RAILROAD WEEK IN REVIEW
OCTOBER 19, 2007

"The quarter finished strong as we set new records for seven-day carloadings several times through the last week of September." – Jack Koraleski, EVP marketing and Sales, Union Pacific

CSX kicked off the third quarter Earnings season with a 3.4% revenue increase over 3Q06 driven by an 8% improvement in RPU even though the total number of revenue units moved declined by 4.3% yoy. The railroad's operating income increased 13% as operating expenses were held to a mere 1% gain helped by decreases in equipment rents and inland transportation, both a function of the volume decline. The operating ratio came down 1.8 points to a respectable 77.9, though if you back out the $15 mm insurance recovery in 3Q03 the OR came down seven points.

Every merch commodity group except the usual suspects (forest products, food & consumer) posted revenue gains with phosphates and fertilizers in the lead at plus 22.0%, putting the entire merch group at a plus 3.8%. Coal revs were up 7.8% but intermodal revs fell 7.4% as the mix change between international and domestic, short and long haul changed for the worse. Revenue unit volume was a different matter. CSX revenue units system-wide were off 4.3% with every group ex-auto but including IM and coal down.

Out on the railroad GTMs came down 3% but there was a silver lining to this cloud. Tony Ingram and the ops crew used the opportunity to improve on service metrics from the personal-injury frequency ratio (injuries per 200,000 hours worked) to the average number of re-crews. OT originations were up by 9% and OT arrivals improved by 20%, and there were 16% fewer re-crews (crew outlaws before reaching the train's destination). That tells us the trains are getting over the road better and supports the increase in system train speed (road trains only, yard and local jobs excluded) to 21.4 mph from 19.8 mph.

Reported net income was $407 mm, up 24.1%, to 91 cents a share, including a $110 mm tax credit related to "the resolution of income tax matters related to former activities of the container shipping and marine service businesses." Absent this credit, income from continuing ops was $297 mm, 67 cents a share, down 9.5% yoy. But wait, there's more: other tax benefits adjusted the reported 3Q06 number downward by 17 cents a share, so net-net CSX was able to report a 24.7% gain in eps.

The analyst reports seemed generally upbeat. Jason Seidl of Credit Suisse writes, "Despite being mired in a freight recession, CSX has managed 12% EPS growth over the last 9 months. We believe that CSX' future prospects are bright as the company is well-positioned to benefit when volumes return to the industry. Indeed, the company has reiterated its target goals for the 2007-2010 period: 1) 10-12% CAGR operating income; 2) 15-17% CAGR EPS; 3) $800 mm to $1 bn in free cash flow before dividends in 2010; 4) operating ratio in the Mid-low 70's and 5) exceeding cost of capital. Accordingly, we maintain our Outperform rating on the stock."

Meanwhile, on Tuesday morning (earnings were released after the close Tuesday) The Children's Investment Master Find ("TCI"), owner of 17.8 mm CSX shares, about 4% of the company, made public a scathing eight-page letter to the CSX Board in which TCI "urged" certain changes to "improve corporate governance and business performance." Among other things, TCI called on the Board to separate the Chairman and CEO roles, add directors with railroad management experience, and link management compensation to railroad performance.

The full letter plus supporting graphics are posted at www.strongercsx.com though the short form is that TCI cites “weakness of the CSX management team and strategy” and adds that “we hold the Board accountable for these failings.” The letter continues, “On virtually every major metric of operational and financial performance CSX today is last or near last” in the railroad group. “The inescapable conclusion is that whatever CSX is doing, it could be doing it better and its competitors, in fact, are.”

Reaction to the TCI screed was predictable. The “Breaking News” daily e-mail from *Railway Age* suggests that TCI’s demands “could pose a risk to the railroad’s annual capital expenditures” which CSX estimates will amount to about $1.7 bn a year through 2010, a number which TCI wants CSX to justify. Bill Greene of Morgan Stanley writes, “We can understand shareholder frustration with CSX's performance, but its not as clear to us what the end-game is if change is not forthcoming, aside from replacing management…Our estimates remain above consensus and near the high end of management guidance.”

The view from here is that CSX continues to be a work in progress, needing more money in the track (money that should have been spend years ago but wasn’t) and better execution in the field. And I’m not alone. Bear Stearns’ Ed Wolfe writes, “Yesterday’s letter to CSX’s Board from shareholder TCI not withstanding, we have trouble faulting CSX management’s results and stock performance the past 3-4 years under their current mgmt team. They continue to show solid improvement in virtually all metrics they have focused on, albeit off a low base left by former mgmt.”

