RAILROAD WEEK IN REVIEW
APRIL 20, 2007

"The highway system has barely grown over the past 30 years but the number of trucks on the road moving freight has doubled." – Eric Newman, Force Capital, in Seeking Alpha*.*

From the *TRAINS* newswire: Marquette Rail LLC, a shortline railroad in western Michigan, announced April 9 it would purchase onboard wireless computers for its locomotive fleet. The computers will be installed in four GP38-2 and three SD40-2 locomotives. Crew members will then be able to use desktop functions previously only available to customer service staff. Reporting events such as spotting and pulling of cars at customer's sidings will occur on a real-time basis. Officials anticipate Marquette Rail's installation will be fully functional by the end of May.

Marquette Rail operates approximately 130 miles of line acquired from CSX on Nov. 12, 2005. Its primary route extends from connections with CSX and Norfolk Southern at Grand Rapids northward to Ludington and Manistee, Mich. These lines were formerly part of the Pere Marquette Railway (see *Classic Trains*, Winter 2005, p 16) which was purchased by the Chesapeake & Ohio on June 6, 1947. Marquette Rail's GP38-2s are leased from GATX and the SD40-2s are leased with a purchase option from Great Lakes Locomotive.

Elsewhere, Marquette has installed Hotstart units in all its power. "These high-tech 480-volt units circulate water and oil throughout the engine block when the locomotive is not being used, allowing us to shut the engines down during the coldest of winter nights," stated Kevin Ruble, Marquette's President and CEO. "Not only will this save costly diesel fuel, but it will eliminate particulate emissions resulting from the need to keep locomotives idling all night, contributing to cleaner air in the vicinity of our engine terminals at Ludington, Manistee and Baldwin." Ludington-based Marquette Rail LLC is a short-line railroad serving West Michigan. The website is nicely done and is a good example of what a short-line website ought to be: http://www.marquetterail.com/ .

Genesee & Wyoming (GWR) revenue units for March 2007 increased 4% yoy and for the quarter grew 2.5% yoy including both North American and Australian operations. For the month same-store loads ex-AUS and the Chatahoochie Bay RR were down 5.3% or 3,835 units. NA same-railroad traffic dipped 4.6% or 3,198 units on declines in STCCs 24 and 26 in the PNW and deep south. Lower salt loading in NY pushed minerals down 499 carloads. All other U.S. and Canada traffic decreased by a net 563 carloads.

For the quarter GWR loads increased 2.5% or 5,259 carloads yoy. Excluding 22,121 total carloads from Genesee & Wyoming Australia, which GWI started operating June 1, 2006, and from the Chattahoochee Bay Railroad, which GWI started operating August 26, 2006, same-railroad traffic in the first quarter of 2007 decreased by 16,862 carloads, or 8.1 percent. North American same-railroad traffic dropped 7.3%, 14,615 carloads, thanks to slow-downs among the usual suspects above.

CSX reported "record revenues of $2.4 bn, up 4% yoy, revenue per unit up 8% on continued pricing momentum and steady operating income despite softer volumes." But MarketWatch said "earnings slip on lower volumes" while Reuters wrote, "CSX profit down on derailment, economy; misses consensus view." What's going on?

What's going on is CSX invariably tells as strong a story as it can, accentuating the positives and playing down the negatives. CEO Michael Ward's opening remarks hit on strong core earnings power, secular strength, continued pricing momentum and "sustained operational performance." This was the 20th consecutive quarter of record revenues (a fact repeated three times in the course of the call) and showed a 40% decrease in reportable injuries since 1Q04.

Clarence Gooden cited a 4% or $91 mm gain in total revenue that would have been $181 mm but for lower volumes that in a few cases (forest prods, food and consumer, emerging markets and auto) hit double digits. Fuel surcharges accounted for only 10% of the $103 gain in RPU or roughly $18 mm total revenue. Excluding FSC and mix changes, "same store" (same car type in the same commodity O-D pair) sales increased 7%, the best quarterly gain since they started measuring it in 1Q05.

Merch revenue increased 5% ex-auto with coal up 2% and IM off 5% yoy. Merch units ex-auto dropped 5% on double-digit hits to forest products and food/consumer. Coal units slipped 3% and IM units were down less than 2%. The ethanol boom propelled a decrease in southern grain moves and a bump in northeastern ethanol loads. Phos and ferts revs jumped 18% on 5% more units as longer hauls of potash and other products moved in to support more corn acreage, again ethanol-driven. Across the board it was encouraging to see prices holding even where vols were off by much larger percentages.

My biggest concern is lack of consistency in operating performance as measured by re-crews, average velocity, dwell times and OT arrivals and departures. Re-crews occur when a crew outlaws before completing its run, meaning the train has to come to a stop and wait for a new crew. This degrades velocity and OT arrivals. The biggest cause of late departures is late arrivals and trains leaving without all the cars assigned to them hurt yard dwell times.

