THE RAILROAD WEEK IN REVIEW
MAY 2, 2008

"We have not seen any indication that a customer stops producing products because of freight rates" – Jack Koraleski, UP earnings call

Union Pacific's first quarter hat trick came in the form of record revenues, record operating income and record eps. The ag, coal and intermodal groups each got hat tricks of their own with gains in revenue, revenue units and average revenue per unit. During the call Chief Commercial Officer Jack Koraleski said all six of the business groups posted best-ever RPUs never mind total revenues units were the same as 1Q07 at 2.33 million.

Freight revenues hit $4.1 bn, up 11%, and operating expense held at plus 10% (fuel was up 45% on 1% fewer gallons consumed and 1% more GTMs) and operating income grew 10% to $788 mm. Train starts and yard starts were down 4% and 7% respectively. Below the line, net income rose 15% to $443 mm and eps increased 20%, helped in part by the 4% reduction in the diluted share count. UP generated $64 mm in free cash flow after capex of $771 mm, proving once again it takes a strong revenue base to support a heavy-haul railroad.

Drilling down to the carload sector where most short lines earn their bread and butter, UP once again brought in nearly 60% of its revenues from the non-coal, non-intermodal commodity groups. Ag and chems posted best-ever revenues while auto and IP (industrial products) scored record Q1 revenues. Export grain (wheat up 80%, feed grains up 32%) and potash volumes were exceptional. UP expects Q2 vols to look a lot like Q1 with ag and energy remaining strong with auto and IP bringing up the markers. Yield continues to rank high on the objectives list and UP expects price increases remaining in the 5-6% range through Dec.

I thought Jack's Q&A response quoted above was instructive on a couple of points. The question was, "Have you heard of any instances where people are saying they have decided to ship less as a result of the transportation cost?" There are three factors to consider. First, as I've written elsewhere, freight rates, unlike passenger fares, don't really change the quantity of transportation goods shippers buy and plants keep churning out widgets because to do otherwise induces gross operating inefficiency. Second, markets shift so that when product cost plus transportation is too dear in Market A then Market B becomes the ideal target.

Third, and a driver of reason #2, transportation costs can by themselves cause market shifts. Thus UP may price itself out of Market A but it may have a superior service into Market B that has even greater yields. It's how you play the producers that will either put business on the rails or take it off. The yield gains we're seeing this Q would seem to point to the rails' success here.

Kansas City Southern in Q1 pushed railroad revenues up nearly 10%, and by holding ops expense to an 8% gain leveraged a 15% ops income gain. Fuel expense was up 25%, less than what we're seeing elsewhere. The two main factors were (a) new locomotives and (b) more favorable fuel prices in Mexico where nearly half the business lies. Higher system velocity and reduced dwell times helped. The OR continued its yoy slide to 81.5 in the quarter just passed from 84.2 in Q06.

Revenue increases show the same sequential improvement since 1Q06, starting at $388 mm to the $451 mm in 1Q08. COO Art Schoener said during the call that the leading commodities in terms of sheer dollars and yoy deltas continue to be chems and ag products. Pricing was not as aggressive as

one might like with ags/minerals and intermodal the only double-digit RPU gains. Still, KCS eked out a 9% RPU gain in the merch carload sector, lagging by a couple of points or more the deltas seen on the other US Class Is. This ought to be a vital concern for KSC because the merch carload commodity groups account for 77% of the revenue stream, up 70 BP from a year ago. Reported volumes were off a point though absent a marginal haulage move vols actually increased 4.6%. That's business well shed because it clogs up an increasingly busy core railroad, eating up crews, locos and track time in its wake.

Below the line, KCS, like CP and CN, has foreign exchange to cope with and like CP has equity income from affiliates between operating income and net income. Then there are those pesky preferred shares. Even so, yoy quarterly net income leapt 70% and net income to common shareholders nearly doubled to $0.39 from $0.21 per ticket.

