RAILROAD WEEK IN REVIEW
JUNE 16, 2006

"We believe nothing has changed fundamentally for the rail sector and we reiterate our belief that investors should be buying rail stocks right now." Ed Wolfe, Bear Stearns

Rail stocks surged ahead on Thursday only to mark time on Friday. And so it is that I'm not convinced the bears have all retired. Rail stocks have averaged a 14% drop since May 10. Yet forward earnings estimates for the present quarter, the next quarter and for the full year are essentially unchanged. Lower stock prices divided by the same eps will yield lower multiples, so the rails are getting cheaper. And that supports behind Ed Wolfe's view above.

True, some investors may be spooked by high gasoline prices and inflation but the rails have fuel surcharges, high demand, a lot of remaining rate elasticity, and increasing volumes in the high-rated commodities. Says Wolfe, "Volumes not as important as pricing. We believe potential concerns about a drop in rail volumes from a potential economic slowdown are overblown. Since 2000, we found only a 14% correlation between average rail vols and EPS growth compared to 74% between yields and EPS."

Wolfe concurs with my earlier thread, namely that better service drives better rates and that it's less expensive to run a fast railroad than a slow one. Moreover, perhaps a quarter of all remaining contracts have not yet been re-priced. In the case of NS pricing is being adjusted to reflect $60-a-barrel oil [WIR 4/28/2006] while some will expand FSC coverage.

I also think there's a lemming-like lunge to the downside that's tarring all things railroad with the same brush. I bought TRN a few weeks ago based in part on their full order book, the outlook for grain and ethanol, and coal loadings (UNP averaged more than a thousand coal trains a month Jan-May). Yet it's off a third.

The June *Railway Age* reports (page 6) that "Car orders go from astounding to astonishing" with deliveries forecast at 60,000 to 73,000 units per year through 2011. I've been casting about among my Wall Street contacts trying to find out why an industry with this bright a future has its stock so badly hammered. The only rationale I can come up with is that there were a lot of momentum investors in the rail equipment stocks. Typically when momentum guys (who typically don't get into much detail about the companies they follow) head for the door, they leave as a group. It's definitely a herd mentality.

One contact notes that car builder stocks tend go up as long as the backlog is increasing, and the stocks go down when the backlog is decreasing. A few analysts started calling 2006 the peak for earnings, deliveries, and the backlog for the group generally. Also, the convertible note offerings from both GBX and TRN didn't help because investors typically don't like to see equity-linked offerings. Still, TRN trades at 14x forward earnings and First Call sees a 22% earnings growth rate over five years for a PEG of oh-point-six-six. TRN will do well as long as they can maintain a favorable mix and long production runs.

Regarding Greenbrier, another observer thinks that intermodal "still has cyclical and secular legs," which bodes well for NSC and BNI as intermodal is an important and growing part of their product portfolios. And NSC has ordered 1600 new coal hoppers from FreightCar America's Roanoke shops.

BSC's Wolfe concludes, "The current up rail cycle began in mid-2003 and has been marked by unprecedented pricing since mid-2004 driven by fewer competitors, a difference in how the rails view train productivity, unprecedented truckload pricing, a surge of int'l imports into the U.S. which lends itself to rail over truck, a more friendly regulatory environment and strong coal, grain and industrial carload dynamics. We believe there is visibility through 2007 for strong rail pricing regardless of the economy." I agree.

So does CSX' Mike Ward, evidently. According to an AP dispatch, Ward "sees an alignment of the stars ahead for CSX" with long-term eps growth in the 12-14% range and price increases in the 5-6% range through 2007. CSX reports increased loadings from the "new domestics" -- Toyota, Honda and Hyundai. Nontraditional areas like ethanol and waste are also growing, which is good news for shortlines. Ward said their IM share was growing as they shed the "less-profitable elements of that business."

Elsewhere, the money-changers in Mississippi have finally backed off on a scheme to move a CSX rail line as part of that state's post-Katrina rebuilding. Even though the $700 mm price tag is nowhere as rife with chutzpah as the $2.5 bn coal project in So Dak, it's still nearly half the $1.56 bn Amtrak needs to – among other things – replace electric power substations that were built in Herbert Hoover's time. Recall two weeks ago an Amtrak electrical failure stranded thousands of commuters for hours. Seems an investment to prevent a recurrence is a lot better use of taxpayers' money than building a new Interstate highway to line the pockets of a few casino operators.

Good news, bad news department. First, the good. Tony Hatch was at the recent BNSF analysts meeting and found that industrial carload's (merch less ag less auto) growth rates "surpass intermodal's at virtually any other railroad (12% revenue CAGR since '03). BNSF's velocity focus and engineered productivity program will help the Industrial Products Group more than any other unit, so we expect contribution improvement in the next five years to come the old fashioned way: from better railroad operations. Obviously this will have significant positive ramifications in terms of service." (See also my May 2006 *Railway Age* story on double-tracking the BNSF transcon.)