Back in 4Q05 CSX averaged 78 re-crews a day and less than 19 MPH over the road. Fewer than half the trains arrived according to plan and slightly more than half of all trains got out of town on time. Dwell was just under 30 hours. By 1Q06 re-crews were down to 58 a day, average train speed was 20 MPH, OT arrivals and departures were 61% and 74% respectively, and system dwell was under 27 hours. These metrics pretty much held through 4Q06 but then in 1Q07 re-crews were again above 70 with train speed, dwell time, and OT arrivals and departures all down a tad.

That said, it was still a strong call that told the quarter's story in a positive light, putting the volume losses in the perspective of an increasingly secular rail transport sector and properly down-playing the penny-a share yoy EPS decrease on non-recurring below-the-line items. Turning CSX around operationally is going to take time, and I think they're on the way home. WIR readers are urged to pull up the CSX website and look at Tony Ingram's operating slides and the safety and service metrics. The tea-leaves are aligned for continued improvement in the merch area in particular, the above negative headlines notwithstanding. Short lines take note.

Union Pacific was up second for Earnings Week and what an at-bat it was. The energy and excitement from all four presenters – Jim Young, Jack Koraleski, Dennis Duffy and Rob Knight was palpable. Yes, I know it's only the second call of many to come, however I feel there's something special going on here. Let's look at our Tales of Two Railroads this far.

As at CSX, total UP revenues were up 4%. But revenue units were down 2.5% vs. CSX' 3.9%. Merch carloads (including auto, ex coal and IM) were off 6% on both and merch revs were up some 2.5% on both. The difference was partly mix, as UP's merch RPU increased 9.4% yoy while CSX was up 8.8%. Both respectable, to be sure, but my sense is UP had a stronger mix card to play in chems, autos, forest prods and industrial.

In fact, Industrial Products was the only commodity group to take a double-digit (13%) down-turn as the soft housing market and winter weather slowed down what was left. But it still earned an 11% RPU bump due to mix. Continued growth in ethanol and DDGs helped offset a dip in whole grains and more auto parts made up for some of the finished vehicle loss. Looking ahead, Koraleski sees Q2 vols as lame but with revs up three to five percent. For 2007, he sees vols flat to up 2% (On UNP a one-point delta in loads is 23,000 loads which, at the system average $1565 RPU, is worth about $36 mm, so don't feel too bad.) Look for revs up 4% to 6% for the year.

There was a marked difference in execution, I think. CSX ops expense for the Q was up 5% to UP's 0.5% driving a 19% surge in ops income to CSX no change. The OR at CSX was 79.9, up 80 BP yoy but if you back out the insurance credit the OR becomes 80.6, up 150 BP. Over in Omaha they took 237 BP out, dropping the OR to 81.3 – albeit a bigger number but the story is the yoy delta.

CSX continues to invest heavily in the railroad, especially on the heels of the recent FRA attention, to the extent that the $428 mm capex investment for the Q was 18% of sales to UP's $514 mm or 13% of revs. (In CY 2007 capex as a percentage of revenues for CSX was 17% compared to an average 13% for the other three big US Class Is.) CSX spent $17 per million GTM to $12 for UP even though CSX brought in $39 of revenue per million GTM against UP's $28. Both had RTMs of roughly half total GTMs and both got more than 760 MGTM per gallon of diesel fuel.

The bottom line is that UP's net income was up 24% yoy to $386 mm while eps grew 23% on no real change in the number of shares outstanding. But to get a flavor if what this company is doing behind the scenes, take a look at some ratios. Net LTD is 35.5% of capitalization, the net Q1 margin clocked in at a respectable 10%, the current ratio is less than one, and EBIT covered interest expense by more than six times.

Of all the analyst reports I've read on UP's results, I think Jason Seidl of Credit Suisse nailed it exactly: "In addition to its earnings report, UNP issued yoy EPS growth expectations for 2Q07 of 10-15% implying an EPS range of $1.58 to $1.66. We believe this forecast may prove too conservative in the face of very strong pricing observed in the marketplace and have modeled for 2Q EPS of $1.70. For FY07, we now expect Union Pacific to deliver $7.05 in earnings per share. Our FY08 forecasts have also been revised upward by 15 cents to reflect sustained pricing gains, and we now anticipate EPS of $8.05." Do you think the Oracle of Omaha might be taking a second look at his neighbor? I sure hope so.

Class I railroads revenue unit volume increased 0.9% in Week 15 (through Friday the 13^{th}). Bear Stearns' Ed Wolfe concludes, "Volumes were weak yet again in the second weak of April, despite what should have been an easy Easter comparison over a year ago. We see no signs at this point of improving rail volumes into 2Q. Fortunately for the rail sector, in the near term, the stocks continue to surge on the announcement of activist and well-known shareholders plus continued LBO anticipation as well as strong pricing dynamics. In the near term, we are seeing strong increased interest in the sector and fundamentals likely do not matter as much."