) will be up on the order of 1% yoy. The nice yield increase comes about equally from fuel surcharges and rate increases.

On the down side, 1Q05 fuel costs are expected to average $1.43 per gallon versus the previously estimated range of $1.30 to $1.35 per gallon. The network is still not where it ought to be. Non-intermodal cars-on-line remain right at the 290,000 level, up and down less than a percent week-over-week since Feb 11. System train speed is similarly stuck at 21 mph plus-or-minus a tenth or two. System dwell time was down 5.5% for the trailing four weeks ending Mar 4, but it's unchanged for the trailing four weeks ending 3/18 at 28.7 hours. This is a slight improvement as the mean TTM system dwell was right at 30 hours.

That said, the January West Coast storms had less of an impact on the Company's first quarter performance than previously projected. Preliminary estimates included approximately $100 mm in incremental capital expenditures and $100 mm in lower operating income, reflecting higher operating costs and lost revenue. The Company's current estimates include around $60 mm in incremental capital expenditures, along with approximately $55 mm of lower operating income before any insurance payouts.

In his Mar 11 Customer Letter Chief Commercial Officer Jack Koraleski writes, "We are planning a capital-spending program in excess of $2.0 billion for 2005 that includes $295 million in spending on additional capacity. This includes critical projects on the Sunset Route such as terminal expansions and additional double tracking." For example, work on the former Texas & Pacific Route (Fort Worth- El Paso) calls for a quarter of a million ties, 46 miles of rail, 1150 carloads of ballast, 196 miles of T&S, and resurfacing 184 road crossings. And that only gets them to Sweetwater (MP 450). El Paso is another 412 miles.

The T&P work takes some pressure off the Sunset Route east of El Paso. Without it LA traffic coming east to the Dallas-Forth market has to run via San Antonio and then turn left for DFW. Jim Valentine, Jason Seidl, and Tom Wadewitz (Bear Stearns) have all issued positive notes on these developments and there is talk of the stock hitting $80 or $100 in a year or two.

That's entirely reasonable. UP has the biggest carload franchise in the business and the route structure to support it. As Valentine points out, "UP's historical price discounting strategy has come to an end thanks in part to the industry's new-found pricing power." Competitive advantage depends on quality in the eyes of the buyer, and low price is never a CA. No matter what price I name you can name one lower and we both lose operating income and market share as low prices prevent any kind of quality control.

BNSF has been named a recipient of the Owens Corning 2005 Transportation Systems Excellence Awards. Each year, Owens Corning awards this designation to its top carrier service partners from among a highly coordinated, global network of nearly 400 transportation service providers. Winners are selected based on service quality and consistency and the "ability to anticipate and adjust its processes" to do what the customer expects.

It works both ways. When capacity is tight what there is logically goes to the heaviest users – those that invest in carrier relationships. Last January's changes to the truckers' daily hours-of-service regulations continue to be a challenge for both shippers and carriers alike. In an industry dominated by new supply chain strategies, heavy competition and tight capacity, carrier recognition is important to the continued success of those on both sides of the supply chain.

Not surprising when one looks at BNSF terminal dwell and average train speed. Mean dwell time (half-way between the best and worst) was ten hours, handily beating second-place CN where the lowest of the lows was 13 hours. Revenue unit volumes are up 18% YTD yet cars-on-line is up but five percent through Week

11. I’m a little bothered by the 9% yoy dip in train speed for the quarter to date, however. It suggests the trains are getting out of the yards in better shape but are faring less well out on the road.

It’s springtime in Canada so it’s strike-threat time at CN. What is it with these guys? The IBEW represents 644 worthies system-wide and is angling to take a walk because it wants a better benefits package than the other unions agreed to. Not surprisingly, CN has offered to enter binding third-party arbitration but the IBEW has steadfastly resisted. Recall last time a union walked, CN kept running anyway and figured out ways to do without many of the strikers. Look for a similar outcome here.

Price-earnings and Price-earnings-growth ratios are helpful in seeing which names are most likely to outperform, adjusted by what one sees out on the railroad. The story in Table 1 is the yoy annual growth rate, all handily in double-digits. However if earnings did poorly in 2004 the ’05 comps are going to look strong. Dig down to operating income *above* the line and see inherent strengths in KCS and RRA. But since stock price flows from net earnings *below* the line, wide swings ought to raise a caution flag.

PE-ratios (Table 2) indicate all the rails are trading at the high end of their usual valuations, typically in the 12-14 range. I suspect that buyers are bidding up rail shares precisely because they’ve had a good run, so there’s some momentum built in. The wheel meets the steel in the PEG ratio, IMHO. The theory is that a stock is fairly priced when the yoy growth rate equals the PE ratio so the PEG equals one. Anything more is a hold (shorts start at around two), less than one is a buy, and less than 0.5 is a screaming buy.

To me, this table plus what we know about the companies says one should consider taking a closer look at BNSF, CSX and the two Canadians. With respect to CN and CP one must also factor in exchange rates, eh? Bottom line I think Jason’s call on NS is right and the sudden surge in BNSF shorts is a mystery.

Dismal Science Corner: Wall Street economic observers see increasing interest rates and fuel prices impacting consumer spending. Consequently they are underweighting consumer cyclicals and overweighting energy. This bodes well for the rails as consumer discretionary spending will likely hold, meaning more low-cost goods on the move in trucks and containers. BNSF and NS dominate the intermodal trade and ought to fare well as long as they can control the operating income hit from higher fuel costs. I’m not so sanguine about the carload side, however. High service quality in the eyes of the buyer is essential, though some of the carload performance metrics above may not be trending where they need to be.

Here’s a little quiz sent in by Rian Nemeroff of Connecticut’s Housatonic River RR. Which of the alphabet’s 26 single-letter ticker symbols were assigned to railroads at some point? Hint: there were five plus one capital equipment supplier that at one time was based in Center City Philadelphia.

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Table 1. Year-over-Year Change in Earnings

	1Q04a	1Q05 e	Change	C2004	C2005	Change
BNSF	$0.52	$0.71	36.5%	$2.87	$3.48	21.3%
CSX	$0.31	$0.45	45.2%	$2.12	$2.62	23.6%
NS	$0.40	$0.48	20.0%	$2.18	$2.49	14.2%
UP	$0.63	$0.42	-33.3%	$2.88	$3.20	11.1%
CN	$0.55	$0.78	41.8%	$3.34	$4.06	21.6%
CP	$0.18	$0.28	55.6%	$1.75	$2.36	34.9%
KCS	$0.02	$0.12	500.0%	$0.39	$0.76	94.9%
GWR	$0.35	$0.39	11.4%	$1.45	$1.72	18.6%
RRA	$0.14	$0.17	21.4%	$0.57	$1.00	75.4%

Table 2. Price-Earnings and Price-Earnings-Growth Ratios

	Price	PE '05	PEG '05
BNSF	$55.69	16.0	0.75
CSX	$42.73	16.3	0.69
NS	$38.02	15.3	1.07
UP	$69.87	21.8	1.97
CN	$62.45	15.4	0.71
CP	$35.41	15.0	0.43
KCS	$19.29	25.4	0.27
GWR	$26.52	15.4	0.83
RRA	$12.50	12.5	0.17

All currency figures are in $US.