RAILROAD WEEK IN REVIEW
SEPTEMBER 1, 2006

"When people worry more about the future the risk for spending tends to be greater." – Susan Sterne, Economic Analysis Associates, in WSJ 8/29/2006

UBS Securities LLC produces a very useful research document that provides insights on the relationship between the economy in general and the housing market in particular. Some excerpts: Housing starts will continue their downward trend as homebuilders report an increasing number of contract cancellations. The smallest percentage of households in 15 years think now is a good time to buy a different home. Moreover, recent gains in household purchasing power were largely powered by "equity extraction," which is closely linked to home sales proce inflation. "What," asks UBS, "could happen to consumer spending if such borrowing suddenly swooned?"

Energy prices have been a major factor as they affect purchasing habits and utility prices. However, the Fed seems to think that the rate of energy rice increases to slow in 2H06 and 2007. This in turn will cause a slowing in the core inflation rate. UBS concludes, "U.S. energy consumption as a percent of GDP has been falling, indicating that energy savings adjustments do occur."

The message to shortlines is that to the extent your base traffic business is housing related – lumber, wallboard, cement, bricks, etc. – you'd better tighten your belt (WIR 8/25/2006). RMI's RailConnect Index for Week 31 through August 5 (attached) showed lumber down 5% for the week and 11% YTD. The AAR for Week 31 (also attached) reported lumber down 3% for the week and 3% YTD, which indicates that percentage-wise shortlines are bearing the brunt of the building products slowdown.

As we've noted before, half the performance of any given stock is a function of its sector. Since May, when the cyclicals started selling off, the best performing sectors – in terms of potential rail traffic at least -- are utilities, energy consumer staples (think soup, soap and cereals). Note YTD grain is up 4% on shortlies and 3% on Class Is; YTD coal us up 6% on shortlines and 4% on class Is.

The difference, IMHO, between trading stocks and investing in companies is one of attitude. In a sideways market such as we've had for most of the year one owns a stock as long as the numbers are meeting expectations and when they turn south, one heads for the sidelines. The rule here is "the trend is your friend" and he who bucks the trend may not fare well. I made the mistake of not selling BNI when the lows started getting lower and the highs not as high, losing 20% of my initial stake before exiting. On the other hand, I sold off NSC and CNI a bit at a time and didn't do too bad.

I'm basically a fundamentals guy who buys shares in companies that have good business practices and solid investment fundamentals. I also use the technical indicators to identify bottoms for buying and tops for selling. I don't buy shares in companies whose industries I don't understand (high tech, high finance), have a track record for attracting lawsuits and governmental interference (medical) or that are commodity-based (ADM, BTU, VLO). That pretty much leaves the utilities and industrials sectors, the latter of which includes railroads.

The common thread in the industrial sector is manufacturing (CAT, DE, UTX) and services (BNI, UPS, FDX). The financial reports are straight-forward and one can see quickly how well the company performs for its owners. Chart I lists a few measures of value in terms of company performance as measured in owner returns. A word of explanation is in order.

A key measure of management effectiveness is creating value and the measure is how much market cap changes per dollar change in yoy *retained earnings*. I subtracted 2001 retained earnings from 2005's and did the same for market cap. By this measure, CN created $4.25 of market value for every dollar of retained earnings 2000-2005. Railroads are capital intensive businesses and there's always some LTD and thus *interest* to pay. But interest payments to lenders can't go into the infrastructure, so the less paid out as a percentage of operating income the better.

Shareholder equity as a percent of enterprise value (operating and capital leases omitted for the nonce) is an indicator of leverage. The more money borrowed to support the asset base the less equity there can be (equity equals assets minus liabilities). I look for the highest number here. Earnings per share are really returns on the share price and again the high number wins.

Cash is king in any business because without it you can't build the business. Because railroads consume assets, what's consumed must be continually replaced. *Free Cash flow* – cash from operations less capex -- as a percent of sales tells me how well the company manages the wasting asset and still has money left over to pay dividends, buy back shares, or buy other railroads. *Intrinsic Value* is tricky. It tries to get a handle on how much of a return owners may expect over time and how that return translates into future stock prices. I use an on-line calculator (www.moneychimp.com/articles/valuation/buffett_calc.htm) with the 5-year growth rate from Yahoo.com and 3% beyond.

