THE RAILROAD WEEK IN REVIEW

JULY 22, 2005

"Never let the other fellow set the agenda" – James Baker

The Second Quarter 2005 Earnings Season is upon us and the Street estimates are encouraging. By and large everybody expects solid double-digit eps gains (see Table 1). Earnings growth rates range from KCS' high of 64% to FEC's more modest 9%, but the real story will be operating income. That's why I've included the estimated yoy change in total revenue.

We all know how below-the-line items can create earnings increases on little or no change in operating income. We also know how operating income growth can take huge swings to the positive when there is solid revenue growth and only moderate increases in operating expense. And since yoy change in revenue will have the largest impact on yoy changes on the in operating ratio, we need to keep an eagle eye.

To be sure, this is Finance 101 for the hard-core investors. But in the field it seems the AAR Class III railroads in particular look more to car counts than to revenue-cost ratios, hoping that high-yield cars will support the low-yield ones. As the many fallen flags will tell you, pricing on the margin is the surest way to go out of business. Would that their Boards of Directors would apply the same disciplines here as they do in their own businesses. And if not, well, maybe the SLs need new Boards, or at least get their Boards to pay close attention to their connecting Class Is' Q results. Read on.

Canadian National was first out of the box with 2Q05 earnings. True to form, CEO Hunter Harrison opened the call on a positive note: "CN had a terrific quarter and first half of the year, demonstrating once again the power of the company's business model – precision railroading and the pursuit of profitable, sustainable growth – along with the strength of our freight franchise. A key measure of our success was a record second-quarter operating ratio of 61.2 per cent."

Revenues were up 10% -- 15% if you back out foreign exchange effects – on 3% lower unit volume and no change in revenue ton-miles. The asset management theme continues as 93% of cars arrived at the dock at the hour they were supposed to arrive. The move toward weekend loading and unloading continues, pushing car miles per car day up 8%. The new East Coast train from Vancouver had its book of business before it turned a wheel, so it's no longer a case of "build it and they will come."

The on-going push toward weekend carloadings continues to improving car utilization and reduce cost – equipment rents are down 22% e.g. It's all part and parcel of the Carload Excellence initiative for uncovering new opportunities – Chief Marketing Officer Jim Foote reckons that game is "in about the third inning" where the game is 100% of what's out there. Looking ahead Foote foresees a "solid outlook for the merch biz, better grain export flows, still more Canadian coal, and overseas demand benefiting both Halifax and Vancouver.

Operating expenses declined 3% producing a 24% jump in ops income and a record low OR, down four and a quarter points yoy. That's in spite of a 46% increase in fuel expense driven by 4% more burn on 4% more GTMs and 44% higher price per gallon. Had fuel prices remained the same on the same burn the OR would have been 58.4, holding to Hunter's Rule that fuel price increases are worth about two points on the OR. Additionally, comp and benefits dropped 6% on a combination of headcount reduction, stock-based compensation and other factors.

To close, CN now expects that CY 2005 net income will grow at a rate of 20-25%, double the rate predicted six months ago. That's the kind of earnings growth we've come to expect from a dot-com, not a railroad. No wonder the stock gapped up $2 at the 1300 release – and by the end of the day was up more than 6% from the open.

Union Pacific earned 88 cents a share in Q2, up 47% yoy, on a 30% operating income jump thanks mainly to 10% more in the fare box and only 8% more ops expenses. Said CEO Dick Davidson in his opening remarks, "We've seen stronger demand for our services than I've seen in my 45 years on the railroad and our operating turn-around lets us push more to the bottom line." This was the first yoy growth in ops income in six quarters in spite of continuing high failure costs and diminished coal earnings due to a combination of factors in the PRB.

The 10% revenue gain comes on 1% more volume, 4% from pricing and the balance from fuel surcharges (FSC). It is instructive to note that FSC covered $152 mm of the $162 mm yoy increase in fuel expense, even though CFO Rob Knight observed on the call that UP is still "chasing the curve" as FSC collections lag the expenditure, though better loco use and fuel conservation measures contributed $14 mm in savings.

Total fuel expense was up 39% on a 44% increase in fuel price however flat GTMs burned 3% less fuel than a year ago. The reported OR was 86, still high by Class I standards but two points better than 2Q04, but if fuel prices had not changed the OR would have 80.9 on the reported 2Q05 burn. UP has said before that a 1-MPH change in system velocity is worth 250 loco units, so cutting car cycle time, yard dwells, intermediate yards and crew changes all contributes to fuel efficiency.

Merchandise carload revenues increased 12% on flat volumes with double-digit yield gains in agricultural and industrial commodities. Intermodal revenues went up 10% on 5% more volume while coal still managed to post a 5% revenue gain on 3% lower volume. UP estimates that coal loadings in 2Q averaged 30 a day vs. a plan figure of 35, a miss of 16% that cost 9 cents a share. The outlook is for more of the same, with merchandise revenues more than making up for coal's shortfall.

