THE RAILROAD WEEK IN REVIEW

APRIL 22, 2005

Canadian National led off the First Quarter Earnings Season with a 42% jump in earnings per share thanks to pushing revenues up 19% while holding expenses to a 13% increase yoy. That produced 33% more operating income. Below the line CN bought back 2.5 mm shares and made some other improvements and – *voila!* – eps up 42% to $C1.04.

In his remarks on the conference call CEO Hunter Harrison said that even without the effects of the 1Q04 work-stoppage and foreign exchange effects eps was up 33% and this was the first First Quarter OR ever to break 70 – call it 69.2, down 330 BP. Fuel expense was up 36% on a 24% increase in price per gallon to $C1.60 pre-hedge (CN is 50% hedged) plus 9% more fuel burn on 8% more GTMs. CFO Claude Mongeau added that GTMs per employee improved 8%, loco utilization was up 11% and the incremental income OR was an enviable 51%.

Over on the revenue side, EVP Sales & Marketing Jim Foote showed five of seven commodity groups posting double-digit revenue increases (grains and autos missed). Metals and minerals was an interesting anomaly, however. Revenues increased 13%, revenue per RTM was up 32% and carloads more than doubled, yet RPU dropped 40%. I had to get off the call before Jim got to this point, but it sure looks like mix from here. More short haul, turning cars faster, making more money with fewer assets. That's what it's all about.

On the other hand, this goofy market still doesn't get it. CNI was up for the day until about 1 PM when it turned south. When the earnings came out at 2 PM there was a slight reversal, only to close down 21 cents or 0.3% on the day. Still, it coulda been worse – the rest of the Big Six lost from 1.2% to 2% of their value for the session.

Union Pacific presented its quarterly results on Thursday morning. I didn't get to hear the live call however the website material and wire reports give us a pretty good idea of what's going on. Needless to say, it was an off quarter, earning 48 cents a diluted share, down 23% yoy. Freight revenues were up 9% to a record Q1 $3.2 bn and it was the fourth consecutive quarter breaking $3 bn. But as long as expenses keep going up faster than revenues operating income remains depressed – flat this Q at $314 mm yoy.

The $34 mm storm-related hit was worth about 13 cents a share and the 42% per-gallon fuel price added six points to the OR, increasing ops expense by some $148 mm or 56 cents a share. Thus absent the storm and with fuel prices where they were a year ago UP would have earned $1.17 a share, up 87% yoy. As it was, the OR was the highest in we've seen anywhere for a long time – 90.1 – and 93 BP ahead of 1Q04.

Elsewhere on the Income Statement every expense line item but fuel and materials was held to a single-digit gain. The $12 mm jump in materials had to be partly attributable to the mud slides and we all know what's happening to fuel. Second quarter estimates hover around the 70-cent mark, up a dime yoy. The view from here is that the STB performance measures are improving (see WIR 4/1/2005 for an update), revenues are increasing faster than carload volumes, and the double-digit increase in Industrial Products RPU all bode well.

With only two Class I roads reporting this week it's hard to cite any trends, but CN and UP are about as different a pair of properties as one can find. Table 1 is an except from my Big Six Summary in the upcoming *First Quarter Review* and it's worth a word or two. There's a big gap between the two in the percentage of merchandise carload revenues and they're about equal in intermodal revenues as a percentage of the whole. Coal is the divider.

Forget for the moment that CN is in Canadian dollars. Orders-of-magnitude, CN's revenue per intermodal platform actually exceeds revenue per merchandise carload while UP's intermodal revenue per platform lags the merchandise carload RPU considerably. CN increased intermodal RPU by 12% to UP's 2% and I'm willing bet customer perceptions of service values had something to do with it.

The 12-point spread in OR meant CN could increase ops income by 33% to UP's no change. And not only is CN paying 16% less for a gallon of fuel but it's getting 8% more tom-miles per gallon. These are the kinds of comps we're going to continue to drill down to as they're the only way to find not only cash value for one's stock portfolio but also transportation value for one's shipper clients.

Speaking of value for the money Table 2 picks up Tony Hatch's theme of "expense growth below workload growth" (WIR 3/4/2005). Once again using the only two roads reporting to date, the difference between CN and UP is striking. Quarterly revenue units were up 21.5% on CN and only half a percent on UP. CN's operating expense increased 13.1% to UP's 10.1%.

In other words, UP operating expense increased 20 times faster than revenue-unit volume (I hate "carloads" because it includes intermodal boxes and they're not "cars"). In contrast, CN grew freight revenue unit volumes and 1.6 times the rate of increase for operating expenses.

Bouncing back from last week's back-to-back losses Bear Stearns' Tom Wadewitz picks up the recovery thread in Monday's note. He writes, "Since March 24, the six major rail stocks have declined on average 8.9% with BNSF and NS falling particularly sharply (off 13.3% and 16.4%). Although the economy appears to be softer we continue to expect strong earnings per share performance from several of the rails on strong pricing and volume growth in coal and intermodal (includes different modes of transportation).

