THE RAILROAD WEEK IN REVIEW

FEBRUARY 3, 2006

"*Trinity Industries (NYSE: TRN) should reap the rewards of the boom in railroad activity." – Jim Cramer on CNBC's Mad Money 1/30/2006*

Canadian Pacific operating income (all currency in $Canadian) for the fourth quarter was up 30% yoy thanks to a 15% revenue gain while holding the ops expense increase to just 10%. Like other Class Is, CP experienced only slight volume increases, up 1% across the board with double-digit hits in coal and sulfur/fertilizers and a 6% southerly drift in forest products. Of particular interest to shortlines, during the call President and COO Fred Green said that some smaller lumber and paper producers were hard hit by the double-whammy of high natural gas prices and a softening in demand for new housing.

Full year operating income hit a $billion for the first time ever thanks to revenues up 13% and expenses up only 9% yoy. Revenue units came down only 0.8% yoy with coal, sulfur/ferts and forest products the big losers. However it appears the hits hit hardest in Q4, which is about what one would expect given the price of gas and the rate of housing starts.

Reported eps was $0.86 for the quarter vs. $0.81 a year ago, up 6%, though once you take out the effects of foreign exchange and other on-time below-the-line items you get $1.06 vs. $0.73, a 45% gain. In like manner CP reported eps for the full year was $3.43 vs. $2.60, up 32%. Take out the same items and its $3.43 vs. 2.60, also 45%. Thus CP continues the theme of rail industry double-digit earnings growth for the quarter and year.

For 2006 CEO Rob Ritchie said they expect to see volumes increasing in the 3-4% range and revenues the same. Fuel surcharges represented 4% of the $481 mm revenue gain in 2005 and we ought to expect about the same in 2006 for an all-in revenue gain in the 10-12% range. Among merchandise commodities Forest products and industrial saw the best yoy RPU gains running slightly below the 13% reported for the system.

CP still has some work to do on ops expense. The rate of operating expense growth exceed the rate of traffic volume growth by a factor of ten times whereas its arch-competitor CN increased ops expenses at a rate equal to the traffic volume increase. Green showed (slide 16, of you're following along) that train speeds, cars online and terminal dwell have all improved yoy and CFO Mike Waites showed how headcounts are still coming down (slide 11). But Rob Ritchie summed it up best when he said you can run a consistent railroad with fewer assets than an inconsistent one.

Kansas City Southern gave a very upbeat earnings call on Thursday. They were in NY but due a conflict I was not able to attend in person – my loss. Anyway, exact yoy comps of the numbers are challenging because they fully absorbed TFM and started running the railroad as one, renaming the Mexican lines Kansas City Southern de Mexico. The short form is that KCS remains a work in progress and we ought to expect great things of what CEO Mike Haverty and his team have wrought.

In effect they more than doubled the size of the railroad. Reported revenues jumped 122% to $388 mm from $174 mm for the quarter and 111% to $1.35 bn from $640 mm for the year. Total revenue units increased 86% to 492,000 for the Q and 73.8% to 1.8 million for the year. Unfortunately operating expense was up 132% for the Q and year; operating ratios increased 3.3 points to 88 in the Q and 8 points to 95 for the full year.

But then, one of the chief drivers of this combination is expense control. Said Haverty they've taken three semi-autonomous pieces and made them one with all shared services – what CFO Ron Russ called the back office – under one roof to run a seamless railroad from central Mexico to Kansas City and Atlanta. Key to the latter is the agreement with NS for joint operations between Dallas and Meridian via Shreveport (WIR 12/9/2005).

Hurricanes Katrina and Rita cost about $13 mm in lost revenue (mostly chems and forest products) and added operating expense. Still, yields improved 12% yoy as the effects of the combined operations began to be seen. Safety stats were vastly improved and a program of penalties for customers keeping cars over long is achieving the desired result: putting more cars in the fleet through better turn times.

What the combined railroads are capable of doing is demonstrated by the pro forma operating statement, prepared to show the railroads as if they had been together since January 2004 and excluding acquisition charges, the VAT/Put settlement and other odds and ends. Pro forma full year revenue would have been $1.5 bn, up 12%, while operating income would have drifted down 9% to $179 mm thanks to a 15% pro forma increase in ops expense. But still, in less than one year the new KCS "Nafta Railroad" has literally weathered the storms, made one railroad of three and ought to do very well indeed going forward.

Jim Cramer's "Mad Money" is not a place you'd expect to hear much mention of *railroad* stocks, but he did it not once but twice Tuesday. He said he'd listened to all the RR conference calls and that the eps gains were more like what we'd expect from high tech internet companies than this low-tech under-the-radar business.

