RAILROAD WEEK IN REVIEW
OCTOBER 13, 2006

"Union Pacific has the greatest opportunity for margin expansion of the major railroads." – Tom Wadewitz, JP Morgan

Jason Seidl, rail analyst for Credit Suisse, attended the recent *Rail Trends* conference in NYC and writes, "Railroads, shippers, and governmental agencies came together to discuss various issues on the front burner for the railroad industry. With the industry appearing stretched from handling record carload volumes over the past couple of years, many shippers and policy makers expressed concern over the railroads' ability to handle future growth.

"Indeed, Burlington Northern Santa Fe CEO Matt Rose and Association of American Railroads (AAR) CEO Ed Hamberger both touted potential benefits from the proposed 25% tax stimulus for expansionary capital investment — which appears to have fairly widespread support among members of the shipping community (although we note that UPS, the rail industry's largest shipper, does not support the bill).

"Additionally, shippers expressed willingness to collaborate efforts with the railroads on other issues such as security and common carrier obligation caps. However, these efforts require reciprocation on behalf of the railroads — such as offering to the shipping community improved fuel surcharge application methods (i.e. mileage based instead of revenue based).

"We note that shippers acknowledged that service has gotten better this year, but maintain that is not yet where it should be. Re-regulation was also discussed — an issue that the railroads vehemently reject. Mr. Rose and Mr. Hamberger agreed, arguing that if such attempts were successful (an event we view as unlikely) the rail industry would react with an abrupt pull back of capital spending (something the shipping community would clearly not want)." Thanks, Jason.

Tom Wadewitz, rail analyst at JPM, writes that at the 10/3 UP analysts meeting (WIR 1/6) "management clearly communicated their focus on raising returns within their business through a combination of pricing gains, targeted volume growth, and productivity improvement. We believe management has the right focus, but we suspect patience will be required." And that's my take too. UP has the biggest, strongest franchise in North America but due to a number of mis-steps over the past few years has not fully realized that potential.

Results have not been on a par with other investments (see FLA notes, WIR 9/29). On a per-share basis over the five years 2001-2005 operating income declined 26% to $6.74 from $9.08 even as revenue grew 13% to $50.95 from $43.65. Earnings were up just 3% to $3.85 from $3.77, indicating that operating expense was eating up much of the revenue gains. The share count is up 7% to 266.5 mm from 248.0 mm while elsewhere we see aggressive share buyback programs in place.

The view from here is that the operating railroad has not kept pace with the commercial values espoused by Jack Koraleski and his team. The good news on 10/3 was that COO Dennis Duffy now appears to have the leadership team and direction he needs to improve operating results and drive earnings from above the line. In his remarks (see duffy_slides.pdf under investors at www.up.com) Duffy reiterated the need to align the supply of railroad services (what the RR produces) with the demand for them (what shippers are willing to order).

The five key supply ingredients are designing the product in the context of what can be achieved, maintaining for reliability, transferring knowledge effectively, using the resources at hand to support service demand, and leveraging the network – another asset utilization angle – to generate maximum yield. None of this is new. We see these ingredients long baked into the operating pies at NS, CN and BNSF in particular. It's the top-down, systems approach to railroad operations management pioneered by none other than NYC's Al Perlman. It put to rest the old way of letting division supers run their own fiefdoms with little regard for how their actions might affect the next guy down the line (a nod to Rush Loving in *The Men Who Loved Trains*, a seminal tome if there ever was one).

Based partly on Duffy's remarks last week and on what I saw from the "Shortline Special" (WIR 9/29), UP embraces the former. Out on the line, we saw trains dragged out of yards but held, not for power or crews, but because they were Conway trains being held to help NS remain fluid while it dealt with the Pittsburgh landslides. Moreover, Duffy told the analysts they are using Local Operating Income Statements to measure terminal and division performance. The real benefit will be to hold managers accountable for what they're managing.

Wadewitz continues, "UP is committed to a significant rise in capital spending in order to expand track capacity to both realize network fluidity and to handle future growth in coal and intermodal. We believe substantial investment in the Sunset/ intermodal corridor would be justified by productivity opportunity alone…While there remains meaningful execution risk, we believe that UNP has the opportunity for greatest margin expansion of the major railroads over the next few years and we continue to see upside for UNP stock."

