RAILROAD WEEK IN REVIEW

NOVEMBER 2, 2007

"Cornelius Vanderbilt depended on volume and economies of scale to increase his profits" – John Steele Gordon, The Long View, Barron's, October 29, 2007

The 3Q07 Railroad Earnings Season concluded Thursday. While every carrier but KCS reported revenue units flat to down, revenues increased at five of seven Class Is with revenue-per-unit up across the board, save for CP where changes in the traffic mix took the averages down. Operating expense deltas were held to the low single-digits and as a result we saw healthy ops income gains, with UP taking the prize, up 33%. The ORs came down at five of seven properties with UP grabbing another first place, down five points. For the full flavor, see the table following the disclaimer.

Kansas City Southern Q3 total revenues increased nearly 7% yoy, handily beating the 5% sales gain at UP and BNSF's 3% increase. Its freight revs before demurrage etc. jumped more than 7% even as revenue units including the loss of certain NS haulage volume slipped 3% yoy (absent the NS loss, organic revenue units actually increased 3%). Total revs including ancillary charges was $444 mm comprised of the volume slippage mentioned above offset by a whopping 9% price gain complemented by a 0.6% mix delta.

Coal, Auto and chems/pets all posted double-digit revenue increases. The carload sector (ex coal, IM) grew revs by 7% as the forest products group eked out a 1% yoy revenue gain. The volume story was not quite so heady with merch loads off 2.9% including forest prods' 12% revenue-unit decline. Chems, auto and coal were the only increases, 5.3%, 16.7% and 4.9% respectively. System RPU leapt 10.5% aided by the merch group (10.3%, including forest prods +14.8%) and coal, up 11.4%. Operating expense gained a paltry 2.2% with notable gains in casualty and insurance (derailments in Mex) and materials (old locos wearing out). Still, the OR came down another 352 BP to 77.9.

There are a couple of trends worth noting. Starting with 1Q06 the OR has come down in four of the last six consecutive quarters starting at 84.2 and ending with the present 77.9. The 2007 YTD number is 80.2 and COO Art Shoener says they are on track to come in under 80 for the full year, implying a 4Q07 operating ratio of 79 or less. Take a point off the latest number and the OR comes in at 79.3 for the full year. As for revenue, the number has increased in five of the last six successive quarters and is now 31% ahead of the 1Q06 number.

Below the line, eps zoomed up 50% to 48 cents a share from 32 cents in 3Q06 as net income available to common grew 58% yoy. KCS is the only Class I to break out EBITDA and I wish everybody would. It's good to know that Q3 EBITDA for KCS increased more than 7%, in line with and slightly better than the gain in total sales. Interest expense came down 11% and as a result EBITDA-interest coverage increased to 3.17x from 2.67x a year ago. For the nine months FCF before dividends was four times what it was a year ago, $83 mm vs. $20 mm.

In short, the tealeaves are all pointing toward a story of sustained growth. KCS will shed the last of its older leased power in the next few months and will finish taking delivery of the 150 new locos that started arriving on the property a year ago. More than 60% of the $150-mm new-business pipeline has been added this year and the conversion rate thru Sep has been 88% (imagine fielding an 880 hitter!!). Loadings from Lázaro Cárdenas are up 49% and the Panama Canal is setting new growth records – the chart of TEUs handled since 2002 is a classic hockey stick with revs up 50%.

Canadian Pacific President and CEO Fred Green kicked off the Q3 call (presented in person in a 7th floor meeting room at the NYSE – more on that anon) saying that it was "a busy time and a quarter of records." I'll say. Quarterly revs were a record C$1.2 bn, the OR came down 110 BP to a record 72.9 and both RTMs and GTMs jumped 5% yoy. They moved 1.8 mm revenue units, up 6.2% and clearly the best of show. Operating income was up a more modest 7.2%.

Though sales increased but 3.2%, roughly in line with the other Class Is, CP excelled with its revenue-unit gain of 6.2%, and this was the major contributor – not rate increases, unlike some others – to the 4.8% pure revenue gain before the 2.3% foreign-exchange (FX) hit. SVP Marcella Szel showed that all commodity groups except sulphur/ferts and forest products posted revenue gains. Industrial Products, the second largest merch carload revenue generator after grain, grew revenues before FX by 2% on no change in revenue units. Intermodal and coal boosted RUs by 12.0% and 7.3% respectively.

That said, RPU dropped 3.7% thanks to adverse changes in traffic mix, 3Q06 one-time adjustments, FX, and a change in rates for Elk Valley Coal (EVC). Said Szel, the best indicator of price is same-store sales and renewals, up 5.0% and 3.5% respectively, the latter ex-EVC. COO Kathryn McQuade, in her first quarterly call appearance for CP having joined the team in June from NS, reported that they held train-miles to plus 1.5% even as they increased car-miles per day by 4%, a trend that continues into Q4 – "exactly the operational performance the Integrated Operating Plan is deigned to produce," said McQuade.

