RAILROAD WEEK IN REVIEW
JANUARY 19, 2007

"American Railcar's market share can double by 2009." Bear Stearns

Union Pacific moved 194 mm tons of coal from Wyoming's Southern Powder River Basin (SPRB) during 2006 - a new record for the railroad. Compared with 2005, Union Pacific moved an additional 895 trainloads of SPRB coal during the past year - an increase of 15 mm tons of coal, or enough to generate a year's worth of electricity for nearly 2.5 mm homes.

As train numbers increased during 2006, so did train size. UP trains transporting coal out of the SPRB averaged just over 15,000 tons each in the fourth quarter--an increase of 200 tons over last year's average. Investment in capacity improvements and new processes helped UP achieve the increased tonnage. Additional rail line improvements in Wyoming are expected to help boost capacity on the Joint Line owned by UP and BNSF. Future improvements - a fourth main line on Logan Hill and a third main line north of Reno Junction - coupled with the addition of 14 landing spots at the mines for trains, also are expected to increase Joint Line capacity.

According to data released late last year by the Energy Information Administration (EIA) of the U.S. Department of Energy, coal inventories at the nation's electric utilities were expected to end 2006 at their highest levels in four years. As of 12/21/2006 the EIA reported utilities' coal inventories stood at 125.6 mm tons, up 27.9% over a year ago. In its Short-Term Energy Outlook released on 12/12, EIA said it expects inventory levels to rise again in 2007, reaching 139 mm tons by year end.

UP estimates that 19% of its coal traffic touches shortlines. Figure the extra 895 trains were 150 cars each – 134,250 carloads – implying 25,507 additional carloads to the shortlines. Taking an average coal RPU of $1,308 (see 3Q03 Analyst Meeting materials) and applying a nominal 20% split with shortlines, we're looking at $261 a shortline car. Bottom line, the UP increase in PRB loading could be worth $6.7 mm to shortlines.

This is not to say that 19% of all PRB coal goes to shortline points; in fact I would not be surprised to see more Colorado coal on shortlines than PRB coal. But the $6.7 mm figure provides a way to put the UP load increase in shortline context and a reason why it's important to pay attention to figures like these.

Re car hire reclaim (WIR 1/12/2007), the howls of dissent never materialized. I got only two e-mail replies, both of which support my thesis. The first, from a former shortline manager for a Class I, writes, "In all my years in the shortline group we did not give car hire relief, except to get box cars reloaded under our boxcar deregulation agreements. None of our line sales included it and in my experience, car hire was an expense which start-up short lines often underestimated.

"It was surprising to read that some short lines might keep cars for as long as ten days. We had incentives that encouraged short line connections to get the cars off line as quickly as possible. And they did, even when a car which might have arrived on Friday wouldn't be eligible for demurrage until Monday, even if it was placed on Saturday." As I have often said here and elsewhere, in a well-run shortline there should never be *any* demurrage because cars will arrive as needed and thus be loaded or unloaded promptly.

My second response was from an eastern shortline ops guy who's pretty much up on the national situation. He writes: "Our short line has never had nor never asked for car hire relief and I couldn't agree with you more. Relief was a monster created by some Class I market managers as a substitute for direct revenue, and now they are paying the price, literally. The present Class I mkt mgrs are now going to have to put their real money where their predecessors' mouths were and pay fair revenue allowances with no hidden revenue sources."

A Midwestern shortline operator told me on the phone that the Class I revenue guys he deals with don't want to pay any more to shortlines than they have to and if they can pay less by giving away some car hire that's OK with them. Trouble is, my friend notes, that car hire expense not passed to the shortline increases the Class I ops expense and limits the ops manager's ability to increase car turns and lower car hire expense.

The real loss is in asset utilization. A car making six visits a year to a shortline with a ten-day dwell spends 60 days in the shortline's account regardless of whether or not there's any CH relief. Folks seem to agree that a 15-day turn is about what a boxcar gets so 60 days on a shortline is four revenue trips lost. On the Class I in question, that's worth nearly $9,000 in revenue.