Then I take the current stock price as a percentage of the intrinsic value to get a sense of how much I'm paying for that intrinsic value in *cents on the dollar*. Then I score the lot: a point for every first-place and half a point for every second. I'm looking for Best of Breed and by these metrics CN gets the nod. Look for me to add to that position over the next few weeks.

Performance Metrics have always bothered me, especially train speed. We talk about velocity but I can ride my ancient 12-speed road bike faster than most system train speeds without breaking a sweat. How can this be? The AAR says "Train Speed measures the line-haul movement between terminals. The average speed is calculated by dividing train-miles by total hours operated, excluding yard and local trains, passenger trains, maintenance of way trains, and terminal time."

In other words, train speed reflects transit time point-to-point between terminals. And if transit times are this slow there must be a lot of delay between train-start and tie-up. Where is it happening and why? Amtrak's "Monthly Performance Reports" are a start and they're available on the Amtrak website. Section C, the "Route Performance Report," and Section E, "Performance Indicators," are particularly revealing.

The top three host railroads in train miles are BNSF (18.2%), CSX (16.2%) and UP (15.6%). Amtrak scores minutes of delay per 10,000 train-miles and from most to least they rank D&H, UP, and NS. Top scorers (least minutes) were CP/Soo and BNSF. Kinda gives you an idea how the host railroads must treat their own freight customers. Slow orders and signal delays affect both freight and passenger and Amtrak tracks both by host railroad. UP and CSX had most delay minutes in the two categories combined.

The AAR Performance Measures for July (US roads only) ranks all trains train speed in MPH thus: BNSF 22.9, NS 22.1, UP 21.6 and CSX 19.6. The Southwest Chief running over the BNSF transcon east of KC and west of Belen was on time at destination 76% of the time in May. As you know, I rode the transcon with Matt Rose and company in March (WIR 3/31/2006) and Velocity with a capital V is the name of the game out there. On the other hand, CSX does not fare well on its I-95 corridor to Florida. May's best on-time performer was the Silver Meteor at 11%. It's all on page E-2.

Want to check out present performance? Go to the Train Status section of the Amtrak home page and plug in the California Zephyr. It was running 8 hours late eastbound on Tuesday, most of which was incurred on the UP. Wednesday's Vermonter was actually making up time on RailAmerica's NECR once it got out of Metro North's clutches. The northbound Crescent was 40 minutes late into Atlanta but 20 minutes early into Washington.

The bottom line is that investors need to be watching this stuff to see *why* system train speeds are so laughable when compared to truck speeds – 80 MPH on I-80 across Nebraska and straight through Denver. It all comes back to *running to plan*, and the CN and BNSF take the honors here. I mean, Hunter Harrison's book *How We Work and Why: Running a Precision Railroad* wouldn't mean much if shippers can't depend on scheduled service. Larry Kaufman's *Leaders Count* documents the BNSF culture and why it works. And BNSF's own Dave Dealy's *Definining the Really Great Boss* provides further insight as to how a company's culture can affect performance.

Amtrak this week tapped Alexander Kummant as president, succeeding David Gunn, who was dismissed last November. Kummant is leaving Komatsu America where he was EVP and Chief Marketing Officer and will start with Amtrak Sep 12. Prior to joining Komatsu Kummant had worked for UP from 1999 to 2003, working up to Regional VP.

What a remarkable coincidence as UP is one of the worst host railroad performers for Amtrak (May Performance Report, page E-2, Under/Over Recovery). The Coast Starlight, Texas Eagle and Sunset to New Orleans are all UP trains; it also handles the California Zephyr west of Denver. Another coincidence is that he is married to the former Kathleen Regan, whom shortliners will remember from her excellent e-commerce presentation at BNSF's2003 shortline conference. BNSF's performance with Amtrak is a lot better that UP's. The Empire Builder and Southwest Chief are second only to CN's City of New Orleans by the same metric. The kitchen table conversation ought to be interesting.

