RAILROAD WEEK IN REVIEW

MAY 19, 2006

"The average age of the North American freight car fleet is approximately 19.5 years, with over 38.3% older than 25 years." – Trinity Industries 10-K for 2005

One way to plan your railroad strategy is to watch the markets your customers serve. Rails do well when their biggest customers do well. And the rails are on a tear right now because the hot sectors are all big rail users. The four sectors are minerals (Martin Marietta, LaFarge, Florida Rock), metals (US Steel, Nucor), energy (coal more than oil and gasoline, and Peabody is the play here), and agriculture (particularly the ethanol business). Another, indirect, play is infrastructure – think Fluor, Foster Wheeler, McDermott – because they build the power plants and refineries and chemical factories that need the railroads to run their businesses.

Another way to gauge potential rail performance is to watch the car builders – Trinity, Greenbrier, Freight Car America, and American Railcar. I listened to the first quarter conference calls and these guys are ecstatic. They can't build enough tank cars, covered and OT hoppers, and intermodal platforms fast enough. The four together put 11,000 new units on the rails Jan-Mar and have backlogged orders for 76,000 more. ARI and TRN to name two are sold out into 2007.

TRN made the Zacks Growth & Income Number One Buy list on Tuesday. According to the note, "TRN exceeded earnings estimates for seven consecutive quarters, most recently by 11%. EPS are projected to grow 15.8% over the next 3-5 years. The company is in great position to ride the railroad industry's latest boom. The five-year average dividend is 1.5%."

TRN delivered more than 6,000 rail cars in Q1 – more than twice as many is its closest competitor, GBX, and has a backlog approaching 26,000 units or a third of the total backlog of the gang of four. According to TRN's most recent 10-K, "Global Insight, an independent industry research firm, has estimated the average age of the North American freight car fleet is approximately 19.5 years, with over 38.3% older than 25 years and has estimated that U.S. carload traffic will expand by about 1.1% per year through 2010."

Global Insight estimates a run-rate of about 60,000 new cars a year through 2010 and TRN has about a 30% share. The stock trades at 23.6 times the 2006 estimate for a PEG of 1.5, on a par with GBX and certainly better than RAIL's 4.4, a short indicator if I ever saw one. And for dessert, TRN announced a 3:2 stock split on June 9 for holders of record May 26. The quarterly dividend will go up six cents payable July 31 to holders of record July 14.

Though the car builders don't split out car deliveries by type, we know from their websites and advertising that ARII and TRN build a lot of tank cars and covered hoppers, that GBX does a good business in center-beams and intermodal platforms, and that RAIL is heavily into coal gons and hoppers. Ergo it's safe to say chems, corn and coal plus grain and intermodal are where the growth lies. The challenge to shortlines, then, is finding profitable niches in these areas.

RailAmerica's April revenue units were down 6.6% yoy and down 2.1% YTD, roughly 7,500 units, of which about a fifth were the net result of the Alcoa and Michigan acquisitions less the three Canadian properties sold to CN. Same-store April 2006 loads decreased 5.4% yoy with eleven out of fourteen commodity groups down – mets, chems and paper were the main culprits. YTD loads were off 2.1% en toto; the same-store score was off 1.2% yoy. RRA same store totals exclude traffic volumes associated with railroads, or portions of railroads, sold or acquired by the Company after January 1, 2005. See chart.

GWR April revenue units increased 14.2% yoy and 23.4% YTD thanks mostly last June's Rail Management acquisition. Same-store loads increased a more modest 5.9% but still better than the Class Is since most of this is carload – 99.6% in April 2006, to be exact. GWR's Mexico Region, which continues to be negatively affected by the impact of Hurricane Stan, experienced a 1,011 carload decrease. System-wide GWR saw a softening in its forest products business, both STCCs 24 and 26. See chart.

Watco sold its Appalachian and Ohio Railroad (A&O) interests to Four Rivers of Paducah, Kentucky. The A&O operates a 158-mile railroad in West Virginia that over the past year of Watco stewardship has seen loadings increase by nearly 20%, most of which was coal moving from West Virginia mines to end users all across the eastern one-third of the United States. According to a press release, the terms of the A&O lease with owner CSX "would not allow Watco to reach an acceptable level of profitability."

Four Rivers Transportation is a holding company for the 300-mile Paducah & Louisville as well as the Evansville Western Railway, Inc., a new shortline that began operations in January 2006 and operates between Mt. Vernon, IN, and Okawville, IL. CSX and PAL are joint owners of Four Rivers and its President and CEO is PAL's Tony Reck.

Caterpillar has bought Progress Rail Services, a supplier of remanufactured locomotives, railcar products, and services, with operations in 29 states plus Canada and Mexico and some 3,700 employees. Last year's sales exceeded $1 billion. Progress Rail had been majority-owned by One Equity Partners, an affiliate of JP Morgan Chase & Co. Inc.

