RAILROAD WEEK IN REVIEW
JULY 28, 2006

"This will be a fascinating earnings season for the railroad industry, after a busy and mostly terrific quarter chalked up by almost everyone save rail investors." – Tony Hatch

As we conclude Week Two of the Q2 earnings reports, I'm reminded once again that Wall Street industry perceptions can account for half of a company's stock performance and at times many of these guys -- who really don't know the rails intimately -- can be flat wrong.

Happily, others about in the land see the good news. My good friend Tony Hatch penned this note July 18, before the first olive was out of the jar. "With traffic up over 4% (almost double the Q1 rate) and revenues over 12%, combined with a newfound Street respect for the opportunities afforded by the *Railroad Renaissance*, you might think that rail investors would be counting their riches this summer. But the major rails are off some 16% from of their 52-week highs, 'led' by Canadian Pacific (down 21%; Union Pacific is the relative winner, off 11%).

"The primary reason for the stock under-performance seems to be ordinary profit taking, slowing (if still impressive) rail revenue growth as comparisons get tougher and a general economic fear brought about by the Fed's apparently ceaseless pattern of rate increases and the sense that GDP growth in the quarter will be less than half of that of Q1, reversing the pattern of rail revenues. And, perhaps, the latter is the story in a nutshell – the rails, while carrying an increasing share of the economy, are growing faster than GDP, because of secular (as opposed to cyclical) changes occurring both to and within transportation/supply chain systems.

"The Railroad Renaissance: To reiterate the primary examples, at the risk of dead-horse abuse, coal (growing as an energy source), grain (changing global diets and ethanol), and intermodal (elongated supply chains to Asia, TL issues, fuel price) are secular events – as is the new pricing paradigm." Read on and see how nicely it's all coming together.

Burlington Northern Santa Fe once again shows how shareholder value increases with the power and leverage attained in higher revenues, reining in ops expense and buying back shares. Total Q2 sales increased 18% to a record $3.7 bn on 9% more revenue units (the only commodity decreases were "other consumer" and auto which together account for a mere 3.5% of total units). Operating expense was up 17% but that one point spread was enough to power a 22% ops income gain.

Continuing below the line, net income grew to $470 mm, up 28%, while eps was up 32% helped along by a 3% decrease in the diluted share count. All of which is lovely, but it all begins with top-line sales. Recall CEO Matt Rose's remarks on the "Media Tour" of the transcon [WIR 3/31/2006, "Velocity with a Capital VEE"] – it takes revenue to generate the cash to do the capex to make the railroad run better and faster. And that, friends, is what makes even more revenue possible.

The payoff is in Return on Invested Capital and this week BNSF was the first railroad to show exactly how it calculates ROIC. The handouts (see www.bnsf.com/investors) include a nine-year scorecard that ought to be required reading for every railroad operator or investor. In 2005 BNSF generated a 10.1% ROIC and Tuesday CFO Tom Hund said they were on their way to 11% in 2006.

The velocity push is starting to pay off. Yes, Tuesday's slide 31 shows a definite slowing of the railroad's 2Q performance since 2003, but the story is in comparing this slide with #29 from the 1Q06 slide set. There is sequential on-time performance in four out of five commodity groups (only coal lags) and for the system. And it's getting even better. Carl Ice said during the Q&A that velocity measures "are not yet at targets," which says to me that the velocity push is still in full force.

Chief Commercial Officer John Lanigan says they've got 80% fuel surcharge coverage and that the fuel surcharge component of yoy revenue increases in every commodity group is shrinking. Thus it would appear that yoy comps are going to get tougher and that the gap between rates of revenue and volume increases will shrink. The luxury of taking a 5% ops expense increase against a 2% GTM gain will no longer be available. The winners will be the ones with a quality product in the eyes of the buyer, the power to charge accordingly, and the ability to manufacture the quality product at a profit. I think BNSF has this happy formula.

Canadian Pacific increased quarterly sales to $C1.1 bn yoy, up 2.3%, though SVP Marketing and Sales Marcella Szel noted that absent the negative effects of volume, mix and foreign exchange they would have been up 8% on roughly 5% price hikes and 3% fuel surcharges. Ops expense was held to a 1.7% gain in spite of fuel being up 10%. CP took 40 basis points off the OR to 75.1 for the quarter. Ops income increased 4%.

Merch traffic sales including auto and ag grew 8% on a 2% volume decline as potash, lumber and paper – 31% of merch traffic in 2Q05, now 25% of merch loads – fell thanks to global and industry pressures. Similarly coal vols slid 25% yoy, dropping to 13% of total volume from 19%. Intermodal revenue was up 9% on 4% more units, increasing RPU by 6%. One positive take-away is that CP sales are more geared to the global economy than to North America's and thus are less susceptible to local whim. Once again, the secular thesis of some leading analysts seems to ring true.

