RAILROAD WEEK IN REVIEW
JANUARY12, 2007

“CNI has a materially higher operating margin, return on total capital and free cash flow return on capital than its peers.” – Ed Wolfe, Bear Stearns

Rail sector stocks have entered another lull similar to what we saw last May. The Market Edge technical signs letter has *Avoid* on nine of ten rail stocks and the sole *Long*, KSC, is weakening. Among suppliers Trinity and Greenbrier are both *Avoid* and RailCar America is a cautionary *Long* and not a buy. FSTR (which I own in my RA) is still a *Long* although with caveats.

But tech signs of weakness can mean opportunity when the fundamentals of the company remain firm. Just today Bear Stearns upgraded CNI to Outperform from Peer Perform calling it “an opportunity to buy the highest quality rail on weakness.” There are two reasons. First, at $44.06 (mid-day Friday) CNI is down about 10% from the recent high of $48.77 hit mid-Nov. Second, the 2007 Street estimate of $3.32 yields a PE of 13.3, toward the low end of where “quality rails” trade.

Bear’s Ed Wolfe writes, “CNI is finally positioned to grow volumes in 2007**.** For the past 15 months CNI management has publicly focused on accelerating its volume growth with little result (volumes are flat over the past two years). We view deferred volumes from recent storms, easy comparisons (particularly paper & lumber), the beginning of Prince Rupert intermodal volumes, continued Canadian oil sands business and potential acquisitions as drivers of volume growth during 2007.”

Moreover, “CNI has a materially higher operating margin, return on total capital and free cash flow return on capital than its peers. It also has the best proven record in the rail sector for performing in a downturn and successfully making and integrating acquisitions. For these reasons we believe CNI should trade at a premium and not a discount to the group.” Couldn’t agree more.

NSC is another carrier in that class. Its recent high was $55 in late Oct and it was down 10.5% from there at Friday’s open. NSC expects to earn $4 a share in 2007 for a PE of 12 and change. I’ve been buying NS in increments below $50 and think we’ll see $59 by next Peak season. The Street pegs NSC’s five-year annual growth rate at 16% meaning a PEG of 0.75, clearly a Buy indication.

Back-testing is a very useful tool to find trends and returns over time for a basket of stocks. I run a test on a number of tech indicators selected to show returns over 100 days with no trading in the time frame. My list includes value stocks like MO and growth stocks like AAPL. To this brew I add the railroads plus suppliers from ARII to WAB.

FLA, CP and CSX show returns of 15%, 12% and 9% respectively. NSC, RRA, PWX and GWR return minuscule but positive returns; the rest fall off the chart because negative values are suppressed. How can this be? FLA’s Florida East Coast Railroad has dominated corporate returns and the Florida market is growing nicely. CP was up 25% in Oct but has since given back half the gains and CSX has done a terrific job selling itself to The Street on pricing and yields even though revenue unit volume increases haven’t been particularly outstanding through 3Q03, up 0.3% yoy.

The magic of CSX’ eps results and thus stock price appreciation comes from cutting volumes in low-margin lanes (short-haul ferts in Fla, e.g.) and taking up rates in high margin business – double-digit RPU gains in food & consumer, metals and chems, e.g. CSX has also been doing some neat things to lower ops expense and interchange costs with shortlines (more on this next week). And once again the shortline focus has to be on taking CSX' lead in product and commodity differentiation. When both shortline owner and CSX market manager know the avoidable cost of every commodity lane both are better off and the customer gets a superior product.

Here's yet another indication that forest products companies are not yet out of the woods. S&P analyst Stuart Benway cut TIN to three stars (hold) from four (buy) based on S&P's outlook for "a 17% decline in housing starts for the year." TIN is presently close to the S&P 12-month price target of $48 ($46 on Friday at 1400) so the upside is limited. The housing situation, says S&P, will invariably lead to "reduced prices and profits for lumber and wallboard, and limiting growth in Temple-Inland's financial services and real estate units."

Among the forest products companies in my "railroad commodities" basket TIN has seen the most price appreciation -- up more than 6% from its SMA-50. IP, WY and BOW, while all positive, are not having what one would call a banner year. And RMI's RailConnect Index of shortline traffic shows lumber off 29.4% for the full year. Recall too that the forest products group as a whole sports RPU numbers slightly higher than average for the Class Is, meaning it's not exactly a high-margin business and that's one reason so much of it has been spun to shortlines.

And it's why I wouldn't be beating down my banker's doors to buy a shortline heavily dependent on forest products. The forest products trade is like the little girl with the curl: when it is good, it is very, very good and when it is bad it is horrid.