As late as March, Progress Rail had been considering an initial public offering of its common stock, but the Caterpillar deal will cancel those plans. Caterpillar will pay roughly $800 million in cash and stock to buy Progress Rail and will assume about $200 million of the company's long-term debt. The deal is subject to regulatory approval and is expected to close during the second quarter.

That Progress sold for just one times sales indicates the company was not exactly in the best of shape. Similar deals I've seen have been in the 1.5 to two times sales. However, according to the WSJ account of the transaction, CAT has been pushing to diversify its revenue streams to make it less dependent on the mining and construction industries that have been its core business for so long. This week's sell-off in commodity stocks would seem to give that argument some merit.

Morgan Stanley's recent report on the truckload freight industry is instructive. Through May 11 the MS proprietary TL Freight Index "remained below year-ago levels, indicating industry capacity additions continue to outstrip demand growth." Pricing appears to be holding up yet as supply approaches and potentially exceeds demand "year-over-year improvement continues to decelerate."

Moreover, the report concludes, "Because of increasing capacity and more stringent engine emission standards, we see few positive [earnings] catalysts on the horizon." It's safe to say that as a general rule truck rates on a cents-per-unit-weight basis run at a premium to rail rates between the same OD pairs. However, as rail rates including FCS increase, the rail price advantage could erode. Continued or perceived irregular or erratic rail performance add cost to the supply chain and, together with the higher rail rates, begin to put rail on a par with truckload, especially in the merch carload business.

The reason IM is competitive is that it's point-to-point with no railroad-provided gathering and distribution and minimal terminal time. BNSF and CN have made strides in getting the merch carload model to this point but others lag, thus adding support to the perceived notion that rail carload service is erratic. Add shortlines that can't or won't turn cars in a timely manner and it gets worse.

Jim Valentine will depart the rail analyst scene. He's been tapped as Global Director of Product & Development for Morgan Stanley's Research Department. He's been a sell-side analyst these 14 and now steps into a role that will let Jim work with MS analysts and associates to build an even better product. In his new role, he will be working with the analyst teams, regional research management, and the MS editorial group on a global basis to enhance the standards of our research product. As if that weren't enough he'll also be responsible for creating a global platform for training and development.

In Chicago Bill Greene and Chad Bruso will continue to work the rail desk. Due to the global nature of this role, Jim will be relocating to London so as to be in a time zone that is conducive for regular conversations with his colleagues located in the major financial centers around the world. The position will also satisfy a personal goal that he and his wife Emma have had for some time, namely to allow their children to spend quality time with Emma's side of the family, who live in the London suburbs. Thanks, Jim, for your friendship and first-rate work as a rail analyst. We all wish you God's speed and god luck.

Trading Alert: Since I first announced my GWR buy (WIR 5/5) the stock has run up to $37 and dropped back to less than $30 in last week's sell-off. That's a broken stock, not a broken company. This might be a good place to add to one's position. The FY 2006 consensus eps is $1.48: at $30 we're talking 20 times earnings for a 31% eps growth rate 2005-2006. That's a PEG of 0.64, a screaming buy.

But, you ask, can they consistently do 31% growth if the yoy carload comps are presently fueled by the June 2005 RMC acquisition? I think yes, for two reasons. One, the AUS step away from shared ownership will be quickly accretive. Two, GWR has the cash to buy whatever NA shortline or Class I branch it wants at the price it wants to pay whenever it decides to pull the trigger. Those who've read my recent *Trains* article know there are, IMHO, too many weak shortlines out there and a third or so will go away as independent entities in the next few years. The best will be snapped up by the likes of GWR, the rest will succumb to their own egos.

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GWR vs RRA Revenue Units

2006 by month, YTD

	2006	2006	2005	2005	Change	Change	2005
RRA		**YTD**	**month**	**YTD**	**Month**	**YTD**	**ch MTM**
Jan	112,829	112,829	105,507	105,507	6.9%	6.9%	
Feb	103,249	216,078	106,256	211,763	-2.8%	2.0%	0.7%
Mar	111,915	327,993	118,115	329,878	-5.2%	-0.6%	11.2%
Quarter	327,993		329,878				
Apr	104,651	432,644	111,993	441,871	-6.6%	-2.1%	-5.2%
GWR							
Jan	69,114	69,114	52,705	52,705	31.1%	31.1%	
Feb (1)	64,327	136,594	53,316	106,021	20.7%	28.8%	1.2%
Mar	72,180	208,774	58,765	164,786	22.8%	26.7%	10.2%
Quarter	208,774		164,786				
Apr	65,981	274,755	57,787	222,573	14.2%	23.4%	-1.7%

Source: Company material

(1) Starting in Feb 2006 GWR includes RMC haulage not previously reported in commodity groups, thus adding some 3000 loads to the YTD number, a variance from the sum of Jan and Feb loads