THE RAILROAD WEEK IN REVIEW

JULY 29, 2005

Week Two of the Second Quarter 2005 Earnings Season rounded out the Class I reports and I must say it's been breath-taking. See Table 1. Revenues, operating incomes and revenue-per-unit broke records across the board. Finally there's talk about putting less emphasis on the low revenue-to-cost ratio traffic and using improved service quality to earn the right to premium pricing. To be sure, there is still some customer grousing about bunching and yard delays, but the fact is if the value proposition were less than the competition's the business would not be on the rails.

To date we've seen Q2 results from seven roads. Stock prices of five – the exceptions being CSX, RRA -- gapped up on the earnings announcement. Earnings gains were such that PE multiples were easily surpassed, lowering effective PEG ratios to as low as 0.62 (CP). Among Class Is UP still has some catching up to do (PEG = 1.75) as does CSX (1.14). Possibly traders are betting on the combination of UP's sheer size and clear signs of an operating turnaround thus pushing the PE to 29.

The CSX earnings story may be perceived as less compelling. Revenues were up only 8.5% against some pretty heady gains elsewhere. Among the US peers CSX showed the only yoy volume decline and has the smallest intermodal portfolio among the Big Six measured as percent total revenue. And eps before a tax credit actually declined. It is no longer a tech buy as the five trading days through Thursday the stock went nowhere. But that's a minor quibble in what's been a great story thus far.

BNSF kicked off the week Tuesday with net income of 96 cents a share, up 43% over 2Q04 and beating estimates by three cents. Freight revenue increased 14% yoy and expenses were kept well enough under control to drop the OR two more points from Q1 to a record 76 and produce a whopping 44% operating income increase. System RPU was up 12 % with intermodal up 9% and merch carloads up 14%. More important, of the $406 mm revenue increase merch accounted for 51% to IM's 39%.

This was the 13th consecutive quarter of yoy volume increases and the sixth consecutive quarter of double-digit freight revenue growth. And no other US Class I has managed to lower the OR in every consecutive quarter going back to 1Q04. (Note: BNSF calculates OR as ops expense plus other income as a percent of freight revenues whereas I use the classic operating expenses over operating revenues that include "other.")

That 15% revenue gain is comprised of 3% more GTMs plus 6% each from fuel surcharge and price increases. It's important to note that the FSC component was $158 mm, 117% of the yoy spread in fuel expense. Overall fuel consumption was up 3.3% on 3.8% more GTMs and 4.4% more revenue unit volume. The killer is that even after hedge per-gallon cost went up 37%. Still, the BNSF edge is a service edge, with Consumer Products (intermodal, auto, refrigerated box car) revenues up 19% to $201 mm, partially as a result of double-digit volume increases in international, truckload, automotive, and perishable sectors.

Industrial Products revenues were up 16% to $718 mm on strong demand in the building products, petroleum products, and construction products sectors. Agricultural Products were likewise up 16% to $493 mm thanks in part to robust corn, soybean and wheat export moves to the Pacific Rim countries. Coal revenues grew 7% to $591 mm never mind the operational and maintenance disruptions caused by adverse weather conditions in the Powder River Basin.

As if to top it all off, BNSF upped the quarterly dividend three cents a share to $0.20, an 18% increase and a yield of 1.6% at Tuesday's opening price of $51. The new amount will be paid October 3, 2005, to shareholders of record September 12, 2005. Increasing dividends is always a sign of a company with the shareholders' interests at heart. The present increase follows the 13% increase and 25% increases approved by BNSF's Board of Directors in July 2004 and July 2003, respectively.

Canadian Pacific was the fourth railroad in a row this Earnings Season to check in with Q2 earnings growth north of 30%, earning C$0.78 to last year's C$0.53, a gain of 47%. Once again revenue was up double digits (10%) to single digits for expense (7%) for a handsome double-digit operating income improvement, up 23% to C$270 mm. True to form, CP took the OR down another 250 BP to 75.5 for the number three spot following CN and NS.

Total revenue was up 10% to C$1.1 bn with increases in five of CP's seven business lines, led by coal up 48%, intermodal 10% and grain 7%. CP's continued focus on the high-yield traffic segments brought the overall system RPU up 13% with coal (+67%) on mix and distance plus food & consumer (which CP now breaks out from intermodal) up 22%.

The freight revenue growth is worth a closer look because it's the first time anybody's come right out and said there is some business that does not fit the mold. In his opening remarks, CEO Rob Ritchie credited CP employees with "growing our business with a focus on quality revenue." Well, COO Fred Greene's slide 13 comes right out and says "strategic reductions" took C$10 mm out of the revenue stream. But the same slide shows a C$19 mm gain in "targeted growth" opportunities.

In other words, you can't clutter up the railroad and consume scarce resources moving stuff that doesn't pay its own way. It costs as much to move a box of rocks as it does to move racks of autos, but on CP at least the latter generates half again as much revenue. The Industrial Products group has the lowest RPU in the merch carload group including auto and food & consumer and is 20% less than the average RPU for the entire merch group. Kudos to CP for being so candid about it.