During the call CEO Fred Green didn't seem to be overly concerned about the shortfalls in ferts and forest products. Paper is the weakest of the group and lumber runs hot and cold with housing starts. What's important, he said, is to be ready for the inevitable rush when potash and grain start running again. Recall a year ago CP added about 12% more track capacity; Green says they're only scratched the surface of what it can do.

They're running more efficient trains – 17,000 tons in potash, 15,000 tons in coal and maybe 5,000 tons in merch – but those disparities can cause operating headaches. Different size trains have different ops profiles and it's like restricting trucks at 45 MPH on a 75 MPH super highway. Getting the railroad "in balance" is the key. Coal will be back, potash will be back, and one shipper told Green to "expect a wall of grain coming at you."

They're already moving grain trains 14% faster than a year ago, indicating Green's sharp words about "turn times and outliers" [WIR 12/9/2005] must have hit their mark. As we've seen elsewhere, moving the big trains better makes everything else run more smoothly, and it shows in crew-starts per train and in car hire. The former is down 16% and the latter 19% yoy.

CP expects that in Q3 and beyond they will see revenue growth in the 5-7% range yoy driven by strength in intermodal, industrial/consumer, grain and automotive. Forest products and coal will not be as robust. Still, given that 58% of CP revenue is carload ex-coal, that's not too shabby. I'm hopeful CP shortlines will get to see some of this at the September 2006 gathering in Saratoga Springs, NY. There ought to be a lot of happy faces.

Norfolk Southern posted record yoy operating revenues of $2.4 bn, up 11%, record operating income of $677 mm, up 14%, a 71.7 operating ratio, down 82 basis points and the best since pre-Conrail days. Merch carload revenue increased 14% and intermodal was up 16%. Coal was up 1% but backing out the $55 mm rate case settlement in 2Q05 coal was really up 12%.

Revenue units were up 4% with IM in the lead, up 8% with merch vols up just 1% yoy. Still, 4% in a supposedly shrinking economy isn't bad and certainly in a range with NS peers (see summary table attached). And NS hit another record with more than 2 mm revenue units in a quarter.

Operating expenses were up 10% with fuel up 60% or $100 mm. EVP Marketing Don Seale said that FSC amounted to 60% of the RPU increase -- $45 per unit or $91 mm, 93% of the yoy increase in fuel expense. If NS had not seen fuel jump to $2.01 from $1.78 a gallon and had burned the same amount of fuel in 2Q06 total ops expense would have been up 2%. Backing out the $91 mm FSC collected puts adjusted revenues at $2.301 bn, up 7% yoy (assume for the minute last year's FSC collections are frozen in time) and the new OR would be 68.9, a 2.2 point spread.

However, as NS takes the rate bases up to accommodate higher fuel prices, the rate of revenue increase yoy will come down. With roughly 90% of the revenue base covered by FSC, up from 85% just six months ago, NS will have to rely increasingly on its "value pricing" proposition to keep it traditional leverage between revenue gains and ops expense increase.

NS stock took a major hit this week, never mind these respectable above-the-line results. GAAP earnings were $0.89 vs $1.04 a year ago. The difference was attributable to the combined effects of a change in Ohio tax legislation plus the gains from the settlement of two coal rate cases, increasing the 2Q05 results by 29 cents a share. Absent these items the apples-to-apples comps would be 89 cents in the present quarter vs. 75 cents a year ago, a gain of 18%.

Looking ahead, NS expects 2H06 revenue units to run 4% ahead of 2H05 with the same kind of pricing leverage. This bodes well for shortlines that can bring in new merch business where 1H06 carload RPUs are running 14% ahead of last year. Said Seale during the call, "Our new fuel surcharge program rebased the fuel surcharge applicable to our originated non-Intermodal tariff traffic to $64 per barrel of WTI crude oil and increased the line-haul transportation rates on this traffic by 16.4%." Letters have already gone out to shortlines on how to tap into the new rate base on existing business, so new business is new money in both cash registers.

RailAmerica gave a new meaning to "same store sales" on their conference call Thursday. The revenue, carload and expense columns are not the same ones that appeared in the 2Q05 reports – everything has been adjusted up or down so that the data excludes everything that isn't there any more. That's a ton of knuckle-drilling and RRA has to be commended for taking the pains.

Reported freight revenues were up 10% to $103 mm vs $94 mm a year ago; a 38% gain in other revenues (ancillary fees, mostly) pushed total revenues up 13% to $117 mm vs $103 mm a year ago. Unfortunately, operating expense before a small gain on asset sales was up 22% causing a 42% drop in ops income to $9 mm from $15 mm. Comp & Benefits., equipment rents, purchased services and fuel (not surprisingly) were all up by more than 20%. The operating ratio declined 6 points to 92.2.