I found it instructive that CP, alone among Class Is, uses GTMs as the unit measure rather than revenue unit volume. Whereas we generally look at revenue and expense per carload/IM box first, CP reports on GTMs, noting that ops expense per GTM is down 3.5% while GTMs per active employee is up 7%. This in spite of a 26-day strike, more slow-moving bulk trains and higher traffic volumes attributable to the "strong global traffic base" as Fred Green put it.

Working one's way through a CP income statement can be a bit of a challenge because of the foreign exchange and "other" adjustments. However, the bottom line, once you get to it, shows net income up 33.5% aided by a $43 mm FX gain on the long-term debt, nearly wiping out the $45 mm of interest expense. Diluted shares outstanding came down 2% so shareholders saw a 36% eps improvement. Cash from operations increased 27% and capex was essentially unchanged at $569 mm, pushing FCF before divs up by 150%. Divs increased 19% and stock repurchases increased 2%, meaning that FCF after divs and buy-backs was a positive number. I like that.

So much for the morning. We broke for a buffet lunch and an hour later sat down to four hours of insights on what CP has planned for 2008. That will have to wait for next week as there is a LOT of material to digest. My sense is that all CP's short line connections will particularly benefit from what Marcella Szel and Brock Yates, SVP Operations, have to say. Stay tuned.

Genesee & Wyoming rounded out this week's earnings calls with a 9% gain in revenues including carload, intermodal and non-freight (Rail Link contract switching and some AUS) sales. Revenue units were down 6% (Rail Link does not count units) however the all-in revenue per unit increased 10% benefiting in part from the appreciation of the Australian dollar and the Loonie relative to the US greenback. Non-freight revs were up 10%.

The operating ratio improved 3.5 points to 77.4. Ops income for 3Q07 includes a pre-tax gain of $5.5 mm on asset dispo and 3Q06 ops income included a $million expense relating to a legal action. Absent these the OR would have been 81.6 and 80.0 for 3Q07 and 2Q06 respectively. Below the line there's a lot of noise between operating income and net income. Results from GWR's Mex ops for the quarter and YTD are now included under disc ops and add back 18 cents to the reported 42 cents eps in 3Q07 and 85 cents to the reported 29-cent loss a year ago. Thus earnings from continuing ops become 60 cents for the present quarter vs. 56 cents in 3Q06. Also included in the 3Q07 are residual amounts from the ARG sale.

Brian Holtz, a retired short line operator who now has his own consulting practice, writes, "I disagree with the comment in your October 26 newsletter that a significant reason for CN and NS poor showing for the quarter was due to larger cars. I don't believe either carrier or their customers purchased enough larger cars to explain the results.

"My unproven theory is that the more organized and better-run railroads tend to have highly defined operating plans that do not perform as well in downturns as do the less organized railroads. When railroads like CN, highly organized to the point of being a scheduled railroad, have fewer carloads, they still "run the trains" because of service commitments to customers, employees and power requirements. This results in shorter trains as the entire operating plan does not change much or as quickly because of all of the interdependent parts. The upside is that expenses will not change much if/when business returns and expands as trains will fill to capacity and ROI will improve faster than their less organized counterparts.

"In contrast, less-organized railroads face every day as a new day and plan crews, power and run trains as they need them. As a result, they quickly adapt to changing circumstances which result in greater cost swings as business drops or increases and costs swing accordingly. Customer service, employee work schedules, car supply and power dislocation are severely effected and affected as train starts are adjusted daily.

"This said, I believe over time the highly organized and better run railroads will outperform their counterparts and I have stock in these companies. However, I think it is important to recognize the downside of well defined, consistent service and the need for continually rechecking the plan for continual improvement in adjusting plans to the changing business environment.

I believe operating changes are easier for railroads that have a higher percentage of unit coal, grain and intermodal trains that can be quickly and easily combined or annulled. This plus commodity mix would tend to explain why CN performance was poorer than NS; and NS lagged behind BNSF." Thanks, Brian, for the thoughtful taking of the opposite side. Further comment is invited.

Correction: In last week's WIR re NS earnings I wrote," The only revenue gainers were ag and auto…" It should have read, "The only revenue-*unit* gainers were ag and auto…" (Italics added for emphasis). Thanks, Don Seale, for your sharp eye. Also, NS has posted its *Quarterly Financial Review* at www.nscorp.com under the investors tab – click on Reports & Documents and then Financial Reports. Clicking on Third Quarter will take you there. WIR regrets any inconvenience.