I say give the shortline $60 more a car to cover three days car hire – a day on, a day at the customer, a day off – and the shortline picks up all car hire. That's $180 more in revenue transferred to the shortline and a lot better than not getting $2000 in new per-unit revenue for want of a car. Maybe the performance measures for Class I market managers need a closer look.

Don Phillips sent me this piece the other day. These excerpts are worth some serious reflection. "Throughout the world, the prevention of train collisions depends mostly on the train engineer. Some of the world's worst rail disasters have been the result of nothing more than exhausted train crews' going to sleep and running through stop signals. For almost a century, electronic and mechanical methods have been available to automatically stop trains if an engineer fails to heed a signal telling him to slow or stop.

"High- speed trains like the French TGV and the German and Japanese systems have such protection. Yet the cost and complexity of these systems have left the vast majority of the world's trains dependent on the alertness of the engineer. In the United States this week, the government approved use of a system on BNSF, one that could turn out to be a simple and relatively cheap solution to the prevention of train collisions.

"It is far too early to tell if this system or some version of it will be a worldwide solution to the collision problem. At a minimum, it is the forerunner of a new generation of rail safety equipment. Using satellite systems, including the Global Positioning System, the new Electronic Train Management System will determine the exact location and speed of all trains. If the system detects a possible collision, it will first send the engineer an alert. If the engineer fails to acknowledge the alert and take action, the system will slow the train and stop it in time to prevent a collision.

"The system goes beyond collisions, enforcing speed limits and stopping trains if a switch is improperly set. It is also capable of adding other safety overlays without the need for expensive wire lines or track equipment. [It's instructive to note that] such modern systems were successfully tested over a quarter-century ago. A different era of railroad management, upset at the cost of the systems, ignored the tests. The major differences today are that railroads are far more profitable, a new generation of lower-cost equipment is available, and [the FRA] is dedicated to moving more rapidly on such major safety systems.

"With BNSF having gained government approval to use the safety technology, there is little doubt that the others will not be far behind. NS Chairman Wick Moorman told an audience in Washington last April that with freight crowding the railroads and earnings growing, such a system would make it possible to haul even more freight safely on current infrastructure."

To which I must add that there are shortlines with systems that, while no where near as robust, do a lot of the same things – see my NECR write-up in WIR for 9/22/2006; there's a link to it on my home page below the NECR copy and photo.

Wabtec (WAB) has affirmed its 2006 guidance for revenues of about $1.06-$1.07 bn and earnings per diluted share of about $1.70-$1.73. The guidance excludes previously announced restructuring expenses of $0.09 per diluted share recorded in Q3. Wabtec also issued 2007 earnings guidance of about $2.10 per diluted share, ex- previously-announced restructuring expenses of about $0.05 per diluted share.

WAB expects "another strong performance in 2007," and if it comes to pass it'll be its fifth consecutive year of revenue and earnings growth. Credit continued strength in the core markets, the ramp-up of several long-term contracts, benefits from strategic growth initiatives, integration of 2006 acquisitions and a diversified business model. One which already generates a forward PE of only 15 and $117 mm more cash than debt. Enterprise value is just 9x EBITDA and the YPEG (5-yr growth rate plus div yield over forward PE) is less than one. See chart for comps. (I own this in my IRA.)

American Railcar (ARII) has a 20-25% share of the tank car market and Bear Stearns' Peter Nesvold reports that "we will likely see continued strength in tank and covered hopper cars, while intermodal car delivery will likely slow. Coal hopper demand was relatively soft in 4Q though we may see a couple of large orders that were placed too late to be recorded in 3Q show up in 4Q. Moreover, we think ARII's market share can double by 2009." But the stock's too volatile for me – off 10% in two days this week, possibly on the RSI report that ARII's order intake was less than expected and suggesting a lower Q4 backlog. Let it come up a bit before pulling the trigger.