This was by way of his lead into a discussion of Trinity Railcar. Which, BTW, Cramer called "a locomotive stock," but why quibble. The thesis is that TRN is a way to play the increasing use of coal, particularly that of a personal favorite, Peabody (BTU). But he missed what's happening in the whole rail car field, namely that as service improves rail is more attractive to shippers who in turn shift more of their business to rail.

TRN stock has more than doubled since last May, closing Wed at $50. MarketWatch.com has a LONG rating on it and has since last Nov. I back-tested the stock using a buy-and-hold strategy for the past 100 days and got a 33% return, best of the car builders and trailing BNSF, CN, RRA and UP in total returns for the period. Putting TRN's results in perspective, it outperformed such internet darlings as E-Bay, Amazon and Yahoo.

Sources tell me TRN is sold out for 2006 and the order books are closing rapidly on 2007. Covered hoppers are the hot car, and that bodes particularly well for the chemicals and grain business. Faster turns on the railroad mean more loads per year and lower lease costs per ton per piece of equipment. Shortlines, hear again what CN is advocating: run your railroad seven days a week.

Companies that extract stuff from the ground and so something useful with it are on a roll, and that's good for railroads merch carload business. Michael Kahn, technical columnist for *Barron's*, writes that metals, energy (read coal) and basic materials companies are the most important sectors. Want proof? Vulcan Minerals, LaFarge and the Basic Materials ETF (exchange-traded fund, XLB) all achieved 52-week highs this week.

Steel companies have done exceptionally well. In Thursday's column Kahn notes that steel stocks have almost doubled since June. Some have suggested that the acquisition efforts of Mittal Steel have contributed to the stock price increases. But then again, the metals sector fared quite well for the rails'

Q4 and full-year results and the metals outlook during this season's conference calls continues to be favorable.

This suggests to me that the Class Is pushing unit trains of everything from rock to coil steel will only capture more market share in the metals and aggregates commodity groups and do it with higher yields. And if this is the case it presents a great opportunity for shortlines to follow the leads of GWR and the North Shore Group, creating high-volume, rapid-turn short-haul moves in dedicated trains. The latter, for example, moved more than 4 mm tons of rock between quarry and consumer with one 12-car train running twice a day five days a week for eight years.

Two more fatalities in West Virginia coal mines have prompted calls for all WV mines to be shut down. In a note to clients, Morgan Stanley's Jim Valentine writes, "Based on a flurry of press reports suggesting West Virginia's coal mining industry may be temporarily closed down for mine inspections, we conducted a sensitivity analysis for CSX and NSC, the two railroads that serve WV mines. If the mines were to be closed for a full month, we estimate it would cause a drop in CSX's 1Q06 EPS of 11% and 8% NS. C's 8%."

Working backwards from those estimates with net margins and share-counts for FY2005 it looks like the 1Q06 revenue losses could be in the neighborhood of $175 mm to CSX and $158 mm to NS. Hardest hit would be shortlines such as Watco's Appalachian & Ohio which exits mainly to serve former CSX mines in WV.

Valentine writes that there will be minimal impact on the other Big Four Class Is however, "Given that there's minimal new coal mining capacity to pick up the slack, we estimate at least 75% of this lost coal tonnage would be made up later in the year. West Virginia produces 12%-14% of all US coal tonnage. With utility stockpiles already well below normal levels, we don't see how a mandated closure could continue for more than a few weeks without creating regional electricity shortages."

Incidental Intelligence Department: *Barrons OnLine* reported Friday that Tractor Supply (TSCO) stock jumped 22% to an all-time high of $62 as the firm reported "robust same-store sales (especially in agricultural, seasonal, livestock and pet products and clothing) and higher selling prices, particularly in southern stores." One analyst said the company's "strong management team should foster growth in its niche market." CSX and NS will be the prime benefactors of any farming activity up-tick in the Southeast.

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Big Six Class I Commodity Carload Comps

Quarter ending 12/31/2005

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP*
Railroad revs (1)	$ 3,550	$ 1,886	$ 1,167	$ 2,219	$ 2,257	$ 3,621
YOY Pct. Change	19.2%	8.6%	14.2%	1.8%	15.8%	12.6%
Revenue Units (000)	2,581	1,208	684	1,818	1,983	2,419
YOY Pct. Change	3.2%	-3.0%	1.2%	-8.3%	2.9%	1.0%
Carload revs (2)	$ 1,572	$ 1,383	$ 634	$ 1,305	$ 1,214	$ 2,132
Pct carload	44.3%	73.3%	54.3%	58.8%	53.8%	58.9%
Pct Intermodal	34.8%	18.0%	27.8%	16.5%	23.0%	19.2%
Pct Coal	17.9%	4.1%	15.9%	23.5%	23.2%	17.4%
Mdse Carloads (000)	719	785	305	818	720	1,021
YOY Pct. Change	-1.0%	-4.0%	0.2%	-10.5%	-0.3%	-1.8%
Rev/CL x coal, IM	$ 2,208	$ 1,762	$ 2,077	$ 1,595	$ 1,686	$ 2,088
Operating Expense	$ 2,750	$ 1,488	$ 865	$ 1,804	$ 1,663	$ 3,088
YOY Pct. Change	19.0%	3.3%	9.6%	-3.3%	11.8%	11.6%
Ops exp chg/Vol chg	5.95	(1.10)	8.35	0.39	4.07	11.06
RR Operating Income	$ 800	$ 720	$ 302	$ 415	$ 594	$ 533
YOY Pct. Change	19.8%	18.6%	29.6%	31.7%	28.6%	161.3%
RR Operating Ratio	77.5%	61.8%	74.1%	81.3%	73.7%	85.3%
YOY Point change	(0.10)	(3.21)	(3.08)	(4.25)	(2.61)	(0.70)

