THE RAILROAD WEEK IN REVIEW
MAY 5, 2006

"With every quarter the potential of our combined rail network becomes increasingly evident." – Mike Haverty, KCS

KCS first quarter revenues rose 5.4% yoy ($20 mm) to $388.4 mm thanks mainly to KCS' success in expanding higher margin business opportunities, improved service performance, a strong pricing environment, and fuel surcharges in both the U.S. and Mexico. Operating expenses for 1Q06 were 3.1%, higher yoy due in part to an $8.6 mm, or 17.3%, quarter-over-quarter increase in fuel costs. Operating income for the quarter came in at $61.3 mm, an increase of $10.3 mm, or 20.2%, over first quarter 2005 combined operating income.

With this quarter we're beginning to see the benefits of the combined KCS-TFM network. It's been a tough row to hoe getting here but CEO Mike Haverty's determination and patience are beginning to pay off. Operating metrics, especially train speeds, terminal dwell times and cars on line have improved significantly and have begun to translate into greater bottom line profits. There has been continued improvement in safety measurements in the US and KCS is "laying the groundwork" for a safer railroad in Mexico. The integration of US and Mexican shared services is lowering the cost of purchased goods by "terminating some unattractive arrangements and replacing them with market-competitive contracts."

Says Haverty, "We are also working on ways to capture the value of our exceptional franchise. We expect to attract new business, to improve our yield, and to lower our costs as we migrate toward one seamless rail network across the border." On tap is a new intermodal service between the southeastern US and Mexico, an encouraging pricing environment, and extending KCS' proprietary Management Control System into Mexico for enhanced car scheduling and tracking.

KCS has now achieved 12 consecutive quarters of revenue growth while increasing train speed, severely cutting terminal dwell time and – as noted above – running a safer railroad. Moreover, it appears KCS is having some success with yield improvement. Revenues are up in four out of six commodity groups even as revenue units have declined everywhere but coal. Merch carload RPU is up 11.4% with paper and forest products in the lead, up 20% on 4% fewer units.

Operating expense grew 3% but with revenue units down 4% the seven-point spread is disconcerting. The consolidated OR came down two points from 1Q05 to 84.2 however it's the US that's the drag, not Mexico as I might have thought. The organic KCS posted an 86.8 OR in the quarter while Mexico turned in an 81.2 OR. Below the line net income available to KCS common shareholders in the first quarter of 2006 was $8.0 mm, or $0.11 per diluted share, which compares favorably with first quarter 2005 net income of $7.0 mm, or $0.09 per diluted share. Exclusive of peso devaluation, EPS would have been $0.16, up 78% over 1Q05.

GWR operating income jumped 55% on a 34% revenue gain and a 30% operating expense increase. Of the $29 mm net increase in revenue, $9 mm was North American same-railroad revenue growth and $20 mm from the Earl Durden transaction and $1 mm from the First Coast RR deal with CSX (see June *Trains*, page 34). These gains were partially offset by a $million shortfall in Mex where a portion it the line has remained out of service since Hurricane Stan blew through in Oct. Paper was the big winner with revs up 49% on a 39% volume gain. Aggregates, lumber, metals, chems, STCCs 01 and 20, and coal all posted solid revenue gains with commodity RPUs up accordingly.

CEO Mort Fuller noted that, unlike most post-Staggers shortlines, 90% of the revenue stream is ISS-based (divisions of line-haul revenue rather than FAK[1] allowances) and GWR's "lean operation" keeps expenses pretty much fixed as a percentage of revenue. In fact, average merchandise RPU is $436 vs. $384 at RRA where FAK allowances predominate. Moreover, said Fuller, "We grow by acquisitions" as opposed to cutting costs on flat volumes. Can't argue with that.

Strict yoy expense line comps show every item increasing in absolute dollars; the better measure is how each line changed with respect to revenue. Fuel was the largest increase at 54 BP (same-railroad FSC covered 90% of the $3.4 mm yoy fuel expense delta) with most every other line down so that yoy OR improved 256 BP to a very respectable 80.5. Below the line, net income was up 28% yoy to $14 mm and diluted eps up 25% to 33 cents vs. 26 cents in 1Q05. Net margin was 12% and free cash flow (cash from ops less capex) from NA ops was $21 mm or 19% of revenues.

Looking ahead, Fuller sees 2Q06 earnings in the $0.38-0.40 range exclusive of the ARG transaction gains and $1.43-1.53 for the year, potentially a 30% yoy gain. At Tuesday's $32 share price we're looking at a forward PE of 21.6 and a PEG of 0.72. So when GWR gapped down 6% to below $32 after the call (other rails dipped following good results last week as well) it looked like a buy to me. I'll probably put it on a quarter of a position at a time.

