RAILROAD WEEK IN REVIEW
OCTOBER 20, 2006

"The CN price-service package shines." – Claude Mongeau, CN Earnings call, 10/19/06

In an Oct 13 note to clients Tony Hatch asks ten rhetorical questions ranging from the state of the economy not only in Q3 but also thus far into Q4 to the impact of housing and auto slowdowns to whether the pricing environment will remain similarly robust going forward. Volumes are key, though. Specifically, Tony writes, "Building materials have been flattish as public construction remains string even as housing nose-dives, autos have been lousy even as transplants grow. Perhaps more important than the direct impact is the indirect impact on the consumer: CN and CSX are the biggest merchandise carriers, and we see comeback at one and sustained excellence at the other."

For my part, increasing units at a reasonable cost trumps increasing revenue at any cost because shortlines – my clients – live or die on volume. Ergo the name of the shortline game is increasing market share, not just getting more money for the same work. I'm also looking for volume growth to continue into 2007 and beyond. If the railroads' claim that better service wins converts, then it ought to show up in higher volumes. But to blame poor service metrics on congestion when volumes are flat is disingenuous at best.

CSX was the first olive out of the jar. Their Q3 report was encouraging: EPS doubles yoy to 71 cents on a 14% revenue increase. Operating income was up 35% on just 9% greater operating expense. The OR came down to 79.8, a three-point improvement. EPS after income tax and insurance adjustments came to 54 cents, up 50% yoy and three cents better than the Official Estimate. System yield (revenue/carloads over expenses/carloads) improved 38% to $211 per unit.

Operating expenses before the insurance credit were 80.4% of surface transportation revenues and were up 10.2% yoy. Revenue units increased only 1.8% yoy as merch carloads including auto were down 20,000 units or 2.4%, exactly offset by intermodal gain of 20,000 units. Keep in mind that the average merch carload RPU is $1726 vs. $645 for intermodal.

Ag products volume was the best gainer, up 16%, 14,000 units, offsetting auto's loss of 14,000 units, though for an RPU $100 less. The phosphates and fertilizers group was the biggest volume decliner, off 16.2% due to "recent closure of domestic phosphate plants [in Florida's Bone Valley] and increase in offshore phosphate production" (CSX Quarterly *Flash*). EVP Marketing Clarence Gooden expects these unfavorable comps to go away by 2Q07. Coal was the strongest performer in terms of units, 33,000 to be exact, up 7.5% yoy, while intermodal increased 3.7%.

In his opening remarks CEO Michael Ward said, "Improved service, growing volumes and continued strong pricing drove our strong third quarter financial results." I have to give him items one and three as revenues increased in every commodity line but auto and RPU was up similarly, with auto and coal missing the DD mark. During the conference call Gooden addressed pricing by saying the trucks are still faced with driver capacity and congestion constraints so he sees a favorable pricing environment through 2007 at least. As for units, CSX sees 2-3% expansion in Q4 and into 2007, good for shortlines as they profit from both volume and price thanks to CSX' unique junction settlement process for shortline compensation.

Union Pacific set a few records in Q3. Commodity revenue increased 15% yoy to a record $3.8 bn, operating income rose 56% to a record $752 mm as ops expenses were held to an 8% gain, and the

OR dropped to 81.1, five points better yoy. Revenues by commodity were up double digits without exception; RPU was up double digits ex-auto and intermodal, up 6% and 8% respectively.

Reported EPS rose 12% yoy to $1.54 from $1.38, however a one-time income tax adjustment a year ago added 44 cents to GAAP earnings, meaning the core earnings were 96 cents a share. Ergo the 3Q06 eps figure is actually a 64% improvement on the earlier number. Also, fuel surcharges brought in nearly half the yoy revenue gain, $231 mm. Volume, mix and pricing accounted for the balance.

As at CSX, merch carload volume deltas were modest -- single digit gains or losses. Most worrisome to shortline operators, volumes in the industrial products fell four percent yoy; chems and ag were off a point and up a point respectively. UP does not provide a yoy commodity breakout for industrial products, though some insights may be gleaned from the pie chart on Slide 9. Lumber, steel, construction products and non-ferrous metals make up 75% of the group's revenues.

All of which brings up an important point about relative importance of volume and pricing at CSX and UP. Shortlines paid on a flat allowance (UP Handling Line Allowance, e.g.) will be hurt more when volumes are down because they do not necessarily participate in revenue increases. The CSX junction settlement method, however, passes revenue increases to the shortlines as they are on divisions.