I think UP has moved ahead with amazing speed implementing the Unified Plan with half a dozen initiatives complete to date and two more set for completion in August. One has to do with intermodal, where UP is segmenting the market much as CN did with its IMX plan. There is no doubt that UP runs one of the tightest IM loading patterns in the business with fewer voids (empty box spaces) per train than one sees elsewhere. That alone, combined with the distant node discipline of the Unified Plan, will make the railroad run still faster and at lower unit cost. Nice job in the Q, guys. (After the close Thursday UNP was up $2.19 to $68.12.)

The common thread is the merchandise business is alive and well. The "other fellow" (the truckers) has set the agenda for too long and now with driver shortages, highway congestion, increased federal scrutiny of operating practices and record fuel prices it's no longer the rate free-for-all of yore. CN and UP reported significant merchandise carload yield improvements and have the top two carload franchises in NA based on merch revs as a percent of total revs. Like I said, the merch biz is good.

Moreover, all rail stock prices spiked following these heady reports. And since shortlines touch about a fifth of all Class I revenues, the shortline opportunity is there. At the moment I'm writing an RFP for an Eastern Shortline seeking new management and the response to my initial inquiry has been gratifying. We saw the multiples GWR paid for its recent acquisitions and others I've seen where the final price was not made public followed the pattern. Shortline owners would do well to pay attention.

Kansas City Southern's Tex Mex subsidiary was awarded a Railroad Rehabilitation and Improvement Financing (RRIF) loan by the FRA. As you know, these RRIF loans are available to assist short lines and regional railroads in acquiring, improving or rehabilitating rail equipment and infrastructure. The $50 mm 4.29% senior notes will be used to enhance Tex Mex's rail infrastructure between Laredo and Corpus Christi, upgrading 146 miles of track, rehabilitating 26 bridges, construct two new sidings and lengthening another one, and replacing 75,000 cross ties. In addition, rail yards at Laredo and Corpus Christi will be upgraded and expanded. Vanness Company acted as the Independent Financial Advisor (IFA).

Watco and KCS this week shook hands on a lease deal that transfers the operation and marketing of five KCS branches in Oklahoma, Arkansas and Louisiana to the shortline. Four of the five are along the KSC spine line between Heavener and Shreveport and conveniently located not all that far from Watco's South Kansas and Oklahoma (SKOL; see maps at www.watcocompanies.com). This fifth runs southeast out of Columbus, MS, right in the back yard of Roger Bell's CAGY family of shortlines.

To serve these new markets Watco will create three new shortlines, the Arkansas Southern, the Louisiana Southern and the Alabama Southern. The two Louisiana lines will turn their first wheels in Sep, Arkansas and Alabama properties will follow in Oct and early Nov. Specific dates will be announced soon.

The KCS-Watco news above tells a larger tale about shortline relationships with their connecting Class Is. It's what one Class I manager calls a "supplier mentality" -- doing what it takes to accomplish common goals. On the other hand there are shortlines that are always "pushing the envelope" according to another Class I manager who deals with shortlines.

Both of these Class I folks named names, and, knowing the personalities involved as well as I do, it's not difficult to see their points. A recurring theme over the years in my *Railway Age* columns, in my newsletters and in my consulting practice is that shortline relationships with their connecting Class Is are constantly shifting between customer and supplier. The trick is knowing which role is being played out at the moment, and for now it's largely the latter.

The manufacturing sector reports "unexpected vigor" according to a page 1 of Monday's WSJ. Of particular interest to shortlines whose livelihoods depend on merchandise carload (manufactured goods) traffic it's a mixed message. On the one hand, the Federal Reserve said last week that industrial production was up nine-tenths of a point in June, the best monthly gains since early 2004. On the other hand, gains in hi-tech and aero space aren't going to mean much to the RRs except in raw materials for the finished goods.

The paper holds that global competition has hit companies that depend on low-skill workers the hardest. As a result "the manufacturing sector is quietly adjusting to a demanding environment by shifting to higher-end products that might not be on many consumers' shopping lists."

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Second Quarter 2005 Results

($US)

	Date	2Q04a	2Q05e	Change	Rev chg	2Q05a	Change
BNI	26-Jul	$ 0.67	$ 0.93	39%	14%		
CNI	20-Jul	$ 0.83	$ 1.09	31%	na	$1.20	45%
CP	26-Jul	$ 0.48	$ 0.68	42%	26%		
CSX	27-Jul	$ 0.60	$ 0.81	35%	6%		
FLA	28-Jul	$ 0.22	$ 0.24	9%	7%		
GWR	1-Aug	$ 0.39	$ 0.43	10%	17%		
KSU	3-Aug	$ 0.11	$ 0.18	64%	28%		
NSC	27-Jul	$ 0.54	$ 0.65	20%	13%		
RRA	28-Jul	$ 0.17	$ 0.24	41%	14%		
UNP	21-Jul	$ 0.60	$ 0.77	28%	10%	$0.88	47%

Source: Railroad financial reports