# RAILROAD WEEK IN REVIEW
## OCTOBER 27, 2006

*"Our goal is to position our Company to grow profitably." CEO Matt Rose on the BNSF Earnings Call 10/26 in response to a question from Merrill's Ken Hoexter*

**BNSF brought in** the greatest Q3 percentage increase in total sales (18.8%) and revenue unit volume (7.4%) of any of the Big Six with double-digit revenue increases in each of the Company's four business groups. The record number of revenue units during was led by a 10% unit increase in coal, an 8% unit increase in both intermodal and agricultural products businesses and was the 18th consecutive quarter of yoy volume increases.

Freight revenues hit an all-time quarterly record of $3.8 bn, up $597 mm including fuel surcharges of approximately $500 mm, up $200 mm yoy. The increase in fuel surcharges was driven primarily by rising fuel prices which pushed up fuel expense by 58.7% or $293 mm. Merch carloads (all but coal and intermodal) increased by a Best of Breed 4.6% led by ag and industrial while auto and "other consumer" (reefer biz, e.g.) were off modestly. Total freight sales ex-ancillary charges was a record $3.815 bn, besting arch-competitor UP's Q3 freight sales by some $13 mm.

Industrial Products revenues increased 17.2% led by double-digit revenue growth in chemicals and plastics, petroleum and construction products. Agricultural Products revenues were up 19% due primarily to strength in corn and soybeans. Pricing continues to hold as the merch group revenue increased 17.8% to $1.7 bn and RPU increased 12.7% to an industry-leading $2226. Coal revenues rose 20% due to record loadings of Powder River Basin coal, up 3% yoy. BNSF exceeded second quarter 2006's record loadings by nearly 3%. Intermodal revenues rose 18.5% on 7.7% more volume due to strong revenue increases in the international and domestic intermodal sectors.

Operating expenses increased by 18.9% to $3.02 bn compared with third-quarter 2005 operating expenses of $2.54 bn. The $480 mm increase in operating expenses was principally driven by a $293 mm increase in fuel expense primarily reflecting higher prices and a declining hedge position as well as a 7% increase in unit volumes. The all-time quarterly record operating income of $920 mm represented an 18.3% gain over 3Q05 though the OR was essentially unchanged at 76.6%. Below the line EPS increased 22.2% to $1.33 thanks largely to the 3.6% reduction in share count. Fee cash flow (cash from operations less capex) was $762 mm, 6.9% of revenues.

BNSF says the outlook calls for further growth in coal, grain and intermodal volumes and revenues with industrial products more or less following the economy. [IMHO, merch carload revenues are more secular and tied to consumer staples (soap, cereal, soup and suds – beer) and IM is more tied to consumer discretionary spending (electronics, shoes, stoves, etc.)] Housing starts will be a drag on forest products but coal will continue to be weather-dependent. That said, BNSF still expects Q4 revenue growth around 10% with EPS gains running twice that. For the full year, look for FCF after divs in the $700 mm range and ROIC approaching 11%.

**Norfolk Southern reported** record Q3 net income of $416 million, or $1.02 per diluted share, a 38% yoy increase compared with $301 mm, or $0.73 per diluted share. Third-quarter income from railway operations increased 35 percent to a record $715 mm on best-ever Q3 sales $2.4 bn, up 11% yoy. All markets, with the exception of automotive, posted significant revenue gains, and several set new revenue highs including fuel surcharges representing 40% of the RPU increase, down from 60% in the previous quarter.

General merchandise revenues were $1.28 bn, up 13% yoy. Q3 coal revenues increased 9% to a record $595 mm while intermodal revenues rose 9% yoy to a Q3 record of $515 mm. Revenue unit volume was a different matter, though. We keep hearing the mantra of "trucks off the highway" yet the merch car count was unchanged yoy. Gains in ag/consumer and metals/const were buried under the double-digit decline in auto.

Coal was off 3% and IM down 2%. This is especially bad news to the shortlines that touch some 40% of all merch carloads (less auto). Recall most of these guys get paid a flat FAK allowance that doesn't change with pricing. NS operating expenses came to $1.68 bn for the quarter, up 3% yoy, with the 38% yoy increase in fuel expense the main culprit. Comp and benefits were actually down eight-tenths of a percent and material, services, and rents grew only 2.2% yoy.