Class I Commodity Carload Comps
Quarter ending 9/30/2007
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 4,069	$ 2,023	$ 1,188	$ 2,501	$ 444	$ 2,353	$ 4,191
YOY Pct. Change	3.3%	-0.4%	3.2%	3.4%	6.8%	-1.7%	5.2%
Revenue Units (000)	2,630	1,204	687	1,773	470	1,909	2,522
YOY Pct. Change	-4.7%	-3.0%	6.2%	-4.3%	-2.7%	-4.0%	0.5%
Carload revs (2)	$ 1,764	$ 1,361	$ 650	$ 1,456	$ 340	$ 1,291	$ 2,400
YOY Pct. Change	4.8%	-2.4%	-0.9%	3.8%	7.1%	0.6%	4.6%
System RPU Pct Chg.	8.6%	1.1%	-3.7%	8.0%	10.5%	2.5%	4.6%
Pct carload	43.4%	67.3%	56.7%	58.2%	76.4%	54.9%	57.3%
Pct Intermodal	32.8%	17.8%	30.4%	13.5%	8.4%	20.6%	18.3%
Pct Coal	20.9%	4.6%	13.0%	25.9%	11.4%	24.6%	19.7%
Mdse Carloads (000)	724	771	293	778	255	692	1,010
YOY Pct. Change	1.5%	-2.9%	0.1%	-4.3%	-2.9%	-3.0%	-0.6%
Rev/CL x coal, IM	$ 2,400	$ 1,765	$ 2,218	$ 1,871	$ 1,330	$ 1,866	$ 2,376
YOY Pct. Change	3.2%	0.5%	-1.0%	8.4%	10.3%	3.7%	5.2%
Operating Expense	$ 3,068	$ 1,255	$ 866	$ 1,949	$ 346	$ 1,672	$ 3,186
YOY Pct. Change	1.7%	5.6%	1.6%	1.0%	2.2%	-0.4%	-1.4%
RR Operating Income	$ 1,001	$ 768	$ 322	$ 552	$ 98	$ 681	$ 1,005
YOY Pct. Change	8.7%	-9.0%	7.6%	12.9%	27.0%	-4.8%	33.6%
RR Operating Ratio	75.4%	62.0%	72.9%	77.9%	77.9%	71.1%	76.0%
YOY Point change	(1.22)	3.57	(1.10)	(1.85)	(3.52)	0.94	(5.10)

YTD through 9/30/2007
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 11,557	$ 5,956	$ 3,519	$ 7,453	$ 1,283	$ 6,978	$ 12,086
YOY Pct. Change	4.1%	0.5%	3.7%	3.9%	5.4%	-1.6%	4.0%
Revenue Units	7,718	3,539	2,015	5,355	1,387	5,723	7,289
YOY Pct. Change	-3.0%	-3.8%	3.1%	-3.5%	-2.8%	-4.2%	-1.7%
Mdse Carload revs (2)	$ 5,039	$ 4,116	$ 1,989	$ 4,359	$ 986	$ 3,839	$ 7,039
YOY Pct. Change	4.3%	0.1%	1.4%	3.5%	5.5%	-0.9%	3.4%
MGTM	833,083	258,583	184,218	344,400	70,321	291,200	785,100
YOY Pct. Change	-0.5%	-2.3%	5.7%	-2.9%	0.4%	-5.0%	-2.5%
Pct carload	43.6%	69.1%	56.5%	58.5%	76.9%	55.0%	58.2%
Pct Intermodal	32.9%	17.1%	28.8%	13.4%	8.1%	20.4%	17.8%
Pct Coal	20.6%	4.8%	13.0%	25.8%	11.0%	24.6%	19.2%
Mdse Carloads (000)	2,128	2,286	888	2,384	769	2,096	2,993
YOY Pct. Change	-0.5%	-3.4%	1.4%	-4.6%	-4.2%	#DIV/0!	-3.9%
Rev/CL x coal, IM	$ 2,368	$ 1,801	$ 2,239	$ 1,828	$ 1,282	$ 1,832	$ 2,352
YOY Pct. Change	4.9%	3.6%	3.2%	8.5%	10.2%	#DIV/0!	7.6%
Operating Expense	$ 9,021	$ 3,816	$ 2,661	$ 5,811	$ 1,029	$ 5,079	$ 9,575
YOY Pct. Change	5.8%	4.4%	3.0%	4.7%	2.8%	-1.3%	0.3%
RR Operating Income	$ 2,536	$ 2,140	$ 859	$ 1,642	$ 254	$ 1,899	$ 2,511
YOY Pct. Change	-1.6%	-5.9%	6.2%	1.3%	17.4%	-2.3%	21.1%
RR Operating Ratio	78.1%	64.1%	75.6%	78.0%	80.2%	72.8%	79.2%

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal
Source: company financials
Week in Review for Nov 2, 2007