Still, the points raised by TCI merit careful consideration by not only investors but also shippers and short line owners. As to the latter, I would urge close monitoring of interchange performance (Is it in accordance with the ISA? Are cars taking too long between serving yard and your interchange? Are transit times between your interchange and the other end of the move reasonable and consistent?) My anecdotal evidence from CSX short lines indicates that there is room for improvement. Comments?

After all that excitement it was nice to hear Union Pacific’s call, an up-beat performance if there ever was one and with good reason. Let me give you the full Koraleski quote to put UP’s accomplishments in perspective: “Despite the soft economy, our volumes grew about 1% in the third quarter, making it our highest-volume quarter ever. The quarter finished strong as we set new records for car-loadings in any seven-day period several times right through the last week of Sep with a new benchmark set -- just over 205,000 cars, about 4,000 cars more than the old record set in June 2006.”

In other words, while everybody seems to be wringing their hands about rail volumes being down, here is UP going about its business building volume and revenue gains in five out of six commodity groups. CEO Jim Young said in his opening remarks that the record results were “driven by both sides of the earnings equation,” meaning that better market results (revs up 5%) supported by sharper operating practices (ops expense down 1%) made the 34% ops income gain and a 76 OR a reality.

RPU was up in every commodity group and as a result system RPU was up 5% yoy. Both Young and Koraleski talked about the strength of the franchise where gains in one commodity could offset weakness in another. For example, Industrial Products (construction materials from aggregates and cement to roofing, consumer goods including furniture and appliances, and all the metals) units were off 8% and IM was flat while ag, auto, chems and coal were all up two points or more. Another way, Industrial Products represent 13% of total revenue units on UP, a third of all non-coal or IM units.

EVP Operations Dennis Duffy said safety scores improved 15% yoy on five percent fewer train-starts even though vols were up. Terminal dwell, car-cycle times, fuel consumption per MGTM and AAR train-speed all improved, taking equipment rent expense down 4%, fuel down 2% and

compensation expense down 4% as a result of better train operating discipline and improved OT performance (though UP did not give the same amount of detail as did CSX).

The quarterly record revenue of $1 bn drove net income to a 27% increase even though income taxes more than doubled. Diluted eps increased 30% to $2 a share. CFO Rob Knight suggests a Q4 operating ratio in the 78.5+ range and a net of two bucks a share for a full year eps of $7 on revenue units down 1% but with a 5% revenue gain. Earlier in the call Koralski said intermodal would be the leader in Q4 volume growth even as the economy continues its general malaise. That said, UP reiterated its strength is in its "depth of commodity mix." If I were a short line, I'd be scouring my customer list to add value to my transportation offerings, keying in on what was said in this call.

Keying in on the Class I message was what the recent BNSF short line meeting (its 12th) was all about. In the BNSF Q3 "Shortline Connection" newsletter Shortline AVP Mark Schmidt writes, "The BNSF vision strives for the operation of a high-volume, broad-reaching mainline network supported by a lighter-density feeder network operating at the lowest level of cost and the highest level of service… [We need] better identification of business opportunities with shortline partners and we need to bring more focus on measuring success and realizing the vast potential for growth that BNSF shares with its short lines."

The pieces are all there. BNSF connects with some 200 short lines that among them operate more than 19,000 route-miles of railroad. Revenue units are up roughly 8% ytd against shortlines as a whole down 6% per RMI's RailConnect Index. The BNSF short line commodity mix is more than 80% industrial products and agriculture against 53% industrial and ag nationally.

What I find particularly interesting is that BNSF merch carloads (all but IM and coal) contribute a smaller portion of total revenue than at any other North American Class road (43% in FY 2006, e.g.). Yet in FY 2006 BNSF short lines handled more loads than any those of other of the Big Six Class I railroad, which seems to say BNSF has done the best job shifting the predominantly single-carload business to the short lines.

There's still more to be done, however. Seventy percent of short lines are meeting velocity goals and BNSF wants to close the gap. It has hired an "emerging growth team" to get shortline requests to the right account managers and insure prompt responses. Industrial Products Group VP Dave Garin wants short lines thinking in terms of the AIM (Assess, Improve, Maximize) carload strategy first introduced at the 2005 shortline meeting and has offered his team to help short lines implement it. COO Carl Ice talked up short line help in blocking trains. And Vann Cunningham, AVP for Economic development gave an unqualified YES in response to a question about joint ED ventures on short lines.

In sum, this BNSF meeting was the best I've seen in terms of laying out a corporate mission and showing where the short lines can profit (literally) by being part of that mission fulfillment. "Listen to your class Is" is a continuing theme in WIR and it's getting traction among more and more short lines. BNSF has led us to water; let's see how many of us drink. Deeply.

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