As a result of this exemplary cost control the OR dropped more than five points to 70.1, the best since pre-Conrail days. NS stock gapped up more than $6.00 at the open (earnings were announced at 0900) mainly on the EPS figure of $1.02, 20 cents or 24% above the Street estimate. It has since drifted back to the $53 range (I took some of my position off at $54) and I suspect once the small volume deltas sink in, it'll drop back some more presenting an attractive buying opportunity.

Though NSC does not provide forward earnings guidance, we did learn from the call that there is "more pricing power on a go-forward basis than in the past," that Q auto comps will be tough and that the rate of container growth at east coast ports has slowed. Perhaps Chief Marketing Officer Don Seale summed it up best: "While we still see some economic expansion ahead, it appears to be less robust than what we saw in the first half of the year."

The view from here is that NS can do better than flat or "organic" volume growth equal to the GDP growth rate, now in the 3% range. Shortliners tell me there is a lot of single-car business to be had if only the price-service offerings were better. Given NS' toolbox of powerful network measurement processes from LOPA to the Operating Plan Developer to the Algorithmic Blocking and Classification system, one has to conclude better volumes are out there to go with the pricing increases we've seen thus far.

**Canadian Pacific continues** its torrid pace of improvement across all aspects of its operation. On the earnings call SVP Operations Brock Winter said the "relentless focus on velocity" has yielded lower equipment rents, a 90% on-time record for IM and merch trains, a 33% improvement in crew-train ratio and 21% less loco deadheading. During the Q&A Fred Green, CP President, added that CP is increasing capacity by improving fluidity, a recurring theme heard throughout all the calls this season. Green also pointed out that as Q4 unfolds there will be more business moving over the same network and there is room to add volume beyond even that.

Railroad revenues increased 7% yoy with pure pricing and mix adding four points and FSC three points. Unfavorable foreign exchange took out three points, leaving CP revenues up 4% yoy to C$1.122 bn. Grain, sulfur/ferts and industrial products were the brights spots, up 18%, 9% and 13% respectively. Double-digit RPU gains were posted in the Forest and Industrial groups. Revenue units declined 3% largely as a result of the coal lost when the Latta sub (ex-MILW line to Indiana) was sold to Tom Hobak's Indiana RR. Grain, sulfur and ferts were up 11% and 6% respectively while IM, auto and industrial products experienced smaller car-count losses.

Operating expense actually declined a tenth of a percent in Q3 as reductions in equipment rents, compensation and purchased services more than offset the 13% increase in fuel expense due to 10% price increase and 3% more gallons burned. Though GTMs were off 1%, it's entirely possible the faster railroad of which Fred Green was speaking needs more juice to go faster even as loco utilization is up and crew-starts are more evenly matched to train-starts. Reported net income was C$162 mm, down 21% from C$204 mm in 3Q05, however backing out the effects foreign exchange and other items gives a core railroad net of C$163 vs. last year's C$104 mm, a 56% increase. EPS before items increased 26% to C$1.06.

CP guidance is for FY 2006 revenues including FSC to the C$4.7 bn range, up 5-8% over FY 2005. Operating expenses are expected to rise by 3-6% for an implied OR in the neighborhood of 75, down a point yoy. Diluted EPS is C$3.60 to C$3.85, up 10% or so over the FY 2005 amount. We should look for FCF after divs someplace north of C$200 mm and a share buy-back up to 5.5 mm shares.

**The ASLRRA held its Eastern Region meeting** in Lancaster, PA last week (that's LANK-ester, not Lan-CAST-er, if you please) and Growing the Business was a recurring theme. That's why the remarkably low Class I growth rates in merch carloads are so worrisome. As noted above, we know where there are quantum leaps in carload volumes available for the taking and at decent yields, if run right – with acceptable velocity, in other words.

As it turned out for the quarter the best yoy increase in merch carload volumes came from BNSF, the only Class I where the non-coal and non-IM trade represents less than half its quarterly revenues. At the other end of the spectrum, CN has the highest percentage of revenue coming from other than coal and IM yet has the lowest OR among the Class Is. This seems to say that the single-carload business works where there is an intense corporate focus on velocity (BNSF) and attention to doing the same thing the same way every day (CN's "precision railroading" thesis).