Canadian National rounded out this first week of earnings. Revenue units increased 2.1% yoy, 30 BP better than CSX but behind the UP gain by 100 BP. However CN did best with merch carloads, up 1.7% to the other roads' losses. Operating expense actually decreased 0.7%, ops income was up 26.9% and CN took the OR down six points to a record 57.4%. Net income rose 20.9% while the reduced share-count propelled diluted EPS to C$0.94, a 27.1% gain.

CN appears to have been less aggressive in pricing as average RPU increases did not hit double-digits except in auto, where vols were down 8.1% to begin with. Grains & ferts car-counts were strongest, up 9.5% while forest products fell 6.8%. In an interesting twist, Chief Marketing Officer Jim Foote noted that slowdowns in building products loadings to the Texas area have been largely offset with northbound shipments of piping and other petroleum extraction supplies from Texas into the oil sands fields in Alberta.

As one would expect, the operating story takes center stage at CN, even down to the "Precision Railroading" tag on every presentation slide. Train lengths are up 13%, yard dwell is down 27%, and system train speed is up 9%. These gains key directly to three elements of CN's "Guiding Principles of Precision Railroading:" service, asset utilization and cost control. Moreover, execution excellence leads directly to free cash flow (cash from ops less capex), and here CN leads the pack. For nine months FCF was 17% of revenues, some 15 percentage points better than either CSX or UP.

Earnings guidance for FY 2006 now stands at C$3.40, and another 10% on top of that for 2007. The cash flow story continues, albeit at a less torrid pace. The 2006 FCF estimate is C$1.3 bn and C$800K a year out thanks to higher cash payments for Canadian taxes. Foote's FY 2006 guidance is for exchange-adjusted revenue growth of 10%, up from 7% previously, slowing to 5-6% exchange-adjusted in FY 2007. Volume outlooks remain favorable across all commodity groups but forest products which is neutral or at least not declining.

Every WIR reader is heavily invested in the railroad business, whether a shareholder, railroad operator or employee or shipper or government official. It is imperative that they, like any other investor, listen to the quarterly earnings calls because that's the only way to see *and hear* for oneself what management is really doing and how they can tell their own story. Earnings calls fall into one

of four groups: management has a strong story and knows how to tell it; management has a great story but has a weak presentation; the story is weak but management gives it the energy of a strong story; the story is weak and management tries too bluff its way through.

Thursday's CN performance gets the Best of Calls award for the week. It's a strong story and everybody had a hand in telling it. Hunter Harrison opened with a self-effacing "I don't know where to begin," and was followed by Jim Foote's seeming to ad-lib his way through commercial details in more depth than anything on the slides. CFO Claude Mongeau as usual brought life to the financials and all three dove into the Q&A with nary a pause for breath, stall or stutter. To be sure, the numbers are in the press releases, but there's nothing like the call to capture the spirit if the place. I would not be surprised to see CNI take on a few points in quick order.

The car builders have had a good run of late. Greenbrier (GBX) announced its intention to acquire freight-car wheel supplier Meridian Rail Services, Freightcar America (RAIL) is doing a booming business in hopper cars (BTU is recovering rapidly from its recent slump, e.g.), and tank car builders are booked into 2009. Peter Nesvold, Bear Stearns' equipment guru, writes, "The majority of our contacts continue to forecast strong railcar demand supported in large part by replacement demand. Demand for tanks should be the strongest (driven by ethanol), followed by covered hoppers (DDGs).

"We spoke with an industry consultant about his expectations for intermodal railcars. Going into '07, our contact is looking for slowing yoy growth in intermodal volumes; however, he expects most of the slowing to be seen in domestic containers versus ISO containers. That said, longer term our contact expects to see intermodal volumes continue to grow in the 5-6% range. A sales and marketing VP continues to be bullish on long-term railcar demand supported by strong replacement demand. Our contact pointed out that the rail industry saw a lot of growth in railcars during the 1970's and 1980's. As a result, roughly 41% of the North American railcar fleet is currently over 24 years old."

Finally, "We spoke with the director of market research at a Class I railroad to get a sense of his outlook for '07 and beyond. Directionally, our contact is looking for the economy to slow modestly in '07, though he still expects to see growth in the total tonnage of freight shipped by the rails." That seems to be on-target given the outlooks of the three railroads reporting this week. All three brought home earnings north of the estimates and I believe the trend will continue next week.

The railroads are just now beginning to capitalize on their inherent competitive strength and, as CN's Jim Foote put it so succinctly, "There's more than enough business out there for all the North American Railroads." That ought to gladden the hearts of shareholders, shortlines and shippers alike.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and shortlines with less than $12 mm annual revenues $125. Corporate subscriptions $500 per year. A publication of the Blanchard Company, © 2006. Subscriptions are available by writing rblanchard@rblanchard.com .

Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned here.