Below the line it gets worse. The net before a $3 mm tax benefit was $2.4 mm, off 76% yoy and $5.4 mm after the tax credit, off 40%. Benefits from disc ops credits added back $2.5 mm for a net of $7.9 mm, still off 15% yoy. It should be noted that results were impacted by a pair of one-time charges: $3 mm in severance charges stemming from last month's reorganization and a final $600,000 payment to the former CEO. Absent these it could have been an up quarter.

During the call CEO Charles Swinburn said they are getting the problematic Ohio Division under control with new business initiatives including a new Honda Plant on the CIND in Indiana, worth some 13,000 cars plus new business from P&G and others for another 8,000 cars. There is one line segment – he didn't say which one but I can guess – that's on the block, closing by year end.

RRA will complete Phase II of its Process Improvement Plan to simplify structure, push decisions to the field, achieve greater accountability and lower overall ops costs. RRA anticipates savings are in the $10-20 mm range over 12-18 months with most sooner rather than later. The safety drive continues and the PI rate dropped to 1.7 from 1.9 per 200,000 hours worked.

On tap are projects to improve Class I car supply and customer service matters, especially where the larger roads' pricing and ops practices may adversely impact RRA shippers. There is a renewed push on building same-store revenues as opposed to buying business with more names. RRA has, for example, fronted $2.4 mm on four projects worth more than $1.2 mm in new revenues in the first year and has ethanol plants in discussion on six railroads. And where the opportunities for same-store growth are nil, well, cuz, there may be a For Sale sign out soon. Couldn't be too soon for me.

The Shortline reporting thread [WIR 7/21, John Gallagher] drew some helpful insights. A shortline owner writes, "You report that a UBS survey of 400 short lines got back 80 responses claiming that Class I service needs to improve. You then change the subject and lecture short lines about event reporting, going so far as to suggest that if the little guys would just get on the stick and report via the Internet, their Class I service would improve. I think that's called blame the victim."

Perhaps I did a poor job of making the case. Timely event reporting or lack thereof will not by itself make Class I service better or worse. But not reporting cars ready for interchange means cars get left and that naturally segues into a perception of poor service on the part of the Class I. To bring it full circle, shortlines have an obligation to themselves and their customers to score the Class Is on interchange performance and communicate that scoring to the Class Is.

What's a second Class I worth? A friend writes, "A landmark study of the relationship between railroad concentration and pricing power in grain transportation markets found that as the number of intramodal competitors or the intensity of intermodal competition increased, the prices railroads could charge decreased.

"More specifically, the study found that moving from a railroad monopoly to a duopoly at a corn-shipping point located 75 miles from water competition reduced rates by 17.4 percent. Moving from two to three railroads at corn-shipping points reduced railroad rates another 15.2 percent. Similar results were observed for wheat markets. Moreover, the farther the shipping points were from a navigable waterway, the greater the effect on rates as additional railroads entered the market."

Big Six Class I Commodity Carload Comps
Quarter ending 6/30/2006
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 3,701	$ 1,946	$ 1,131	$ 2,421	$ 2,392	$ 3,923
YOY Pct. Change	17.9%	5.9%	2.3%	11.8%	11.0%	17.3%
Revenue Units (000)	2,679	1,246	656	1,870	2,025	2,510
YOY Pct. Change	8.7%	1.7%	-2.8%	0.1%	4.0%	5.0%
Carload revs (2)	$ 1,627	$ 1,387	$ 630	$ 1,430	$ 1,311	$ 2,316
Pct carload	44.0%	71.3%	58.0%	59.1%	54.8%	59.0%
Pct Intermodal	33.8%	18.8%	28.8%	14.7%	20.8%	17.7%
Pct Coal	19.3%	5.1%	13.2%	24.5%	24.4%	18.6%
Mdse Carloads (000)	742	800	293	853	755	1,071
YOY Pct. Change	3.6%	0.9%	-2.0%	-1.6%	1.2%	1.2%
Rev/CL x coal, IM	$ 2,193	$ 1,734	$ 2,152	$ 1,676	$ 1,736	$ 2,163
Operating Expense	$ 2,838	$ 1,141	$ 850	$ 1,776	$ 1,715	$ 3,206
YOY Pct. Change	16.9%	1.4%	1.7%	1.8%	9.8%	11.5%
Ops exp chg/Vol chg	1.95	0.83	(0.62)	34.29	2.45	2.29
RR Operating Income	$ 863	$ 805	$ 282	$ 645	$ 677	$ 717
YOY Pct. Change	21.5%	12.9%	3.9%	52.8%	14.4%	53.2%
RR Operating Ratio	76.7%	58.6%	75.1%	73.4%	71.7%	81.7%
YOY Point change	(0.69)	(2.57)	(0.39)	(7.16)	(0.82)	(4.28)
LTD/Capital	51.1%	37.0%	43.3%	40.9%	45.9%	38.1%

Source: Company financials
Week in Review for 7/28/2006