# RAILROAD WEEK IN REVIEW
## MAY 26, 2006

*"Risk-based investment in track structure has reduced track-caused derailments." – Ken Koff, VP Engineering, Rail America*

**Required Reading Department.** The RailAmerica analyst presentation slides (www.railamerica.com >> investor relations>> presentations) ought to be on every shortline manager's reading list. Go directly to The Five Year Plan and note the specific goals in such key disciplines a safety, service, cost control and asset utilization. Then jump to Ray Stephens' Service Design presentation and run some comps with your shortline's expectations and performance.

It's no secret that shortline car cycle time is less than adequate in too many places. So what RRA has done is to establish specific measurable goals in both cycle time and car hire expense together with the means to measure the progress toward attainment of these goals. The car hire-cycle time chart (page 43) shows at a glance what need to be fixed and where. This process, once incorporated in management's tool box, can be invaluable in showing Class I partners where and how to improve operating, financial and commercial results from the relationship.

Tom Owens' commercial presentation is instructive because it shows where the revenue is coming from and specific dollar returns on business development initiatives. There needs to be more shortline discipline in this area. One must ask questions such as "If I build a run-around to reduce the time to serve Customer X, what are the benefits in terms of turn time and car hire and how much more business can I expect because doing so lowers the customer's supply chain expense?" And in this regard, see also Ken Koff's capital expense remarks in the following section.

Finally, every shortline operator ought to know what percent of revenue is going against each expense line *and* how well he compares with his peers. Mike Howe's breakout (page 81) is the standard. I say that because RRA's dispersed network has a lot of stand-alone properties that closely resemble many independent shortlines. Note too Mike's sequence in presenting the means for reducing the OR: raise revenue, reduce expense. Increasing sales faster than expenses produces out-sized operating income gains every time -- look at the leverage CN and NS get every quarter.

I'm not a buyer of RRA at the moment. The stage is set, however, for RRA shares to break out of the $10 to $12 range where they've been stuck for too long. Swinburn and Co have said, "Look, here's where we need to go and here's how we're going to get there." That's the kind of clarity every investor – and shortline railroad operator – needs.

**Carload freight on U.S. railroads** reached its highest level so far during 2006 during the week ended May 20 according to the AAR, with revenue unit volume up 8.4% yoy. Western roads posted a 17.9% gain due largely to easy comps arising from last year's PRB derailments and subsequent slow-down in coal shipments. Revenue units skidded 1.5% in the east. Intermodal volume gained 8.4% yoy as container volume grew by 10.7% and trailers went up 1.3% yoy.

Six of 19 individual carload commodity groups were up from last year, with coal up 28.1% yoy on easy comps. Also up were loadings of metals (7.5%), crushed stone, sand and gravel (5.8 percent) and petroleum products (5.6%). Commodities registering declines included primary forest products (19.4%), nonmetallic minerals (13.3%) and coke (9.9%). Canadian carload traffic was off 5.0 percent yoy; combined cumulative carload volume for the first 20 weeks of 2006 on 13 reporting US and Canadian railroads increased just 0.3% yoy.

The AAR also said that during the week ended May 20 Mexican railroad Kansas City Southern de Mexico (KCSM) reported total carload volume down 14.2% and IM down 9.1% from the 20th week of 2005. YTD carload volume was off down 6.3% from last year and IM dipped 7.3%.

Railroads reporting to AAR account for 87% of U.S. carload freight and 96% of rail intermodal volume. When the U.S. operations of Canadian railroads are included, the figures increase to 96% and 100%. The Canadian railroads reporting to the AAR account for 91% of Canadian rail traffic. Railroads provide more than 40% of U.S. intercity freight transportation, more than any other mode, and rail traffic figures are regarded as an important economic indicator.

**The DM&E has taken another step** toward its goal of building its own railroad into the PRB. At a public meeting in Rochester this week, 14 representatives from communities, ag groups, utilities, economic development organizations and contractors in Minnesota, South Dakota and Wisconsin joined with DM&E President Kevin Schieffer to speak in favor of the project. Mayo Clinic, the City of Rochester and Olmsted County declined to send representation.

**FreightCar America (RAIL)** made the *Forbe's* list of five companies with healthy cash positions. Researchers screened for companies whose cash and equivalents represent 60% or more of their shareholder's equity and RAIL came in at 67%. However, digging beyond *Forbe's*, it turns out the recent March 31 Balance Sheet shows $224 mm in debt, $162 mm in debt less cash, and $92 mm in equity. Net debt is therefore 176% of equity.

Now, *Forbe's* notes, "Hoarding cash and its equivalents isn't always a good thing. Cash doesn't tend to return much and having a big pile of it around could either invite a takeover or tempt a company to make a dumb acquisition. Still, cash reserves provide an important cushion if business slows down, particularly for those companies carrying significant debt." Which RAIL, in fact does.

Best of Breed still goes to Trinity (TRN). As advertised, I took a position in TRN because (a) it's been around longer than RAIL, the management has an excellent track record, and it has a broader product base. RAIL has built itself a nice niche in OT and rotary hoppers for coal but that's about it. And for dessert, TRN stock splits 3/2 for holders of record today, payable June 9.

**The press release accompanying** GATX' Q1 earnings report says the firm bought 785 new cars at a cost of $70 mm in the quarter. Paul F. Titterton, Vice President of Fleet Portfolio Management writes, "The 785 cars acquired in the 1st quarter include both new equipment and used railcars purchased in the secondary market. Our current new-car purchases are predominantly various types of general-service and high-pressure tank cars, as well as covered hoppers for a variety of commodities and open-top equipment primarily for coal and coke service."

