RAILROAD WEEK IN REVIEW

JULY 7, 2006

"Managers ought to study investing more because if they did they'd be better managers." – Warren Buffett

Wednesday's stock market downturn was exacerbated by crude oil surging past $75 a bbl amidst a generally over-bought posture; BTU, TRN, NSC, BNI -- to name four – have been down significantly. And even though there was a slight breather of late, these four are all carried as AVOID by the MarketEdge ® tech service. Meanwhile, stocks in my mother-in-law's IRA – a baby bell, a Midwestern bank and a southeastern utility -- have all withstood the onslaught.

S&P's May 2006 *Sector Watch* warned that consumer discretionary items (cars, shirts and shoes), cyclicals (many still view the rails as belonging here never mind Jim Valentine's earlier secular protestations), natural resources (forest products and energy) and utilities were all neutral or negative. Defensive plays in health care, consumer staples and telecommunications were the out-performers while the sectors that make the stuff that rails haul the most of were the under-performers.

Last week's "Schwab Market Perspective" suggests more of the same, underweighting the energy, consumer discretionary and materials sectors. Schwab differed from the S&P on the industrials with aerospace and defense in the lead. The bottom line is that today's reasonable earnings projections and general sense of corporate health may not last.

Shortline operators ought to be reading this stuff every day. Sure, chickens have to eat, but what about the diversion of feed corn to ethanol, pushing up the price of feed corn and putting pressure on the supply of covered hoppers? RMI's RailConnect Index for Week 24 (ending 6/17) showed shortline volume declines YTD in ores, lumber and paper and chems (see attached). On the other hand, good showings in coal, STCC 20 and intermodal helped push up YTD loads to 3.6% over the first 24 weeks of 2005.

Meanwhile, carloads ex-IM on the US and Canadian Class Is thru week 24 increased total volumes a paltry 0.7% according to the AAR. As usual, IM saved the day, up 6.3% yoy. However, it says once again that the shortlines are seeing greater percentage gains than the class Is in the merch carload arena and at some point shortline gains will mask organic Class I losses on the AAR scorecard.

This being the case, shortline operators have a vested interest in each customer – in short, they are investors in their customers' companies. It thus behooves them to treat each as an investment and do the homework – read the 10-Ks, know the relative values of their customers *vis a vis* their competitors, listen to the conference calls, and so on.

Week in Review harps on railroad investment measures because it's the only way to know with some degree of certainty why each class I does what it does, what works, what doesn't work, and how behaviors can affect shortline relationships and even their very survival. One would hope therefore that shortline market managers will apply some of the Class I operating metrics to their own roads ands see how they make out.

A caveat, however: The "Rule of 100" and other metrics are averages, and whether they suit one railroad as well as another is debatable. Each shortline has its own unique capital and asset allocation requirements so the real measure at the end of the day is What Works Best for each property.

More on "same store" sales (SSS). The retail press has taken some hits lately over reporting or not reporting SSS. Sears Holdings' (SHLD) Eddie Lambert, a Goldman grad, takes the position that although it's "an important metric for retail performance," it falls short. Stores, like shortlines, are constantly upgrading, modifying, adding to and otherwise improving properties, and none of this comes through in SSS. The way Lambert sees it, spending $500,000 in remodeling and only getting $10,000 in new operating income does not make for good use of capital.

Continuing the retail store-shortline metaphor, neither retail stores nor shortlines show their full potential right off the bat; it can take several years. We know that shortlines tend to grow revenue rapidly in their first years and taper off as the customer base settles in. It's also a given that a shortline operator aggressively buying new lines may have better SSS than another operator making nice money with a roster of ten-year old lines.

A better metric would be yoy comps in revenue units moved per expense item – cars per man-hour, gallon of diesel fuel, dollar of car hire, etc. To that one might add margin, yield, leverage and – the product of multiplying these three together – return on equity. And if you're a bit rusty here, see the free downloadable Benchmarks Spreadsheet at www.rblanchard.com/resources/index.html and fill in the blanks.

Trading places. If 2Q06 estimates hold true NS will for the first time take in more revenue dollars than CSX while BNSF may well tie the larger UP in revenue. Both NS and BNSF passed their larger rivals in market cap some time ago and revenue gains have a lot to do with it. AAR Performance Metrics -- flawed though they may be -- are the best we have and they tell one quickly how railroads compare in average train speed (excluding locals and yard movements) and dwell time.

In week-to-week train speeds BNSF slowed down 3% yoy to 22.5 mph but was still better than unchanged UP at 21.3 mph. NS must have left the independent on as average train speed slowed nearly 4% to 20.8 mph; while CSX improved 1.6% it got them to 19.5 mph, the slowest of the Big Six. Who cares? Well, on a big railroad one mph in train speed can mean 200 locomotives more or less to move the same traffic volume. At nearly $2 mm a copy, that's a fair amount of capex.