On the expense side comp and benefits were up a mere point while equipment rents were down 10%. Fuel expense increased $C37 mm or 34%, almost entirely on price as consumption was up a point to support two points more GTMs. Fred Greene's revenue mix slide doesn't break out fuel, but the graphics make it look like the FSC recovered a large chunk of the increased expense.

Norfolk Southern set four new records on Wednesday: quarterly revenue $2.15 bn, ops income $592 mm, net income $424 mm, and a 72.5 operating ratio. Two non-recurring items helped, though even without them the records would still stand. Favorable (to NS) resolution of two coal rate cases and the Ohio State Tax change (WIR 7/8/2005) brought in $120 mm or 29 cents per diluted share. The $24 mm coal settlement added $24 mm above the line and without it ops income would have still been up 34% and the OR 73.3, both still record-breakers. Below the line, absent the Ohio tax break eps would be a record 80 cents, up 49% yoy.

Out on the railroad Q2 revenue was up 19% on a mere 4% volume increase, pushing system RPU up 14% on double-digit gains in merchandise, coal and IM. Coal RPU was reported up 36%, though without the rate settlement it would have been only (!!) 30%. Ops expense increased 13% with fuel, comp and materials-services-rents all up in the range of $56-60 mm partially offset by the $69 mm reduction in Conrail items as a result of the restructuring. Once again, fuel is the big hammer on the OR. Had prices not changed yoy for the actual 2Q05 GTMs the OR would have been 70.1.

During the Q&A the questions turned to mix and fuel surcharge coverage. The prepared materials (see www.nscorp.com to follow along) show volume worth 4% of the 19% revenue increase and "RPU/mix" worth 14% with a point lost in rounding, I guess. Later on in response to a question it was noted "about a third" of the yoy revenue increase was FSC. Running the math backwards you get volume 4%, FSC 6% and price/other worth 9%.

This is very interesting in the context of what CEO David Goode refers to as the "value pricing model." On the one hand, STB Performance Measures for NS haven't changed much in the past year. Average train speed is still 22 MPH plus a few tenths. Yard dwell hovers around 22 hours and cars-on-line is up less than 4% yoy. Maybe not record-setting but consistent, and this fits with what shortlines and shippers say about NS service and with what I see out on the line.

The railroad running a Unique Selling Point based on consistency will continue to attract new customers and more business from old ones because you know what you're getting when you sign up. Moreover, investors know that it costs less in crews, locomotives and consumables to do the same thing the same way every day – which is what TOP and now TOP-2 are all about. Before the conference I was chatting with Vice Chair Steve Tobias about how much more volume you can handle per crew-start at 22 MPH than at 17 MPH, and that speaks volumes.

Railroad President Wick Moorman wrapped up the session with a few observations that go directly to this USP. NS has racked up 16 consecutive Harriman Awards for leadership safety, proving once again that a safe railroad costs less to run than an unsafe one -- NS handled 4% more volume with 4% more crew-starts, e.g. Said Moorman, the next step is to increase volume per train-start, no small challenge on a property making 5,000 blocks for 367 train routes every day. To do this, NS continues to address choke-points with "careful strategic investment." Sounds good to me.

CSX likewise knocked the cover off the ball with Q2 operating income up 43% on just 9% more revenue and 2% less volume as ops expense was up only 2% yoy. This was the sixth consecutive quarter of "core earnings growth" and the 13th consecutive quarter of yoy revenue increases according to CEO Mike Ward. Train speeds are up, accident rates are down, system RPU is up 11% and it's now two quarters in a row for operating income records. A good start.

Drilling down, CSX continues to build the value of its merchandise carload franchise hitting the 13th consecutive quarter of merch revenue increases. RPU increased across all lines with forest products, metals and food/consumer posting double-digit RPU gains. Coal, coke and iron ore did the double-digit as well while intermodal barely eked out a ten-dot-one point RPU gain with 8% fewer revenue moves.

On the expense side CSX did a remarkable job managing fuel costs. Total fuel expense was up 17%, low for the industry. Average cost-per-gallon of diesel fuel was $1.19, up just 19.7% yoy, and CSX generated 792 GTMs per gallon, all Big Six bests. We've already noted the 2% decrease in revenue moves. That translated into a 1% GTM reduction and that in turn earned CSX a 3% decrease in actual gallons consumed. The operating ratio dropped to 80.5, a significant achievement given the much higher numbers we've seen not all that long ago.

Earnings per share increased 37% to $0.73 vs. last year's $0.53, helped along to the tune of $0.31 per share by the tax changes in Ohio that produced an income tax benefit of $71 mm. Absent the credit the eps delta would have been $0.42, down 20% yoy. And that's what may be behind CSX' relatively poor stock price showing in the last few days. Which is a shame because the 2Q05 story is one of continuous improvement. The Mike-Tony-Clarence team is the best CSX has had in a long time and if anybody can turn CSX around it's these guys. Their focus is on above-the-line results and IMOH that's the only way to run a railroad.

