THE RAILROAD WEEK IN REVIEW
APRIL 21, 2006

"CSX produced record first quarter results as the railroad renaissance continues to unfold." – CSX Chairman Mike Ward on Wednesday's earnings call.

CSX blew out the lights as it opened Earnings Week with a 39% yoy gain in ops income thanks to 11% higher revenues against a mere 5% ops expense increase. The OR dropped to a highly respectable 79.1, down from 83.3 in 1Q05 and 89.4 in 1Q04. CEO Mike Ward kicked off the conference saying this was this ninth consecutive quarter of continuous improvement.

Of particular importance to the 230 shortlines that connect with CSX, average revenue per carload rose 14% to $1,655 as revenue for the group increased 11% while the number of carloads was down 3%. Carloads increased however modestly in five of the eight merch groups (I include auto as well for the parts biz on shortlines). Unfortunately, the 9,000 carload gain in emerging markets was mostly offset by the 7,000 loss in forest products. However, double-digit increases in RPU bespeak more corporate emphasis on business that pays its way.

The mix change in phos and ferts is of particular note. Commodity revenues remained at $90 mm yoy as carloads dropped 25%, pushing RPU up 33% to $1.023 from $769. The 29,000 carload spread is equivalent to 290 train-starts of 100 cars each. Figure a train-start costs something in the neighborhood of $1,300 so not starting 290 trains saves $377,000 dollars *and* at no loss of revenue.

During the presentation portion of the call EVP and Chief Commercial Clarence Gooden said fuel surcharges accounted for 35% of the $223 mm revenue increase with price (45%) and mix (20%) making up the balance. During the Q&A Clarence noted that the FSC program covers just under 60% of the traffic base with another 20-25% coverage under RCAF. This squares with the 80% number we're hearing from some analysts.

Clarence added that it is not CSX' intention to "over-recover" for higher fuel prices and if they do they will take another look at it. Well, the 1Q06 fuel delta was $74 mm yoy and 35% of the revenue delta is $78 mm which looks like par plus a crumb to me. Meanwhile, CSX' fuel hedge continues its downward trend from a high of $77 mm in 3Q05 to a projected $1 mm in 3Q06 based on $70 per barrel WTI. For 1Q06 CSX averaged $1.61 a gallon vs. $1.14 a year ago, a 41% hike, yet moved 2% more ton-miles on no more fuel, an especially useful trick in this environment.

Below the line CSX shareholders earned $1.06 a share from continuing operations vs. 68 cents a year ago for a nice 55% gain. However, recall that in 1Q05 CSX sold its international terminals business for a $425 mm net after-tax gain. This amount show up as "discontinued operations" and punches reported 1Q05 eps to $2.56 and a 59% yoy *decline* in eps. We'll disregard that and focus on the fact that CSX earnings from the core rail business posted a handsome yoy gain. As if to say, "Well done," UBS reiterated its BUY rating and increased its target price to $86 from $76.

Union Pacific continued the turn-around theme with a near-doubling of operating income, up 93% to $605 mm. Revenues were up 18% to a quarterly record of $3.7 bn while the ops expense increase held at 9%. The OR improved 6.4 points to 83.7. Fuel surcharges accounted $194 mm of the $539 mm revenue gain while the actual increase in fuel expense was $146 mm for a recovery rate of 134%. Below the line, eps increased 137% to $1.15 from 48 cents yoy

Freight revenues increased 18% to $3.5 bn on a 4% gain in total revenue units; average RPU increased 13% to $1481. Every commodity group save coal increased at double-digit rates. Of particular interest to shortlines, ag and industrial products were up 26% and 23% respectively with chems 14%. Merch carload continues to lead UP's commodity mix handsomely at 59% compared to coal at 19% and IM at 17%.

As noted above, RPU hit record levels driven by all-time record revenues in ag, auto, chems, industrial and coal. As we've seen elsewhere, improving customer satisfaction is key, and to my knowledge UP is the only outfit that actually measures it and publishes the results. And if you need further proof that quality in the eye of the beholder, look no further than Jason Seidl' s Rail Survey Results report of March 27: "Nearly 35 % of shippers surveyed stated they would increase their rail business by 5-15% if the rails 'could show them the service.'"

Canadian National operating income for 1Q06 increased 19% on 9% more freight revenue vs. a 4% gain in ops expense pushing the OR to yet another record low, 66.2, a three-point drop yoy. The expense delta was a mere C$44 mm of which $37 mm was fuel, showing that CN is doing a great job controlling ops expense. Gallons consumed were unchanged yet GTMs were up 2%. All this in spite of the unfavorable C$55-mm translation impact of the stronger Canadian dollar on U.S. dollar-denominated revenues and expenses.

All of CN's seven commodity groups registered revenue gains, led by intermodal and coal revenues, which increased 12% and 10% per cent, respectively. Intermodal benefited from growth in international container traffic and a solid performance in Canadian domestic movements. Merch carload were up 8% across the board though lumber gains were partly offset by a slowing of pulp and paper movements. Total revenue units were down a point or two apiece in the merch carloads with the 5% IM gain evening thing out for a no change in total volumes. System RPU gained 9% helped by double-digit increases in forest products, grains and ferts plus auto. Coal RPU increased 11% and IM was up 7%.

CN's relentless focus on safety, execution and performance continue to produce handsomely. In 1Q06 GTMS per employee increased 6%, average grain speeds increased 6% and system dwell time was down 6%. Looking ahead, CN anticipates growth opportunities in the merch carload sector, key to the financial performance of its more than 60 shortlines, citing good demand for lumber, steel, construction materials and iron ore not to mention oil-sands opportunities.