GWR is making good on its promise to keep buying properties. They picked up Gulf & Ohio's H&S and Chattahoochie & Gulf (CHAT) lines for $6 mm on Wednesday. The purchase is more along the GWR model of contiguous railroads and access to multiple Class Is. CHAT extends east from Dothan AL over to Hilton GA to connect with NS, itself being a former C of G line. HS is also former C of G, extending west from Dothan. The acquisitions give the Bay Line (part of the Railroad Management acquisition) further reach and direct access to NS for the first time.

Meeting Notice: Transportation Clubs International Education Conference, Crowne Plaza, Cherry Hill, NJ, Sep 14-16. TCI has more than 60 clubs and 8,000 members and exists "to stimulate and perpetuate" exploration of transport-related topics. Friday's Shortline panel will be of special interest to WIR readers. Recently retired Genesee & Wyoming Vice Chair Charlie Marshall will team up with SMS Rail President Jeff Sutch and others to discuss shortline concerns from the merch carload business to Class I relationships to the implications of today's traffic crunch on short lines. For more information send an e-mail to Rian Nemeroff, riannemeroff@hotmail.com .

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Table I. Class I Railroad Valuation Measures

Value Measures	BNSF	CN	CP	CSX	NS	UP
MV/RE* 2001-05	$ 0.70	$ 4.25	$ 2.43	$ 2.28	$ 4.01	$ 1.72
Int pd/ops inc	15.0%	11.4%	20.4%	27.3%	23.3%	28.1%
SHE/ev	39.1%	33.6%	45.7%	46.8%	39.8%	46.2%
2007 eps est	$ 6.67	$ 3.23	$ 3.70	$ 2.55	$ 3.76	$ 6.68
Recent price	$ 66.06	$ 42.55	$ 39.18	$ 26.69	$ 42.40	$ 80.94
EPS return	10.1%	7.6%	9.4%	9.6%	8.9%	8.3%
FCF Y	6.6%	21.1%	3.8%	0.2%	8.3%	3.1%
ROE	16.1%	16.8%	12.4%	11.5%	13.8%	7.5%
Intrinsic Value	$ 196.38	$ 122.00	$ 128.43	$ 105.90	$ 147.04	$ 225.31
Cents on the Dollar	$ 0.336	$ 0.349	$ 0.305	$ 0.252	$ 0.288	$ 0.359
Firsts	1	4		2		
Seconds	2	-		1	3	1
Score	*2*	*4*	*0*	*2.5*	*1.5*	*0.5*