For the not so good news, a shipper using all four Big Six US rails reports that he's putting more trucks than ever on the highways thanks to the rails' added costs of irregular transit times and the disadvantage of non-competitive pricing. There are even are places where he's buying imported raw material and trucking it to his plants because it costs less than US sourcing plus the "rail penalty."

Over lunch last week with fellow Philadelphian Michael Sussman and CFO of the Iowa Northern, the subject turned to shortlines buying cars for their shippers to use. It's an area to be approached very gingerly because there are so many variables. Is the connecting Class I long or short the desired car type? Can shippers lease the equipment? What are the turn times and are there any opportunities for triangulation of loads, and so forth.

Consider ethanol. Inbound corn arrives in covered hoppers either railroad- or shipper owned. Ethanol goes out in shipper-leased tank cars (if they can find them). DDGs go out in whatever's available. One reason there is such a scramble is that there are so many new plants on the drawing boards. However, a Class I senior merch marketing manager tells me he doubts half the plants planned for his road and its connecting shortlines will ever be built. Even Tim Newkirk, COO for MGP Ingredients, said on Jim Cramer's Wed "Mad Money" that there is too much hype in the ethanol market.

A car supplier tells me there's already a speculative market in tank cars – those leased for $400-$500 a year ago are now being subleased for north of $600. A VP from a big leasing company says they won't deal with any car user without a long leasing relationship and with quality financials. In other words, shortlines have to be very careful before they get into the car ownership or leasing business.

Rail volumes for the week ending June 10 were up 5.5% yoy with sharp gains in both intermodal and carload freight. Ten of 19 individual carload commodity groups were up from last year, with metals up 20.6%; crushed stone, sand and gravel up 12.2%, coal up 9.7% and grain up 9.8%. Loadings of primary forest products were down 13.5%,lumber was off 10.3%, and metallic ores declined 12.0%. YTD merch vols were up 1.3% and IM was up 6.4%.

Canadian revenue unit volume increased 2.4% for the week yoy. Merch loads grew by less than a point while IM leapt 11.7% yoy. For the full YTD merch loads were off 2.3% from last year while IM was up 5.5% from last year. Combined US and Canada cumulative volume for the first 23 weeks of 2006 was up 0.6 % with IM gaining 6.2 % yoy.

RailAmerica and Genesee & Wyoming reported May revenue units this week. The former saw North American revenue units rise by 20% yoy though most of that was due to last June's RMC acquisition; same-railroad units increased just 2%. YTD loads are up 23% all-in and the April-May 2006 car count was up 4%. Over at RRA loads for May declined 6% with about 10% of the change coming from line sales; same-railroad loads were off 5%. YTD loads are off 3% and May loads declined a point when compared with April 2006. See chart, page 4.

Meanwhile, on Friday *Market Edge* downgraded RRA to Avoid based on a number of technical indicators. This is not wholly unexpected. The stock has traded in a range of $8-14 since late 1999 with the exception of two dips to $5 in 2001 and 2003. Since Jan 2001 neither RRA nor the DJIA have shown any significant growth while GWR is up 400% in the same period. Another indicator is that RRA is 17% below its 50-day moving average; none of the other rails trails the MA50 by more than 5%. Only the car builders are off as much.

CEO Charlie Swinburn and his team are certainly working very hard to turn this puppy around [WIR 5/26/2006]. My impression remains that RRA has too many railroads spread too far apart to get any meaningful economies of scale and that there is too much low-rated traffic. The first quarter 2006 ops ratio was 88, higher than we'd like to see. Expenses by line as a percentage of revenue were in-line with other shortlines so revenue may be the culprit.

RRA's latest 10-Q shows a lot of overhead and other low-rated volume that push system ARC down to $311, low for a shortline of this size and $100 less than what GWR averages system-wide. Get rid of the poor performing properties (my guess is between five and ten) and a lot of the low ARC stuff goes away as well. Get system ARC up, keep up the good work on expenses and perhaps RRA can finally break out of this trading range. (NOTE: The prudent independent shortline operator will want to run some comps to judge *his* relative profitability, too.)

Correction: In your 6/9/06 issue, page 2, what I called UTDC should have been UTCS for Unified Train Control System.

GWR vs RRA Revenue Units

2006 by month, YTD

	2006	2006	2005	2005	Change	Change	2006
RRA	**month**	**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%	-8.5%
Mar	111,915	327,993	118,115	329,878	-5.2%	-0.6%	8.4%
Quarter	327,993		329,878				
Apr	104,651	432,644	111,993	441,871	-6.6%	-2.1%	-6.5%
May	103,464	536,108	109,648	551,519	-5.6%	-2.8%	-1.1%
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%	-6.9%
Mar	72,180	208,774	58,765	164,786	22.8%	26.7%	12.2%
Quarter	208,774		164,786				
Apr	65,981	274,755	57,787	222,573	14.2%	23.4%	-8.6%
May	68,415	343,170	56,919	279,492	20.2%	22.8%	3.7%

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