"We see upside movement potential for BNSF, CP and NS. In our view, the revenue mix at BNSF (56% intermodal and coal) and CP (52% intermodal, coal and fertilizers) make these two rails well positioned for growth even in a softer industrial economy. We continue to see specific drivers of strong earnings performance (and upside vs. expectations) for both these names and an upside for the stocks."

I'll say. The tech signs on Tuesday show the rout pretty well routed with most names getting back half their five-day losses. GWR and CP won back nearly *all* their losses in that short period. We saw seriously oversold signs late Friday a week ago so the snap-back is not totally unexpected.

Most rails gapped up at the open ahead of Thursday's 200-point gain and even with Friday's slide had recovered nearly to their 50-day moving average crossed on the downside on or shortly after April 8. As it works out, the rails that fell the farthest were those most ahead of that 50-day line – NS and CSX for example. On the other hand, the least volatile held the line the best: CP, BNSF, e.g.

On Thursday Florida East Coast Railroad reported 1Q05 revenues increased 16% to $56.5 mm yoy driven by stronger-than-expected demand, improved pricing and new business. Operating Income increased 35% to $15 mm yoy and the OR improved to 73.5% from 77.1%. FEC has increased its full-year 2005 outlook thanks to stronger-than-expected demand in the first quarter. Annual revenues are now expected to range between $216 and $223 mm, an increase of 8% to 11% over 2004, and operating profit is now expected to range between $54 and $56 mm, an increase of 14% to 18% over 2004. Capital expenditures are expected to remain between $32 and $36 million.

Watco wins another one with the lease of BNSF's 15-mile branch between Kearny, MO and the main-line connection at Birmingham, MO, just outside KC to the north and east. The Kaw River Railroad, one of Watco's newest, operates out of KC so this is a natural for them. The lease became effective April 21 and includes related yard, industry and main-line trackage rights. Commodities on the line are primarily paper and plastics.

Continuing the UP shareholder lawsuit thread (WIR 4/15) a reader offers this observation:
"I am inclined to agree with you, although I have a sense that a better plaintiff's lawyer might have done a better job of developing the suit… Personally, I don't like stockholder suits because they usually result in more money leaving the company to pay off the plaintiffs and their lawyers, and I fail to see how that helps either the institution or the larger number of shareholders." Good to see I'm not alone on this one.

Demurrage has reared its ugly head again. It bothers me to see receivers get hit with five-figure demurrage bills because the railroads can't comply with their own trip plans. Say I need three cars of raw material a day for my widget line and I know my scheduled railroad calls for ten days transit time release to place. I instruct my vendor to ship material three cars at a time but my railroad lays off an intermediate yard shift and bunches nine cars. I can only take three at a time, so six get CP'd and I get a demurrage bill not only for those six but all that follow. Will I pay it? NBL, and neither should you.

Quiz Redux. I had no takers on the Rian Nemeroff Challenge (WIR 3/25): Of the available 26 single-letter ticker symbols five were railroads or rail-related. What were they? Read'em and weep. A was for Atchison, Topeka & Santa Fe, now part of BNI; B was for Baldwin Locomotive, with the erection floor not a mile from where I now sit; E was for Erie Lackawanna, now mostly NS or gone; N was for Norfolk & Western, now part of you know who; R was for the Reading Company, with headquarters on Market Street in Phila and now part of the Marriott with the Reading Terminal Train shed now part of the Convention Center; U was for Union Pacific, the only original single-letter symbol railroad still extant, though now relegated to three letters, UNP.

Table 1.

Big Six Class I Commodity Carload Comps

Quarter ending 3/31/2005

Revenue and income in $millions

Metric	CN	UP
Railroad revs (1)	$ 1,706	$ 3,152
YOY Pct. Change	18.6%	8.9%
Carload revs (2)	$ 1,277	$ 1,812
Pct carload	74.9%	57.5%
Pct Intermodal	16.8%	16.6%
Pct Coal	4.7%	21.2%
Mdse Loads (000)	789	994
Rev/CL x coal, IM	$ 1,619	$ 1,822
Rev/IM CL equiv	$ 1,660	$ 1,217
IMCLE/avg CL rev (3)	103%	67%
RR Ops Income	$ 526	$ 313
YOY Pct. Change	33.2%	-0.3%
RR Operating Ratio	69.2%	90.1%
YOY Point change	(3.36)	0.93
GTM/gal. diesel fuel	812	751
Fuel/gallon (US$)	$ 1.22	$ 1.45
YOY Pct. Change	24.3%	42.2%

(1) CN, CP in $Canadian

(2) Excludes coal, intermodal

(3) Intermodal carload equivalent revenue as percentage of average carload RPU

Table 2.

Metric	**CN**	**UP**
Rev Units 1Q05 (000)	1,187	2,300
YOY Pct. Chg.	21.5%	0.5%
Ops exp 1Q05	$ 1,180	$ 2,839
YOY Pct. Chg.	13.1%	10.1%
Revs chg/Units chg	**1.64**	0.05