Source: WSJ, Company materials

*Dollar change in market value per dollar change in retained earnings

RailConnect Index of Short Line Traffic

Traffic Type: All

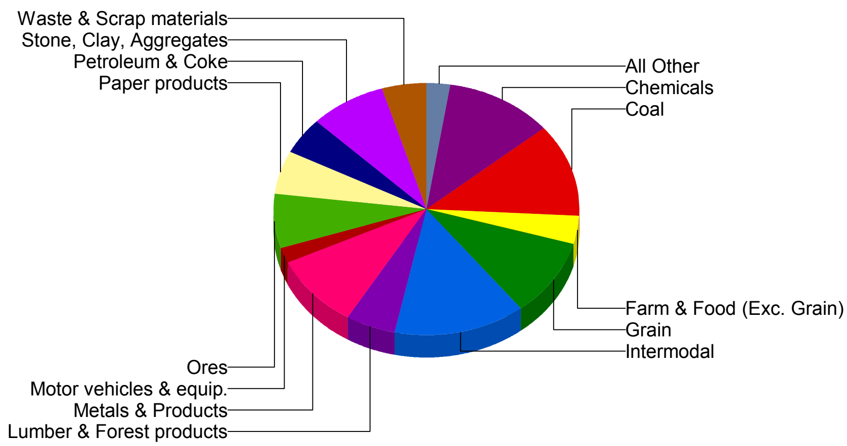
For the week ending: 8/5/2006

Week Number: 31

Carloads Handled	Current Week			Year-To-Date		
	2006	2005	% Change	2006	2005	% Change
Coal	15,421	14,904	3.47%	453,129	426,000	6.37%
Grain	11,913	12,970	-8.15%	379,225	363,855	4.22%
Farm & Food (Exc. Grain)	4,217	4,105	2.73%	131,306	122,522	7.17%
Ores	9,425	8,513	10.71%	266,588	274,109	-2.74%
Stone, Clay, Aggregates	11,484	11,150	3.00%	301,781	280,640	7.53%
Lumber & Forest products	6,340	7,102	-10.73%	194,701	205,920	-5.45%
Paper products	7,127	7,376	-3.38%	211,024	215,891	-2.25%
Waste & Scrap materials	6,267	5,065	23.73%	179,583	163,886	9.58%
Chemicals	14,050	13,784	1.93%	424,016	427,291	-0.77%
Petroleum & Coke	5,553	4,890	13.56%	174,534	158,480	10.13%
Metals & Products	10,571	9,533	10.89%	357,839	322,203	11.06%
Motor vehicles & equip.	1,843	1,924	-4.21%	68,557	67,217	1.99%
Intermodal	17,660	18,879	-6.46%	527,876	508,582	3.79%
All Other	3,313	2,785	18.96%	99,134	90,115	10.01%
Total	**125,184**	**122,980**	**1.79%**	**3,769,293**	**3,626,711**	**3.93%**

RailConnect Index

Year-To-Date



All Other	2.6%
Chemicals	11.2%
Coal	12.0%
Farm & Food (Exc. Grain)	3.5%
Grain	10.1%
Intermodal	14.0%
Lumber & Forest products	5.2%
Metals & Products	9.5%
Motor vehicles & equip.	1.8%
Ores	7.1%
Paper products	5.6%
Petroleum & Coke	4.6%
Stone, Clay, Aggregates	8.0%
Waste & Scrap materials	4.8%
Total:	100.0%

Weekly Traffic of Major U.S. Railroads

For the Week Ending August 5, 2006

Traffic Originated	Week 31 Ending August 5, 2006			Cumulative, 31 Weeks Ending August 5, 2006		
	2006	2005	Change	2006	2005	Change
Carloads Originated						
1. Grain	22,280	21,472	3.8 %	698,559	676,771	3.2 %
2. Farm Products, Ex. Grain	1,000	1,077	-7.1	35,022	34,951	0.2
3. Metallic Ores	7,909	8,651	-8.6	201,256	222,574	-9.6
4. Coal	139,334	131,799	5.7	4,314,216	4,138,320	4.3
5. Crushed Stone, Sand & Gravel	24,315	23,499	3.5	719,712	685,818	4.9
6. Nonmetallic Minerals	6,665	9,138	-27.1	185,061	233,312	-20.7
7. Grain Mill Products	9,561	9,461	1.1	289,361	291,475	-0.7
8. Food & Kindred Products	8,667	8,664	0.0	267,272	258,125	3.5
9. Primary Forest Products	2,592	3,095	-16.3	87,016	99,768	-12.8
10. Lumber & Wood Products	5,528	5,695	-2.9	183,531	188,201	-2.5
11. Pulp, Paper & Allied Products	8,259	8,729	-5.4	254,846	265,743	-4.1
12. Chemicals	30,331	28,325	7.1	917,709	937,475	-2.1
13. Petroleum Products	6,254	6,198	0.9	188,390	184,253	2.2
14. Stone, Clay & Glass Products	10,267	10,528	-2.5	311,486	318,865	-2.3
15. Coke	4,697	6,250	-24.8	173,862	182,874	-4.9
16. Metals & Products	14,176	12,285	15.4	446,699	409,872	9.0
17. Motor Vehicles & Equipment	17,661	21,567	-18.1	670,376	687,958	-2.6
18. Waste & Scrap Materials	9,636	9,008	7.0	312,571	300,980	3.9
19. All Other Carloads	4,917	4,504	9.2	159,151	142,072	12.0
Total	**334,049**	**329,945**	**1.2 %**	**10,416,096**	**10,259,407**	**1.5 %**
Intermodal Units Originated						
Trailers	57,097	57,629	-0.9 %	1,719,801	1,702,427	1.0 %
Containers	184,564	172,384	7.1	5,489,779	5,073,263	8.2
Total	**241,661**	**230,013**	**5.1 %**	**7,209,580**	**6,775,690**	**6.4 %**
Estimated Ton-Miles (Billions)						
Estimated Ton-Miles (Billions)	33.6	32.7	2.8 %	1,030.5	1,002.9	2.8 %