Perhaps the biggest challenge facing Class I carload commodity managers is how to pay the shortlines that touch some 40% of the merch carload volume. Telling a market manager to do more business with shortlines and then docking him the amount of revenue he has to pass on to the shortline is hardly and incentive to grow the shortline volume. It's already been proven that shortlines are better at developing new carload business a car at a time than are the Class Is. So why aren't the Class Is[1] rewarding the shortlines for their efforts with rate divisions rather than FAK allowances?

My bottom line is the the shortline outlook is decidedly dim based on the Q3 traffic trends posted by the Big Six Class Is, and even more so for the hundreds of FAK shortlines. As I look down my list of more than 500 shortline names, it is clear to me the best run are ISS roads that participate in revenue divisions and can tell the profitable business opportunities from the losers. It might just be time to rethink this aspect of the shortline model if the Class Is are serious about increasing volumes at a rate faster than some minuscule organic rate. The Class Is need to think about what Goldman Sachs calls "strategic alternatives to enhance shareholder value" and how shortlines can fill the bill.

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[1] CSX excepted. Shortlines get divisions through a junction settlement system that passes higher rates through to shortlines participating in the particular lanes.

**Big Six Class I Commodity Carload Comps**
**Quarter ending 9/30/2006**
**Revenue and income in $millions**

| Metric | BNSF | CN | CP | CSX | NS | UP |
|---|---|---|---|---|---|---|
| Railroad revs (1) | $ 3,939 | $ 1,981 | $ 1,151 | $ 2,418 | $ 2,393 | $ 3,983 |
| YOY Pct. Change | 18.8% | 9.4% | 4.2% | 13.8% | 11.0% | 15.1% |
| Revenue Units (000) | 2,760 | 1,241 | 648 | 1,852 | 1,991 | 2,509 |
| YOY Pct. Change | 7.4% | 2.1% | -3.4% | 1.8% | 2.3% | 3.1% |
| Carload revs (2) | $ 1,724 | $ 1,414 | $ 656 | $ 1,403 | $ 1,283 | $ 2,295 |
| Pct carload | 43.8% | 71.4% | 58.5% | 58.0% | 53.6% | 57.6% |
| Pct Intermodal | 34.1% | 19.0% | 29.2% | 15.1% | 21.5% | 18.7% |
| Pct Coal | 19.0% | 4.8% | 12.4% | 24.9% | 24.9% | 19.2% |
| Mdse Carloads (000) | 752 | 794 | 293 | 813 | 713 | 1,017 |
| YOY Pct. Change | 4.6% | 1.7% | 2.1% | -2.4% | 0.0% | -0.8% |
| Rev/CL x coal, IM | $ 2,293 | $ 1,781 | $ 2,240 | $ 1,726 | $ 1,799 | $ 2,256 |
| Operating Expense | $ 3,019 | $ 1,137 | $ 854 | $ 1,929 | $ 1,678 | $ 3,231 |
| YOY Pct. Change | 18.9% | -0.7% | -0.1% | 9.4% | 3.1% | 8.4% |
| Ops exp chg/Vol chg | 2.56 | (0.34) | 0.03 | 5.16 | 1.39 | 2.70 |
| RR Operating Income | $ 920 | $ 844 | $ 297 | $ 489 | $ 715 | $ 752 |
| YOY Pct. Change | 18.3% | 26.9% | 19.0% | 35.5% | 35.4% | 56.3% |
| RR Operating Ratio | 76.6% | 57.4% | 74.2% | 79.8% | 70.1% | 81.1% |
| YOY Point change | 0.10 | (5.86) | (3.20) | (3.24) | (5.38) | (4.98) |
| LTD/Capital | 50.8% | 36.5% | 37.9% | 41.0% | 40.9% | 42.7% |

| **Earnings surprise** | **BNSF** | **CN** | **CP** | **CSX** | **NS** | **UP** |
|---|---|---|---|---|---|---|
| EPS est | $ 1.30 | $ 0.76 | $ 0.85 | $ 0.51 | $ 0.82 | $ 1.47 |
| EPS reported* | $ 1.33 | $ 0.94 | $ 1.03 | $ 0.54 | $ 1.02 | $ 1.54 |
| Surprise | $ 0.03 | $ 0.18 | $ 0.18 | $ 0.03 | $ 0.20 | $ 0.07 |
| Pct | 2% | 23% | 21% | 6% | 24% | 5% |
| *ex-items | | | | | | |

Source: Company financials, First Call
Week in Review for 10/27/2006