RailAmerica punched up a 41% yoy increase in operating income. Freight revenues increased 15%, powered by double-digit RPU gains in ten of 13 commodity groups. RRA held the ops expense increase to 11% aided by a 7% reduction in comp and benefits to a very respectable 31% of revenue. Diesel fuel expense was up 43% on 8% more burn on 9% more revenue moves and a 32% increase in ppg. The OR dropped three points in the bargain.

Another notable expense cut was in casualty and insurance, down 10% to $4 mm vs. $5 mm a year ago as derailments, reportable injuries and injuries per 200,000 hours all trended down. This last started 2005 at 3.49, stood at 2.33 at Q2's end and was down to 2.09 as of last week. It just goes to prove once again that running a safe railroad costs a lot less in dollars, productivity and lives. In fact, the safer railroad contributed 1.4 points to the OR improvement.

During the conference call CEO Charlie Swinburn offered his observations on the Ohio situation. Initial shortages of power ($900 a day rental per back-up loco) and crews (hiring temporary workers) added significantly to operating costs. Making matters worse, a new CN/NS Routing Protocol took effect, routing certain traffic around RRA to the tune of about $1.7 mm in lost revenue and as much as $1 mm in operating income. During the Q&A Swinburn noted that this incremental revenue – the trains that hauled this traffic have to run anyway – was running at an OR someplace just south of 60.

Below the line RRA earned $9.3 mm from continuing operations in 2Q05 vs. a loss of $13,000 a year ago, two bits per share vs. zip. But if you put back the $5.6 mm (after tax) 2Q04 charge for the former CEO's retirement and add back credits for discontinued operations the company earned 21 cents a year ago on $7.2 mm of net income.

For the full year RRA anticipates revenue in the range if $435 to $440 mm against 2004's $396 mm, up 10% on the low end with an OR in the mid-80s, four points better than last year's. They expect a below-the-line tax credit around $12 mm from the track maintenance tax credit program and estimate shareholders will walk away with $0.90 to $0.96 a share, a vast improvement on last years negative 61 cents excluding extraordinary items.

IMHO we're seeing a company in transition. Revenues in the last six quarters are up just 15% and operating income's about where it was for 1Q04. Operating ratios have ranged from 83.5 in 1Q04 to 96.6 in 3Q04 and net income bottomed at a $31 mm loss in 3Q04. However, the most recent three quarters show a positive trend with rising revenues, ops income, net income and an improving OR. See the entire picture in Table 2.

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Table 1.
Big Six Class I Commodity Carload Comps

Quarter ending 6/3/2005

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 3,138	$ 1,838	$ 1,105	$ 2,166	$ 2,154	$ 3,344
YOY Pct. Change	16.9%	10.4%	10.0%	8.5%	18.8%	10.4%
Total revenue units	2,465	1,204	675	1,869	1,947	2,391
YOY Pct. Change	4.4%	-2.6%	-2.7%	-1.9%	3.9%	1.0%
Carload revs (2)	$ 1,411	$ 1,334	$ 585	$ 1,294	$ 1,148	$ 1,970
Pct carload	45.0%	72.6%	52.9%	59.7%	53.3%	58.9%
Pct Intermodal	33.2%	17.0%	25.8%	15.2%	19.9%	17.9%
Pct Coal	18.8%	4.4%	18.8%	24.0%	26.8%	18.8%
Mdse Carloads (000)	697	775	299	888	746	1,059
Rev/CL x coal, IM	$ 1,971	$ 1,721	$ 1,957	$ 1,457	$ 1,539	$ 1,860
RR Operating Income	$ 710	$ 713	$ 270	$ 422	$ 592	$ 468
YOY Pct. Change	39.8%	24.0%	22.5%	43.1%	39.3%	30.4%
RR Operating Ratio	77.4%	61.2%	75.5%	80.5%	72.5%	86.0%
YOY Point change	(3.71)	(4.26)	(2.49)	(4.71)	(4.04)	(2.14)
GTM/gallon diesel fuel	752	845	863	792	769	776
Fuel/gallon (US$)	$ 1.32	$ 1.34	$ 1.53	$ 1.19	$ 1.27	$ 1.67
YOY Pct. Change	36.9%	39.8%	33.5%	19.7%	48.6%	44.0%

(1) CN, CP in $Canadian

(2) Excludes coal, intermodal

Table 2.

RRA Six Quarters

2004	Revs	Ops Inc	OR	Net
Q1	$ 95.9	$ 15.8	83.5%	$ 4.7
Q2	$ 96.2	$ 11.4	88.1%	$ 0.4
Q3	$ 100.0	$ 3.4	96.6%	$ (30.6)
Q4	$ 103.2	$ 11.7	88.7%	$ 4.0
2005				
Q1	$ 110.1	$ 11.6	89.5%	$ 7.2
Q2	$ 110.8	$ 15.0	86.4%	$ 9.3