RAILROAD WEEK IN REVIEW
MARCH 2, 2007

"Wide diversification is only required when investors do not understand what they are doing." -- *Warren Buffett*

This week's stock slide has created some wonderful buying opportunities for those who follow the rails and have done their homework. One of Buffett's tenets is to buy stocks "on sale," that is to say, selling at less than their "intrinsic value," defined as the net present value of a company's cash generating capacity over time. The math is arcane and beyond me however there are any number of web-based calculators that will give you something usable.

I prefer the one at www.smartmoney.com where you can enter the stock symbol and get "an estimate of a fair price to pay for a stock based on three main things: the company's earnings, the rate at which those earnings are projected to grow and the stock's volatility." I've run its results against another calculator at www.moneychimp.com and found they both come up with the same answers.

The idea is to find out how cheap the stock is compared to the fair ("intrinsic") value. If it's selling for less than 75 cents on the dollar I'm interested and will dig a little deeper with the classic valuation metrics like price-sales, price-book, PEG ratios etc. Most of the rails meet the six-bit test (see Table 1 after the disclaimer). As you know, NSC has long been a core holding of mine and now I'm using this opportunity to add UNP.

Other considerations might be capex as a percent of revenues after you've actually looked at some track. If you can see the tie ends, there's not enough ballast to hold CWR in place against heat kinks. If that road is spending a higher percent of revenue on capex than a road with better track, it may be a sign of deferred maintenance and potentially higher operating costs. Also look at price-book and stay close to or under 2.0 (NSC is right at 2.0 and UNP is well under 2.0). Lastly, consider the Y-PEG – Current PE over five year growth rate plus divs – and look for low numbers. NSC is 0.71; UNP is 0.93, closer to the high end though its good scores elsewhere still give it the edge.

The DM&E request for a $2.3 bn RRIF loan has been rejected by the Department of Transportation Credit Council. Representative Tom Walz (D-Minn) said, "This is a victory for good government and accountability. The citizens of this district demanded close scrutiny of this loan and they got it. This loan proposal brought people from all walks of life together to insist that members of Congress better monitor taxpayer funds. I believe that today's decision is a direct result of congressional and citizen inquiry and oversight."

The denial came as a shock to a number of industry observers, yet the railroaders, analysts and pundits with whom I've spoken this week seem relieved it did not pass. Just a year ago *Fortune* writer Barney Gimbel penned these lines: "There were problems with the idea, of course. For one thing, the project didn't precisely fit the loan program, whose mandate was to help railroads fix *existing* track" (emphasis added).

Instapundit.com's Glenn Reynolds called it "a significant victory for the Porkbusters. Let's have more like this, please." Recall that the RRIF loan availability was expanded to $35 bn from $3.5 bn as part of the same 2003 legislation that "gained instant notoriety for such pork-barrel excesses as its $223 million grant to build Alaska's "bridge to nowhere." (Gimbel, op.cit.) The current decision ends the process and there is no appeal, according to Rep. Walz' statement.

Moreover, there remained the question of where the coal would go once it got on the DM&E. One study I've seen suggests that DME reaches fewer than ten gen stations even if you include its ICE acquisition (WIR 2/21/2001). Add shortline connections and you're still under 15 possible destinations. A reporter from Minnesota Public Radio told me during the course of an interview that DM&E president Kevin Schieffer said they have no paper barriers so can access both NS and CSX. Maybe so, but if you were either of those roads and you had considerable non-coal business with BNSF nd UP, would you risk that business over a few thousand cars of coal? I think not.

For its part, the DME's press release says simply that "While DM&E is disappointed in the Federal Railroad Administration's decision denying our loan application, we expect to move forward and will spend some time assessing alternatives to accomplish that objective. This project is too important to the future of our company, regional rail transportation and the many supporters in the agriculture and energy sectors, the communities we serve, and beyond who are relying on it. DM&E will make appropriate announcements about next steps in the process as it moves forward."

And from Wall Street comes this thoughtful note from Tony Hatch: "The FRA cited 'excessive risk' to the taxpayer in denying the $2.33 billion loan to the DM&E for the PRB build-out…Champagne will be served in Omaha and Fort Worth , for sure, although judging by the scrum around DM&E CEO Kevin Schieffer at last fall's *RailTrends* Conference, many bankers, commercial and investment, and private equity folks will be calling on South Dakota beginning tomorrow. But if any deal still gets done, the cost basis will be higher than by using Uncle Sam for a big slug."

FRA Administrator Joseph Boardman claims proposed legislation "will replace existing railroad hours of service laws enacted in 1907 with comprehensive, scientifically based regulations that address issues of worker fatigue." Present rules permit train crews to work 12 hours with 10 hours of rest. If they work less than 12 hours they are required only 8 hours of sleep. He adds, "We must embrace new methods and strategies to further reduce the number of accidents in the rail industry. Railroads must be more accountable for the safety of their operations and rail employees need work schedules that reduce fatigue and promote safety."