Elsewhere, Vice Chair Charles N. Marshall ("Charlie" to most of us) hung up his spikes April 30. Charlie signed on to GWR first as a consultant and then as President in Oct 1997 following the Conrail split (Marshall was EVP). It was at Conrail that our paths first crossed and he's been a good friend and superb student of the shortline industry ever since. The press release announcing his departure says Charlie will again take on the consultant mantle so I'm looking forward to continuing our periodic lunches here in the Phila area. Thanks, Charlie, for a job well done and for helping so many of us up the railroad learning curve.

Florida East Coast Railroad first quarter revenues increased 18.7% yoy to $67.1 mm, revenue units were up 6.4% and operating expenses grew 16%. The OR came down 147 BP to a commendable 71.9 in spite of a $2.5 mm or 46.5% jump in fuel expense. The $10.6 mm revenue gain included $5.3 mm in FSC, up from $2.1 mm in 1Q05. Merch carload revenues increased $5.0 mm (rate/length of haul $2.5 mm, volume $2.5 mm) in first quarter 2006 over 2005.

The aggregates group continues to set records, up $3.0 mm in Q1, due primarily to continued demand in the Florida construction market, and representing 30% of total FEC sales. Construction materials and forest products revs were up double-digits owing to continued demand in the Florida construction market and, to a lesser extent, continued clean-up from past hurricanes. Intermodal revenues increased $4.8 m (rate/length of haul $3.5 mm, volume $1.3 mm) to $28.1 million from $23.3 million in first quarter 2005, an increase of 20.7%, and accounting for 57% of volume and 42% of sales.

It's interesting that a railroad of this size should be such an active player in the fuel hedge market. As of the end of March they had made forward commitments for 3.7 mm gallons for delivery April 1, 2006 through March 31, 2007 for an average purchase price of $1.81 per gallon before taxes and freight. This represents 25% of the estimated consumption for the nine months ending December 31, 2006 for an average purchase price of $1.78 and represents 13% of the estimated consumption for the three months ending March 31, 2007 for an average purchase price of $1.97.

[1] Freight all Kinds

As an investor I find the 500-day weekly chart intriguing. FLA lumped along in the $30 range for seeming ever, finally breaking $40 in early Nov 2005. There it stayed for a year, starting the present ascent in early Jan 2006. Since then it's hugged the top line of a 20-day Bollinger band, falling back occasionally to the SMA-50 line ($53) then climbing back up. That's where we are now. FWIW, a Florida architect I met on the plane to Orlando said they can't get aggregates fast enough to keep their projects on schedule. Funny how Florida Rock (FRK) and FLA stocks have been tracking since Jan.

L. B. Foster stock (FSTR) has been on a tear lately, closing Friday at $25.64, 19% ahead of its 50-day SMA and up 67% YTD on much greater volume than the stock has ever seen. First quarter sales increased 24% to $84.3 mm from $67.6 mm. Earnings from continuing operations doubled to $1.2 mm. After-tax income from disc ops added another $2.7 mm; all-in net income was $3.9 mm vs. $0.6 mm a year ago. Earnings per share jumped to 38 cents from six cents.

Piling and Rail Products continued to deliver strong sales. Results for the CXT concrete tie brand improved due to strong activity at the Spokane facility. Tie production at the recently refurbished Grand Island facility increased 10% over last year. CEO Stan Hasselbusch says overall business activity remains strong with $121 mm in first quarter order bookings, up 14% yoy. Backlog at March 31, 2006 was $141 million, up 25% yoy. Recall that FSTR has a 13.4% stake in Kevin Schieffer's DM&E and that $2.5 bn RRIF loan for the new PRB line ought to be worth a few scheckles to FSTR.

Still, this is a tough business with narrow margins. FSTR generates only 44 cents of sales from every dollar of assets. ROE, ROIC and ROA from continuing operations are in the low single-digits. The stock usually trades about 72,000 shares a day yet is currently running at three times that. There's nothing in the trade press to support that spike in trading and half the float is held by institutions.

GATX Rail reported first quarter net income up 25% to $24.8 mm thanks in part to the ability to renew railcar leases at higher rates (up 14% on average) and for longer terms (to 60 months from 40 months). GATX anticipates these steps will "mitigate future earnings volatility in the rail portfolio." To support this thesis, GATX bought 785 cars at a cost of more than $70 mm in the quarter. As of March 31 there were some 108,000 units in the fleet with a 99% utilization rate, up a point yoy.

According to the Federal Reserve Bank North American railcar manufacturing capacity utilization was 81% in March 2006, up from 80% in the same period 2005. RSI estimates that backlogs increased to nearly 87,000 cars at the end of the first quarter 2006, up from approximately 59,000 during the same period 2005 and up from 69,000 at year end.

As reported earlier, AAR first quarter merch carloads were up 0.8% and 0.2% ex-coal. Though GATX did not break out car types in its Q1 report, the website (www.gatx.com) is heavy on tank cars and hoppers, both OT and covered. As the smaller 4750s are cascaded out of unit grain service the need for 286-jumbos will grow, especially as diesel fuel prices increase for truckers. Chemical shipments were down 2.8% in the first quarter of 2006 versus the prior year, a result partially attributable to the lingering effect of last year's hurricanes on chemical production in the Gulf Coast and Southeast regions but Q1 chems were an improving story among Class I reports.