KCS has another strength in common with CP: An aggressive pipeline management program. Through April 2008 the new business opportunity portfolio stood at $126 mm against a revenue conversion rate through Mar of 53% and incremental new business won adding $23 mm in sales. New opportunities added in 1Q08 are pushing $50 mm.

Finally, CEO Mike Haverty said in his closing remarks that Rosenerg-Victoria is so important they are going ahead even without the RRIF loan. We've already beat the economics to death here, so I won't go there again – suffice to say it gives back all the assets that overhead business was taking away. Then there's the Meridian Speedway. Haverty said during the Q&A they've got CTC across it and can do 30 trains a day with IM running times now under 12 hours. A solid quarter all told.

Genesee & Wyoming did not have the best of quarters. Ops income dipped 9% yoy to $21 mm as expenses rose more than 17% on a revenue gain of just 12%. Non-freight (ports and smallish short lines) contributed 38% of revenue, up from 33% a year ago. It's been harder to tell exactly where GWR is making its commodity carload revenue since they combined US and Australian results; further complicating matters is the Australian grain take-or-pay deal that in effect generated a 36% jump in farm & food RPU on a 19% drop in revenues. There was also a 69% drop in haulage volumes and coal was off 7% talking total revenue units down 9% yoy.

Below the line the ARG sale gain and equity income lines are gone, so it's a lot cleaner. EPS from continuing ops was 31 cents, well below previous guidance of 40 cents. Reported EPS after disc ops was 29 cents, down 16% yoy. Free cash flow was $5 mm even though cash from ops was $8 mm and $16 mm went for capex. The difference is $10 mm in government grants -- which goes to show how tax credits and other programs can help short lines. But the real story is acquisitions.

Here is an excerpt from the earnings call that gives us a good look at GWR's approach to acquisitions and where they maybe heading from here. Ed Wolfe asked, "Are you at a point now where management is stretched for making further acquisitions? Shall we think this is it for now, or is it going to be further bolt-ons in Europe? How we do think about that going forward?"

To which Jack Hellman replied, "That's a great question. The answer is no, we're not stretched at all right now. The CAGY acquisition folds right into our Southern region and is a very seamless transition. It is not a traditional tuck-in acquisition in that this is a growth franchise that has a diversified core business [complemented by] a very large steel mill that is expanding output as we speak, investing in further expansion into 2009/2010. [Thus the CAGY] acquisition is more of a forward-looking growth story" that does more than simply reducing overhead as in the South Buffalo, for example, where the savings took the effective EBITDA multiple down a couple of points. "In this case, you've got a growth business."

"With respect to the Netherlands, the minute you go overseas you're making what's deemed to be a platform acquisition. It's one that will require more management time from our business development team as the growth of that business could be through further equipment investment or potentially other acquisitions. So that's the only place where you think about draws on management time. But [as for further] acquisitions, there's nothing holding us back. We have the resources and the manpower in the organization [so] we can easily look at several more. I couldn't have said that to you a couple years ago, but we're much deeper in our management bench."

BNSF took the top spots among the seven Class Is for percent changes in total revenue, merch carload revenue, system RPU, increase in merch carloads handled and was second to CSX in operating income increase (see table attached). For the first time ever fuel expense was greater than comp/benefits at a $billion-nine, up 55%. (Which reminds me – calculating crew-start costs for a short line recently I found fuel expense at $4 a gallon now exceeds crew cost for a 10-hour day.) Revenue, units and tons were all first quarter records.

Ag revs increased 38% on 15% greater car-count as RPU increased a healthy 20%, with all three metrics best of breed. Ethanol revenues nearly doubled while wheat, beans, corn and ferts all posted double-digit yoy revenue gains. The Industrial Products (IP) group gains were less heady, though impressive nonetheless. Construction products (steel, taconite, minerals, e.g.) sales were up 26% followed by petrol prods up 18%, chems up 9% and food/bevs up 7%; building products, alas continues to lag, down 5% yoy.