Greenbrier's first quarter conference call was instructive if only because it clearly demonstrated the need to look beyond the numbers into what drove them. Income from continuing operations was down 76.5% to $1.9 mm from $8.1 mm yoy and eps dropped to 12 cents from 51 cents. Sales were up 32.3% to $247 mm but the cost of sales was up 41.7% thus pushing operating income down 12.6% to $29 mm from $33 mm yoy. Looks grim, eh?

Now look at the balance sheet and see that accounts receivable nearly doubled to $145 mm from $92 mm as cars that had been built for delivery in the quarter were not, meaning the production expense showed up in the quarter but the revenue did not. Also, the Trenton Works in Nova Scotia (boxcars, mainly) went on strike during the quarter ("a continuing drag") and there were other unforeseen non-cash items that took their toll. The combined effect of these items came to 57 cents per diluted share so core earnings were actually closer to 69 cents, up 35%.

GBX is taking significant steps to broaden its base, having purchased Meridian Rail Services and Rail Car America, and is now reporting results from three business segments: manufacturing, refurbishment & parts (Meridian and Rail Car fit here) and leasing & service. Manufacturing revs increased 19% on 2000 units delivered vs. 2400 units a year ago, due in part to a change in mix, now more heavily weighted to conventional cars that carry higher margins than intermodal units.

What appears to be happening in the rail car segment is that as the Class Is improve velocity they can move more traffic with fewer cars and so the manufacturing backlog for the Q was 14,300 units vs 14,700 units at this time last year. Moreover, the large builds in previous years, as many as 23,000 units in 2005 and 2006, have filled up the fleets even as the volume/velocity story shows more GTMs per car or platform.

My bottom line is that after listening to the call and sifting through my notes GBX has had a wobble but there's nothing that can't be fixed. They see the IM platform market as being saturated and so they're shifting production to boxcars and grain covered hoppers. The implied unit value of the backlog is more than $84,000 vs. $59,000 last year.

Rob Himoto, new President of California's Santa Maria Valley Railway (www.smvrr.com) writes, "There is a present and future challenge we see for not only our railroad but for all railroads. Going forward as we expand we will need to hire new employees at an increasing rate over the next five to ten years. Thus we are looking at kids who today are in high school end even young children for a potential labor pool. Yet reaching out to them is tough.

"Part of the problem is the invisibility of the railroad industry. The former owners didn't market the railroad at all. There is a lack of public awareness here in Santa Maria for a railroad that runs right in the middle of town. Our group purchased the railroad just months ago and the local media has really helped us out. They have done a great job of covering the railroad and with dinner train excursions planned for the spring it is really helping with our public awareness.

"The Thomas the Tank Engine videos and toys really do a good job of introducing very young children to railroads. But it seems like the model train industry fails miserably to convert them to model train enthusiasts. Moreover, it seems that the parents of these children lack the most basic knowledge of the railroad industry. So there is no further encouragement from parents after the child has grown out of the Thomas the Tank Engine age.

"Then there is the perception problem. It seems to me that when a child says he or she wants to grow up to be an engineer or conductor the parent is thinking the only jobs are in an amusement park. I just see this as a long term concern in which the industry and ourselves need to address it now, especially with all of the Class Is' needs for upcoming labor shortages."

Well said, Rob. The perception problem is all around us. I mention railroads at an investment club meeting and everybody asks about the future of Amtrak or why can' SEPTA look like the TVG. I mention railroads to my seatmate on a plane and all of a sudden he's studying his shoes. The AAR has made some astounding promo films but I only see them at railroad gatherings. And of all the freight rails only NS has a spot running on CNBC. Rob is giving it a shot; may what he's started in Calif spread to Omaha and beyond.

Buy side or sell side? If I'm buying shares in a publicly held company I'm looking to fill a purpose: value, growth, spec. Similarly, when buying a railroad one ought to be looking for specific values and potential returns. That's why successful stock investors make the best buyers of shortline railroads: they buy companies, not up-ticks and down-ticks. They understand what makes cash flow in a positive manner. Watch this space for more on how to tell what kind of railroad buyer *you* are.

Parting shot. Car hire relief for shortlines is an outmoded idea and ought to be gotten rid of. I wager there will be howls of indignation at the very thought. Bring 'em on and I'll tell you why the idea has outlived its usefulness.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and shortlines with less than $12 mm annual revenues $125. Corporate subscriptions $500 per year. A publication of the Blanchard Company, ***Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned here.***