Earnings Week will be upon us shortly and the recent downturn in rail stocks has created some wonderful buying opportunities. Recall a price-earning-growth ratio of 1.0 indicates the name is fully valued. Under one it's a buy; under 0.5 it's a screaming buy. Over two is way over-priced and beyond two you better check your shorts. Add dividend yield and see what an owner might expect.

The tables below sort by YPEG: the 2007e PE divided by the 5-year growth estimate including the annual dividend yield. Every single Class I is a buy, though CP is right on the cusp. CSX is clearly a come-from-behind story and there's good news to come on the shortline front. NSC, BNI and CNI are my favorite consistent performers (I own NS in my IRA). UNP is a come-from-behind story, though knowing the franchise as I do, my bet is it'll do better than 13.5% forward growth. CP is still shedding the shackles of the old CP holding company and there is every reason Fred Green and his team will do an exceptional job. Watch this space for the final scores.

Commenting on visibility of the railroads, a reader in NH writes, "We have the same problem with manufacturing and all sorts of important skilled trades. One reason seems to be an over-emphasis on everyone going to 'college.' A skilled tradesperson, machinist, electrician, or whatever has better earning potential than many go-through-the-motions college grads.

"That skilled person with the ability to do something useful as opposed to working in retail or some other bland service will add much more to our society as well. A misplaced anti-elitism seems to have led us to be elitist in encouraging us to send kids to 'college' yet not distinguish between schools and programs with true educational rigor and colleges which are grown up day-care. Merit lies in doing something useful well, not something which superficially looks good in a middling way." Ask any shortline manager about the quality of talent coming in looking for work and he'll tell you the problem is significant.

As for my asset management notes (WIR 12/21/2006), the same reader offers these observations: "What you report is contrary to the long-term needs of the nation, especially in rural areas, to reduce highway use and fuel use. It will extend the trend to lose rather than rebuild infrastructure. The trick is improved handling of numbers of small loads, better scheduled such that the aggregate (I don't mean crushed rock) business becomes more viable.

"It's time for RR folks - especially shortline smallish businesses, to think more about 'the long tail' and means of serving efficiently a huge aggregated volume of small orders a la Amazon, FedEx, others. Good action at the federal level might help." This something Finger Lakes' Mike Smith has been touting for some time and to good effect. We need more of this kind of small thinking.

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RR Growth Ests 2007 w divs

Tick	2007e	Recent	pe	5-yr gro	peg5	div	div Y	y gro	Ypeg
CSX	$ 2.55	$ 34.70	13.61	19.50	0.70	$ 0.40	1.15	20.65	0.66
NSC	$ 3.99	$ 50.30	12.61	16.00	0.79	$ 0.72	1.43	17.43	0.72
BNI	$ 5.69	$ 73.96	13.00	15.00	0.87	$ 1.00	1.35	16.35	0.79
CNI	$ 3.05	$ 44.28	14.52	15.50	0.94	$ 0.57	1.29	16.79	0.86
UNP	$ 6.68	$ 91.56	13.71	13.50	1.02	$ 1.20	1.31	14.81	0.93
CP	$ 3.88	$ 54.33	14.00	12.70	1.10	$ 0.65	1.20	13.90	1.01

Source: Yahoo financial page

OEMs ests 2007 w divs

Tick	2007e	Recent	pe	5-yr gro	peg5	div	div Y	y gro	Ypeg
ARII	$ 2.23	$ 31.80	14.26	36.70	0.39	$ 0.12	0.38	37.08	0.38
TRN	$ 3.09	$ 35.13	11.37	12.00	0.95	$ 0.24	0.68	12.68	0.90
WAB	$ 2.09	$ 31.88	15.25	15.50	0.98	$ 0.04	0.13	15.63	0.98
GBX	$ 2.48	$ 28.60	11.53	10.00	1.15	$ 0.32	1.12	11.12	1.04
RAIL	$ 6.22	$ 53.29	8.57	3.00	2.86	$ 0.24	0.45	3.45	2.48
FSTR	$ 1.05	$ 23.11	22.01	na	na	none	na	na	na