Velocity, service and productivity remain the key operational drivers. Loco productivity is closing in on 300 miles/day and cars are closing in on 200 miles/day. Coal, ag and intermodal scored the best on-time performance scores, which is to be expected given their largely point-to-point operating patterns. IP is five points better than it was in 1Q06, perhaps the results of BNSF's leadership in the AIM (Assess, Improve, Maximize) merchandise carload initiative.

As noted above, ops income was up 26% as ops expense including fuel rose but 15%. The operating ratio came down 1.5 points to 79.5 (note: BNSF says 78.9 as they use ops expense less other revs over freight revs whereas the classic OR is simply total ops expense over total revs). Net income improved 30% and EPS hit a buck-thirty, up 35% as diluted shares decreased 3%. Free cash flow after capex was $463 mm, half again what second-place NS brought in.

Wrapping up the formal remarks during the call CEO Matt Rose said, "We anticipate freight revenue growth in the mid teens, on flat unit volumes. Drivers of this growth should be similar to the first quarter with continuing strong yield improvement across our four major business segments. We're clearly benefiting from the diversity of our franchise and expect EPS for 2008 to approach $6 per share. We continue to expect free cash flow after dividends to approach $1 billion and we are committed to resuming our trend of improving our return on invested capital."

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Class I Commodity Carload Comps
Quarter ending 3/31/2008
Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	KCS	NS	UP
Railroad revs (1)	$ 4,261	$ 1,927	$ 1,147	$ 2,713	$ 451	$ 2,500	$ 4,270
YOY Pct. Change	16.9%	1.1%	2.8%	12.0%	9.6%	11.3%	10.9%
Revenue Units (000)	2,486	1,132	648	1,717	452	1,828	2,335
YOY Pct. Change	-0.8%	0.1%	2.2%	-2.2%	-1.0%	-4.0%	0.0%
Carload revs (2)	$ 1,934	$ 1,310	$ 661	$ 1,544	$ 348	$ 1,352	$ 2,495
YOY Pct. Change	21.8%	-3.1%	1.9%	9.3%	10.3%	10.1%	10.9%
System RPU Pct Chg.	17.9%	0.3%	0.8%	14.5%	10.6%	13.9%	11.0%
Pct carload	45.4%	68.0%	58.8%	56.9%	77.2%	54.1%	58.4%
Pct Intermodal	29.5%	18.2%	28.8%	12.8%	7.9%	19.4%	16.6%
Pct Coal	22.4%	4.7%	12.5%	28.1%	10.4%	26.5%	20.1%
Mdse Carloads (000)	678	718	286	746	255	661	957
YOY Pct. Change	7.1%	-2.4%	-0.5%	-4.8%	1.2%	-2.8%	-0.5%
Rev/CL x coal, IM	$ 2,664	$ 1,825	$ 2,307	$ 2,070	$ 1,361	$ 2,047	$ 2,607
YOY Pct. Change	13.7%	-0.7%	2.4%	14.9%	9.0%	13.3%	11.5%
Operating Expense	$ 3,386	$ 1,404	$ 949	$ 2,087	$ 367	$ 1,922	$ 3,482
YOY Pct. Change	14.7%	4.4%	7.0%	7.7%	8.4%	11.8%	11.2%
RR Operating Income	$ 875	$ 523	$ 198	$ 626	$ 83	$ 578	$ 788
YOY Pct. Change	26.1%	-6.8%	-13.6%	29.1%	15.2%	9.5%	9.6%
RR Operating Ratio	79.5%	72.9%	82.7%	76.9%	81.5%	76.9%	81.5%
YOY Point change	(1.50)	2.29	3.27	(3.05)	(0.91)	0.38	0.23

(1) CN, CP in $Canadian
(2) Excludes coal, intermodal
Source: company financials
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