*Before $247 mm asbestos charge taken in 4Q04

Full Year Ending 12/31/2005

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 12,987	$ 7,240	$ 4,392	$ 8,618	$ 8,527	$ 13,578
YOY Pct. Change	18.6%	10.6%	12.5%	7.2%	16.6%	11.2%
Revenue Units	10,024	4,841	2,676	7,350	7,786	9,544
YOY Pct. Change	5.1%	5.7%	-0.8%	-2.4%	4.3%	0.9%
Carload revs (2)	$ 5,791	$ 5,304	$ 2,376	$ 5,072	$ 4,586	$ 7,560
Pct carload	44.6%	73.3%	54.1%	58.9%	53.8%	55.7%
Pct Intermodal	33.6%	17.5%	27.2%	15.8%	21.4%	20.8%
Pct Coal	18.8%	4.6%	17.1%	24.1%	24.8%	19.0%
Mdse Carloads (000)	2,855	3,145	1,185	3,376	2,896	4,102
YOY Pct. Change	1.9%	6.7%	0.0%	-3.4%	0.5%	-1.4%
Rev/CL x coal, IM	$ 2,028	$ 1,686	$ 2,006	$ 1,502	$ 1,584	$ 1,843
Operating Expense	$ 10,065	$ 4,616	$ 3,390	$ 7,069	$ 6,410	$ 11,783
YOY Pct. Change	8.7%	5.4%	8.9%	1.3%	14.3%	10.4%
Ops exp chg/Vol chg	1.70	0.94	(10.49)	(0.56)	3.31	11.48
RR Operating Income	$ 2,922	$ 2,624	$ 1,002	$ 1,549	$ 2,117	$ 1,795
YOY Pct. Change	73.3%	21.0%	27.0%	7.2%	24.4%	16.4%
RR Operating Ratio	77.5%	**63.8%**	77.2%	82.0%	**75.2%**	86.8%

(1) CN, CP in $Canadian

(2) Excludes coal, intermodal

Source: Company financials

Week in Review for Feb 3, 2006

Big Six Class I Operating Efficiency

Full Year Ending 12/31/2005

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP*
Railroad revs (1)	$ 12,987	$ 7,240	$ 4,392	$ 8,618	$ 8,527	$ 13,578
RR Operating Expense	$ 10,065	$ 4,616	$ 3,390	$ 7,069	$ 6,410	$ 10,673
RR Operating Income	$ 2,922	$ 2,624	$ 1,002	$ 1,549	$ 2,117	$ 1,795
GTM in millions	1,061,108	342,894	236,451	463,200	375,800	1,043,900
RTM in millions	596,575	179,701	123,627	246,800	198,300	548,800
Fuel Consumed (mm)	1,402	403	286	596	513	1,353
Route Miles	32,154	19,221	13,626	21,537	21,300	32,615
Employees	39,254	22,246	16,295	na	29,851	49,747

Measures	BNSF	CN	CP	CSX	NS	UP
Operating Ratio	77.5	63.8	77.2	82.0	75.2	78.6
Ops exp/MGTM	$ 0.9485	$ 1.3462	$ 1.4337	$ 1.5261	$ 1.7057	$ 1.0224
Ops exp/RGTM	$ 1.6871	$ 2.5687	$ 2.7421	$ 2.8643	$ 3.2325	$ 1.9448
Rev/MRTM	$ 2.1769	$ 4.0289	$ 3.5523	$ 3.4919	$ 4.3001	$ 2.4741
MRTM/MGTM	0.56	0.52	0.52	0.53	0.53	0.53
MGTMs/gallon	756.85	850.85	827.33	777.83	731.98	771.54
MGTMs/emp	27.03	15.41	14.51	na	12.59	20.98
MGTMs/route mile	33.00	17.84	17.35	21.51	17.64	32.01

CN, CP in $C

Revene line includes freight revs plus other ops rev.

CN includes partial year for GLT, BC Rail

* UP before asbestos charge in 4Q04

Source: Company financials

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