The release goes on to say there are about 108,000 cars in the GATX fleet. Paul writes that covered hoppers make up "slightly less than 1/3 of our North American railcar fleet. Included in this group are more than 11,000 grain-type (trough-hatch, gravity-gate, medium-cube) hoppers, of which over half are currently in grain service and the remainder carrying potash, phosphates, lime, bone meal, coke, and other commodities. Our fleet of grain-type hoppers is 47% 286,000-LB GRL and 53% 263,000-LB GRL." Now, should you need equipment, you have been told where to go. Thanks, Paul.

**KCS has lost the services** of Ron Russ as CFO. The rather terse press release says simply, "On May 12, 2006, the Company announced the departure of Ronald G. Russ as its Executive Vice President and Chief Financial Officer" and that "The departure of Mr. Russ terminated his employment agreement with the Company, which was previously effective as of June 1, 2002." On the same day KCS announced the departure of James Brook as its VP and Comptroller. Patrick J. Ottensmeyer, age

49, will succeed Russ as CFO. Like Oscar Munoz at CSX, Ottensmeyer's resume includes financial work outside the rail industry, which it a good thing. He was also the Finance VP and Treasurer at BNSF from 1993 to 1999.

The *Wall Street Journal* noted that "The executive change comes two months after KCS delayed filing its year-end financial report for 2005, citing errors related to calculation of deferred-income-tax balances in years prior to 2003." On March 17, 2006, KCS said in a press release that it had discovered "certain errors" in the calculation of deferred tax liability going back some years and that the liability had been understated by about $8 mm and that KCS "is developing a remedial plan to address the weaknesses in internal controls" to correct the tax reporting process.

Meanwhile, Mexico's antitrust authority doesn't expect to rule on the proposed railway merger between Ferromex and Ferrosur until the end of June. The decision-making process is taking longer than expected because the Federal Competition Commission, or CFC, must take into account arguments being made against the merger by a rival railway run by U.S.-based Kansas City Southern, the CFC said in a release.

The proposed merger - which would combine the lines of copper mining concern Grupo Mexico (GMEXICO.MX) and two companies controlled by billionaire Carlos Slim - was rejected by commission when it was first proposed in 2002. However, a later court decision that the antitrust procedure should have involved TFM - as the rival railway was known before KCS took full control last year - nullified that commission's ruling, it said.

A spokesman for KCS acknowledged that the judge's decision negated the initial antitrust ruling, but said the arguments against the merger are just as valid now as they were then. The spokesman also said that KCS has participated in the decision-making process since it filed a formal petition against the merger in December, though he claims that Grupo Mexico has attempted to classify all of the relevant documents as confidential. I guess it ain't over till it's over.

**Dave Brown** has shed his NS hat of many years and has headed south to Jax to join is former boss Tony Ingram as VP and Chief Transportation Officer for CSX. Dave most recently served NS as VP-Strategic Planning. In his 25-year career with NS, Brown held a series of increasingly responsible operating positions, including general manager-Northern region. Best of all, Dave knows shortlines and how to use them to great advantage. Like Tony, he likes to see stuff measured and gives short shrift to anecdotal tales. Excellent move. Why? Read on.

As for CSX the stock, I will be a buyer within the week or as soon as it's hits bottom. It's clearly a turn-around story and one can see how CEO Mike Ward is shaping his management team to carry out his vision of what CSX can be. Recall that Ward himself started out on the former Chessie side of CSX so he's no newcomer to these parts. Chief Commercial Officer Clarence Gooden, ex-Seaboard side, has a vision of how excellent service design adds value to the supply chain process. Tony Ingram's discipline and drive behind the One Plan is essential for the quality service design Gooden needs to build the top line. And Tony's bringing in his old cohort Dave Brown to run the RR is the icing on the cake.

Rounding out the team is CFO Oscar Munoz who brings financial experience from *outside* the RR industry and that's a positive. You want a finance guy who's resume includes consumer goods (Coke *and* Pepsi in Oscar's case) and capital-intensive networks (Oscar has telecom) to keep these railroaders' focus on operating cash flow, yield and ROIC.

Bear Stearns' Ed Wolf ranks CSX "outperform" (along with NS and BNSF) with a target price of $77, a 16% increase from today's $52 and the First Call consensus is $79. We're looking at a forward PE of 12 on the 2006 consensus estimate of $4.34, cheap compared to its peers. What's more, the 2006 estimate represents a 30% increase over 2005's $3.34, yielding a PEG of 12/30 or 0.40. Is that a 'mon back or what?

**Paper Barriers and Fuel Surcharges** are going to converge as hot buttons. We continue to hear Class I market managers bemoaning the low multiples they're getting on commodities like wood chips and aggregates, but that's before the fuel surcharge kicks in. Case in point: Looking at a move of wood ships from a shortline origin to a paper mill on a Class I. Plugging in a 1.3 multiple on LTV cost yields a number that is between LTV cost and fully allocated cost. But add a pro forma 10% fuel surcharge and the multiple jumps to a one-five and the resulting rate exceeds fully allocated cost.

Now consider the "new business" shipper on a shortline with access to two Class Is, both of which have rail access to that shipper's customer. The shortline paper barrier keeps him from getting to the second Class I, but that road's FSC program results in a lower multiple and a better rate. Worse, what does one do when the first Class I has demarked that commodity O-D pair or has shifted it to intermodal boxes?

You can't make this stuff up, either. I found the FSC multiplier effect for a real customer with a real problem just yesterday and I've alluded to the intermodal conundrum in this space before. We know the STB is looking into the whole paper barrier issue, and we know certain Class I market managers are petrified they will lose the barriers lest "their" business winds up on the other railroad. In fact, some have said to me they'd rather see the business on a truck than on a competing rail. To be continued.

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