Bear Stearns' Ed Wolfe sees "plenty of yield and productivity improvement for UNP, regardless of the economy. UNP still has 32% of its business that has not been re-priced since 2004, while network productivity and margins should improve as management continues to focus on the Unified Plan. Management estimates that roughly half of its business is not earning its targeted rate of return and affirms 3Q guidance of $1.40-$1.50/share despite track outages on its Sunset line in August and modestly lower than expected volume growth.

"UP also maintained CY 2006 guidance of $5.50-$5.60/share and raised its longer-term revenue growth forecast from about 5% previously to 6%-8%, with more yield in the near-term and volume growth in out years as capacity increases. The preliminary 2007 capex budget of $3.2B is up roughly 15% from $2.8B in 2006. Mgmt. originally announced the possibility of raising its capital spending on its 2Q earnings call.

"While UNP did not set a firm target to finish double-tracking the Sunset route, we don't expect it to be completed prior to 2011, in-line with our earlier expectations. We continue to like the near and longer-term trends for the U.S. rails, including UNP. However, we recommend that investors purchase the large cap rails when they are at or below their historical mid-range forward P/E of 13x." In other words, both Wadewitz and Wolfe sense a Union Pacific turnaround in operating efficiency and revenue yield that will ultimately show up in stock price appreciation.

Shortlines can help. We spoke before about ingredients. Well, the recipes are all there in the slides. If I were running a shortline connecting with the UP there are three things I would do right away. First, I'd put CIMS (Duffy slide 9) into effect for every customer. Second, I'd drill down into the capacity determinants (network slide 4) to see where I could improve revenue yields. Third, I'd use the Local Operating Income Statement (field ops slide 7) to measure at the very least *consumables* for every revenue carload. (See www.rblanchard.com/resources/consumables.htm for more on this, a discipline Watco uses very effectively.)

The Livoinia, Avon & Lakeville, a venerable shortline in upper NY state, took FRA Administrator Joseph Boardman on a tour recently and the outcome was good for the LAL, the communities served, and the shortline industry as a whole. Members of The Press toddled around in the wake of Boardman's entourage and came away impressed. "Some of the biggest employers in the county wouldn't be there but for the LAL," gushed WHAM, the ABC outlet in Rochester.

The purpose of the trip was to let Boardman see how rail transportation supports area job growth. The tour included a train ride to see new and existing businesses that the LAL serves. It must have worked. WHAM quotes the Administrator as saying, "This morning I've had the chance to see the progress being made here. And I can tell you the work being done is about more than putting pasta on the dinner table. It's about creating optimism and opportunity for this region and for the entire nation." He was referring to the new Barilla pasta plant, though the LAL also serves Sweeteners Plus, Perdue Farms and the Kraft plant where Cool Whip is made. Barilla will bring in 120 new jobs and will open in 2009.

The Public Broadcasting radio outlet, WXXI, noted that "Barilla picked Avon because it has good railroad connections to bring raw materials in, and is close to Interstate Highways that lead to its top markets. Railroad President Bill Burt says trains can carry bulk products for a quarter the fuel per-ton that long-distance trucks would need. He says manufacturers are moving to ship raw materials in long distance by rail and finished product out by truck. The LAL is investing five million dollars into upgrading its tracks from Henrietta south to Avon, some of which was originally laid by the former Erie Railroad in World War One."

The LAL story is yet another example of what creative and aggressive shortline operators can do to create an important niche for themselves. I spoke the other day with Rob Robinson, Norfolk Southern's new AVP for shortlines and the topic turned to the need for successful shortline owners to mentor others. My thesis is that business development skills in particular are uneven across the shortline community and that mentoring is one way to fix it.

In my travels I see a common thread among successful shortline marketers: the ability to think in terms of customer supply chains, not just what happens to be moving at the moment. Whether the customer manufactures carpets for office buildings or sells building materials to DIYers, there is bound to be a sizeable collection of inbound products from many origins and, depending on the customer, possibly outbound finish goods to rail-served markets.

Finding the ins and outs is easy. If a public company, go to the 10-K; if private, ask. Determine the daily/weekly/monthly raw material burn and outbound shipments by market. Then see if you can develop a rail product to fit the supply chain and inventory management requirements. For dessert, look around and see if you can help other shortlines do the same – mentor them. Like UP's Dennis Duffy says, "We must align the supply of railroad services (what the RR produces) with the demand for them (what shippers are willing to order)." For proof in shortline-dom, see the LAL.

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