Trinity Industries (TRN) Rail Group increased first quarter sales by 24% yoy to $540 mm, producing operating profits of $57 mm, both of which represent more than 70% of corporate returns. Consolidated sales came in at $761 mm, up 18%, and operating profit was $74 mm, higher than any March-ending quarter in the Company's history. Net income was $37 mm, seven times the $5.2 mm net a year ago. EPS increased to 70 cents from 11 cents.

Trinity received new orders for 12,941 railcars in North America during the first quarter, the highest quarterly order volume since 1998, and completed 6,164 cars, the highest Q total since 1999. From this number TRN placed 1,800 units into the TRN lease fleet, bringing the total number of railcars in the fleet to approximately 26,000, which TRN describes as "a very important part of our ongoing strategy."

The Twin Cities & Western Railroad Company (TCRY) has promoted Mark Wegner to executive vice president and chief operating officer, effective April 14. Based at the Glencoe, Minn. headquarters of the 229-mile regional railroad, he will hold the same title and job function on Minnesota Prairie Line, Inc., a TC&W affiliate. Wegner reports to Bill Drusch, president and chief executive officer. Mark has served as senior vice president and general manager since November 2003. He has 15 years of rail experience and joined the TC&W in 1991 as accounting manager. He was promoted to comptroller in 1993 and assumed additional responsibilities as senior vice president and general manager of Minnesota Prairie Line in July 2002.

At the Red River Valley and Western (RRVR), sister road to the TCRY, Andrew Thompson moves to president and chief operating officer of the 517-mile regional railroad, effective April 14. Based at Wahpeton, N.D., Thompson has served as senior vice president and general manager since joining RRVW March 1, 2005. He too reports to Drusch. Thompson's railroad experience began in 1968 as a switchman and yardmaster for the BN at Seattle, advancing through the ranks to VP Packaged Commodities in 1995.

John Friedman takes the NS Shortline chair. Fresh from an operating assignment (Superintendent of the Illinois Division) John is the first NS shortline manager I can recall with that kind of hands-on experience. He and I worked together in Strategic Planning during the Contrail split and his knowledge of the NS system is encyclopedic. He's now been with NS for 12 years and has already seen many of the more than 200 shortlines that partner with NS. John tells me he's eager to get out on the ground to meet old friends again and make new friends anew. I believe it.

Table comparing results of The Big Six Class Is follows the disclosure. I'll publish the remaining roads when I have the final numbers from the players.

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Big Six Class I Commodity Carload Comps

Quarter ending 3/31/2006

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP*
Railroad revs (1)	$ 3,463	$ 1,847	$ 1,110	$ 2,331	$ 2,303	$ 3,710
YOY Pct. Change	16.1%	8.3%	9.4%	10.6%	17.4%	17.7%
Revenue Units (000)	2,521	1,191	652	1,826	1,958	2,393
YOY Pct. Change	4.7%	-0.1%	0.7%	-1.0%	5.1%	4.0%
Carload revs (2)	$ 1,586	$ 1,373	$ 613	$ 1,380	$ 1,278	$ 2,200
Pct carload	45.8%	74.3%	55.3%	59.2%	55.5%	59.3%
Pct Intermodal	31.9%	17.4%	27.5%	14.3%	20.2%	17.4%
Pct Coal	19.6%	4.6%	15.0%	24.8%	24.3%	18.8%
Mdse Carloads (000)	708	773	291	834	739	1,028
YOY Pct. Change	2.3%	-1.7%	-1.2%	-2.8%	3.2%	3.3%
Rev/CL x coal, IM	$ 2,191	$ 1,776	$ 2,108	$ 1,655	$ 1,730	$ 2,140
Operating Expense	$ 2,671	$ 1,495	$ 881	$ 1,844	$ 1,752	$ 3,105
YOY Pct. Change	13.8%	3.6%	5.5%	5.0%	12.5%	9.4%
Ops exp chg/Vol chg	2.93	(42.43)	8.10	(5.07)	2.46	2.32
RR Operating Income	$ 792	$ 625	$ 229	$ 487	$ 551	$ 605
YOY Pct. Change	24.9%	18.8%	27.5%	38.7%	36.7%	93.3%
RR Operating Ratio	77.1%	66.2%	79.4%	79.1%	76.1%	83.7%
YOY Point change	(1.61)	(3.01)	(2.93)	(4.24)	(3.37)	(6.38)
LTD/Capital	42.3%	36.4%	40.2%	41.9%	41.5%	39.8%
Free Cash Flow*	$ 138	$ 7	$ (107)	$ (78)	$ 121	$ (222)

* Cash from ops less capex less divs less stock repurchased

Source: Company financials

Week in Review for May 5, 2006