Sequential changes in yard dwell tell a similar story. UP led the pack with the longest dwell, 26.4 hours with CSX close behind at 24.6 hours, both declines. BNSF improved dwell less than a point to 24 hours while NS slid 1.8% to 22.4 hours. Again, who cares? If you've got 2,000 cars in a yard and half of them are railroad owned, that's about $1,000 an hour in car hire – nearly $9 mm a year – in that one yard. Take out one hour of dwell at that rate and it's worth half a $million per yard.

Earnings Announcements start with CSX on July 19. I've attached an excerpt from my *Quarterly Review* to preview what you might expect and the sort of stuff I'm measuring to nail down the "quality" question – how good is management at extracting maximum value from the assets at hand. Every quarter for the last five years I've run these metrics or similar on ten railroads – the North American Big Six plus KCS, GWR, RRA and FEC.

For this CSX sample I'm using the consensus revenue and eps estimates from First Call. I'm assuming based on what I've heard from shortline connections and others that they can take at least another point off the OR. If that holds we ought to see a 16% gain in ops income based on 10% more revenue and only 8% higher ops expense.

Please note that the reported 73 cent eps number includes the net benefit from the change in the Ohio State income tax law less a charge for debt elimination so First Call is using an adjusted 2Q05 eps figure of 91 cents. That's one reason I like to look at core earnings – what's the railroad doing in terms of operating income – it's not complicated by accounting. And if you'd like to get your own copy of my *Quarterly Review* it's $100 for subscribers (corp or indiv) and $200 for non-subscribers.

Ethanol may come to the DM&E in the form of a new 100-mm gallon ethanol plant in Springfield MN, some 130 miles southwest of the Twin Cities. The proposed US BioEnergy Corp facility would consume 37 mm bushels a year and employ 40 people.

Do the math. If ethanol garners $2 a gallon the company will rake in $200 mm a year. According to the *WSJ* (6/17/2006) it costs $1.10 a gallon to make the stuff, so US BioEenergy will generate an operating profit of $90 mm a year. IAIS President Dennis Miller writes in June's *Railway Age* that a bushel of corn yields about 2.5 gallons of ethanol, or 40 mm bushels per 100 mm gallons. Using Miller's math, 40 mm bushels is about 11,400 carloads. Call it 103 trains of 110 cars each or two a week 52 weeks a year.

Let's say DME gets $1,500 a car originated in Clinton IA using railroad-owned equipment. *USRail.desktop* ® says that with a 1.2 revenue-cost ratio DME nets just over $250 a car, so this plant could be worth $2.9 mm in operating income to the railroad. So the combined net to the railroad and the ethanol producer is $93 mm a year.

The Reuters news article that triggered these comments also implies that without the $2.5 bn RRIF loan to upgrade the DME for coal this new ethanol facility would not be possible. Maybe we don't really need it. Further south, the Omaha *World-Herald* reported on June 26 that in Nebraska alone there are more than 30 ethanol plants either on the books or in production with the capacity to pump out two *billion* gallons a year.

And Jim Giblin writes in the August *TRAINS* that "as of April there were 97 ethanol biorefineries located in 19 states, with 35 under construction and 9 expansions, as well as 65 biodiesel production plants with 50 under construction and 8 expansions scattered across 30 states." In essence, then, the taxpayers are being asked to pony up $2.5 bn in fed funds to finance DME access not only to coal but also to a non-existent ethanol refinery that may be marginal before it even gets built. Bah.