Dan Machalaba writes in Tuesday's WSJ, "Major railroads and their customers are on a collision course over fuel surcharges that have been climbing much faster than diesel-fuel costs…Some frustrated customers claim they can prove railroads are overcharging." BNSF, NS and UP have posted their 2005 FSC revenue either as a dollar figure or a percentage of revenue in their 10-Ks. In each case the FSC collected is roughly 1.5 times the increase in fuel expense year over year. Moreover, take out the 2005 FSC revenue and note that the 2004-2005 revenue deltas drop to single digits – and UP drops to 3%.

I've written before that revenues were going up much faster than volumes and worried aloud that loss of elasticity in rate-making could slow ops income growth. At UP, volumes were essentially flat yoy while ops expense increased 8%. Just 3% more revs ex-fuel on 8% more ops expense does not bode well for the OR.

Fuel hedging was essentially invisible. You did what you could to buy fuel cheaper. What fuel increases there were showed up in contract rates and tariffs. It seemed cleaner than the FSC program. Besides, once a rate is published, that's it. If costs go down the multiple goes up and that's even better. Best of all, allowance-based shortlines sharing in a base rate that already includes a fuel increment are automatically better off.

Class I revenues increased by double-digits in FY 2005 and we anticipate the trend to continue in 2006. How operating income, net income and eps fare depends on expense management, relative changes in volumes, and the extent of below-the-line noise. The question is which number to take seriously when evaluating company performance.

Let me suggest none of the above. Lately I've taken to looking at how much cash (real, spendable dollars before accounting tools like depreciation) remains at the end of the day and how it relates to revenue – call it "cash flow yield." The tables following the disclaimer compare the Big Six Class Is plus KCS, RRA and GWR.

The premise is this: if you buy the company at present stock prices and wipe out the debt, how much will the operation spin to you for capex and other investments? That number taken as a percent of revenue is Cash Flow Yield. Note that cash is a negative because it reduces the debt part of the Enterprise Value formula.

The extremes among Class Is are CP and CSX. The latter has and EV nearly twice that of the former (1.77 times, to be more precise) yet returns just 9% more in operating cash. Even more striking, RRA beat GWR in FY 2005 revenue -- $424 mm to 385 mm (ARG is below the line) – and has less than half the market cap yet returns 140 basis points more in cash flow yield.

With the Australian restructuring GWR will start reporting on a consolidated basis, meaning everything will be above the line. My suspicion is that cash from operations will increase at a faster rate than market cap and that cash flow yield will approach the 7% range experienced by the Class Is. The next two weeks will tell the tale.

The Railinc Board of Directors has made a decision to exit the ***RailSync*** product line market effective immediately. It is my understanding that Railinc will work with customers on day to day support and transitioning off of the RailSync products consistent with contractual agreements. Representatives will be in Orlando at the ASLRRA Annul Meeting this coming week and I'm sure there will be further news.

My Stock Purchases. Sometime in the next ten days I will be adding to my BNI position to bring it up to a dollar amount equal to my other positions. My preference is to "buy on the dips" and never take on a full position all at once. I try to maintain one "position" (a certain percentage of my portfolio in each of no fewer than four industries. Right now I own energy, rails, aerospace and metals.

Oh, and I should have said (WIR 4/7) that I'll let you know a trade is coming *within* ten days, not that the trade will be more than ten days out. As you know, I try to buy on the dips and they can be fleeting. For the nonce, I'm staying on the sidelines till after earnings season is over.

Factoid: The *Washington Post* breaks out the price of gasoline thus: Cost of crude 54.8%, refining cost 21.7%, marketing distribution and storage 4.5%, and taxes 18.9%.

Cash Flow Yield

FY 2005 operating cash flow from the cash flow statement before capex or other items stated as a return on the Enterprise Value of the firm. Share price as of 12/30/2005.

Big Six Class Is

Cash Flow Yield	BNSF	CN	CP	CSX	NS	UP
Share price	$ 70.82	$ 79.99	$ 41.95	$ 50.75	$ 44.83	$ 80.51
Dil shares (mm)	381.8	281.1	160.1	228.0	394.2	266.5
market cap	$ 27,039	$ 22,485	$ 6,716	$ 11,571	$ 17,672	$ 21,456
LTD	$ 6,664	$ 5,085	$ 3,001	$ 6,037	$ 6,930	$ 7,416
Cash	$ (58)	$ (62)	$ (122)	$ (602)	$ (1,257)	$ 773
EV	$ 33,645	$ 27,508	$ 9,595	$ 17,006	$ 23,345	$ 29,645
Cash from Ops	$ 2,377	$ 2,139	$ 1,051	$ 1,151	$ 2,105	$ 2,595
CF Yield	7.1%	7.8%	11.0%	6.8%	9.0%	8.8%

Shortline Holcos plus KCS

(FEC does not break out a separate railroad balance sheet or cash flow statement).

Cash Flow Yield	GWR	KSU	RRA
Share price	$ 37.55	$ 24.43	$ 10.99
Dil shares (mm)	27.80	$ 92.70	$ 38.50
market cap	$ 1,044	$ 2,265	$ 423
LTD	$ 338.00	$ 1,702.00	$ 433.90
Cash	$ (19.00)	$ (31.00)	$ (14.30)
EV	$ 1,362.89	$ 3,935.66	$ 842.72
Cash from Ops	$ 68	$ 179	$ 54
CF Yield	5.0%	4.5%	6.4%

Source: Company financial reports

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