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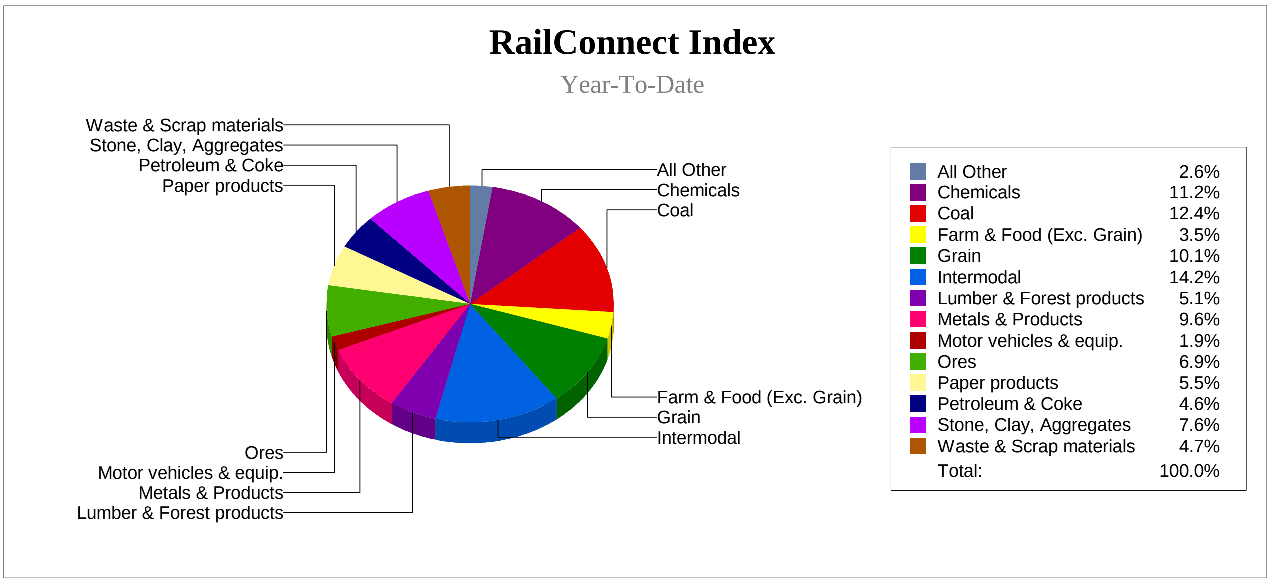
RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 6/17/2006

Week Number: 24

	Current Week			Year-To-Date		
Carloads Handled	**2006**	**2005**	**% Change**	**2006**	**2005**	**% Change**
Coal	14,615	14,848	-1.57%	360,325	342,688	5.15%
Grain	12,169	10,539	15.47%	292,611	278,031	5.24%
Farm & Food (Exc. Grain)	4,381	4,161	5.29%	102,293	94,302	8.47%
Ores	9,526	8,434	12.95%	199,917	211,720	-5.57%
Stone, Clay, Aggregates	10,819	10,406	3.97%	222,021	205,496	8.04%
Lumber & Forest products	6,657	7,395	-9.98%	149,667	156,917	-4.62%
Paper products	7,186	7,089	1.37%	161,118	165,166	-2.45%
Waste & Scrap materials	6,474	5,100	26.94%	136,287	127,809	6.63%
Chemicals	13,484	13,649	-1.21%	326,279	330,791	-1.36%
Petroleum & Coke	6,035	4,323	39.60%	134,125	125,480	6.89%
Metals & Products	11,703	8,847	32.28%	278,511	258,341	7.81%
Motor vehicles & equip.	2,464	2,508	-1.75%	54,826	54,130	1.29%
Intermodal	16,901	18,167	-6.97%	412,412	382,404	7.85%
All Other	3,791	2,496	51.88%	75,927	71,785	5.77%
Total	**126,205**	**117,962**	**6.99%**	**2,906,319**	**2,805,060**	**3.61%**



CSX Carload Revenue Analysis						
Periods ending 6/30						
	Quarter				**Full Year**	
2006e	**2005a**	**Pct Chg**		**2006**	**2005**	**Pct Chg**
$ 2,380	$ 2,166	10%	**Revenues**	$ -	$ 4,274	-100.0%
$ 1,892	$ 1,744	8%	**Total Expense**	$ -	$ 3,501	-100.0%
$ 488	$ 422	16%	**Ops Income**	$ -	$ 773	-100.0%
$ 255	$ 165	54%	Net Earnings	#REF!	$ 744	#REF!
221.6	227.5	-3%	Dil. Shares (mm)		226.9	-100.0%
$ 1.15	$ 0.73	59%	Dil. EPS	#REF!	$ 3.28	#REF!
Value Metrics						
79.5%	80.5%	(1.0)	**Op Ratio**	#DIV/0!	81.9%	#DIV/0!
	$ 1.89		**Ops Inc/share**			
	38%		**EPS % OIS**			
$ 70.44	$ 42.66		**Share Price**			
$ 15,609.50	$ 9,705.15		**Market Cap**			
	$ 625.00		EBITDA			
	$ 2.75		EBITDA/share			
			LTD/Equity	#REF!	79.0%	
			LTD/Cap	#REF!	44.1%	
			Enterprise Value		$ 15,209.15	
			EV/Share		$ 66.85	
			EBITDA/share		$ 2.75	
			EV/EBITDA		24.33	
			Price		$ 42.66	
Source:			Premium/Disct		1.75	
CSX, First Call Ests						
			Cash Flow	**06/30/06**	**06/30/05**	
Week in Review, 7/7/2006			Cash from Ops		$ 329	
© Week in Review, 2006			Capex		$ (381)	
			Divs Pd		$ (44)	
			Stock repurch	$-	$ -	
			FCF		$ (96)	