The FRA would set new regulations for train crews, dispatchers and signal maintainers. A FRA Railroad Safety Advisory Committee would be established to review the issue and develop recommendations on new hours of service limits based on current, sound science before changes are made. In addition to the FRA, members of the Committee would include railroad management, labor representatives and other key stakeholders.

Among other proposals in the bill, the FRA will develop methods to evaluate safety risks systematically and in order to hold railroads more accountable for improving the safety of their own operations. The authority of the FRA would be widened to permit it to disqualify any individual unfit for safety-sensitive service. The bill would reauthorize the federal rail safety program through 2011.

IMHO this is long overdue. A hundred years ago 12 hours on duty was an enormous *physical* strain. As one who's moved a dozen tons of coal on the end of a shovel over eight hours, I can attest to that. However, moving 12,000 trailing tons of freight and rolling stock at speeds of 70 MPH or more is *mentally* taxing and a body needs to recover from that just as surely as it does from shoveling coal.

Shortliners should welcome the change, too. There is a tendency on too many properties to keep T&E crews running until their 12 hours are up. That can mean a different job every day with different starting points and different ending points. Shortening the HOS rules ought to make that less of an option for managers, helping to stop some of the turnover that comes from unpredictable work assignments as well as improving operating efficiency.

Credit Suisse Rail analyst Jason Seidl offers a comprehensive view of weekly traffic trends wherein he goes into considerable detail by railroad. For the week ending Feb 17 he writes, "Carload Weakness Exacerbated by Strike at Canadian National. Class I carloads continued to disappoint for as overall traffic fell 4.8% y-o-y on the heels of weakness in Forest Products (-23.3%), Motor Vehicles & Equipment (-18.9%) and Non-Metallic Minerals (-11.3%).

"Results at CNI drove the weakness as carloads at the Canadian Class I declined 18.6%, primarily due to decreases in Coal (-33.7%) and Forest Products (-33.0%) even as 2,800 union workers at the railroad went on strike last week. In contrast, CP reported a yoy increase in carloads (+2.3%) on growth in Chemicals (+14.0%) and Agricultural Products (+11.3%). NSC reported a steep decline in traffic (-8.7%) on weakness in Metallic Ores & Minerals (-19.4%) and Forest Products (-18.9%). CSX followed suit with a 7.3% decrease in carloads, driven by declines in Motor Vehicles & Equipment (-24.1%) and Forest Products (-16.9%).

"Indeed, we note that the Eastern rails continue to be plagued by winter weather conditions. In the West, traffic at UNP fell 3% on a 24.3% decline in Forest Products and a 15.5% decrease in Nonmetallic Minerals & Products. BNI came in slightly ahead of UNP—posting just a 1% decline in traffic. Strength in Chemicals (+13.2%) and Coal (4.5%) at BNI was offset by a large decline in Forest Products (-30.5%)."

Shortline carloads for the week ending Feb 10 were off 10% yoy per RMI's RailConnect Index (attached). I'm particularly concerned that the non-cyclicals (STTC 01, 20, 14, 26) are down. Representatives from Perdue Farms and GP told the CSX shortline group last week that trucks are more plentiful than rail cars in some lanes and so they're loading more of the former and less of the latter. Shortline owners have to get more proactive about finding new commodity lanes.

From the Department of Corrections: Last week's Letter erroneously reported that CSX shortlines shared "22% of plastics revenues on one percent of carloads." Wrong. It's that the chems group saw 25% of its carloads touched shortlines and that one percent of that was same-store carload growth. I also wrote that 29% of new industrial development success stories were on shortlines. It should read that 20% of ID success stories were on shortlines and there were 29 new shortline customers as a result of ID efforts.

The CSX Shortline Group gets high marks for posting the presentation slides to the website so promptly. Be sure to go to

http://www.csx.com/?fuseaction=customers.sl_news-detail&i=48999

and download them for future reference.

Table 1. Rail Stock Fair Value

Tick	FY 2007	Est 5 yr	Fair Value	Now	Cents on $1
	Eps	fwd growth			
NSC	$ 3.58	14.6%	$ 76.30	$ 47.00	$ 0.62
CNI	$ 3.29	15.2%	$ 71.78	$ 46.33	$ 0.65
UNP	$ 5.91	18.9%	$ 148.73	$ 99.00	$ 0.67
CSX	$ 2.22	15.7%	$ 49.39	$ 37.29	$ 0.76
BNI	$ 5.11	13.4%	$ 103.88	$ 81.70	$ 0.79
CP	$ 3.51	11.6%	$ 63.43	$ 54.69	$ 0.86
GWR	$ 1.39	15.6%	$ 30.80	$ 27.49	$ 0.89
KSU	$ 1.08	15.0%	$ 23.38	$ 33.40	$ 1.43

Source: First Call, smartmoney.com calculator

RailConnect Index of Short Line Traffic

Traffic Type: All

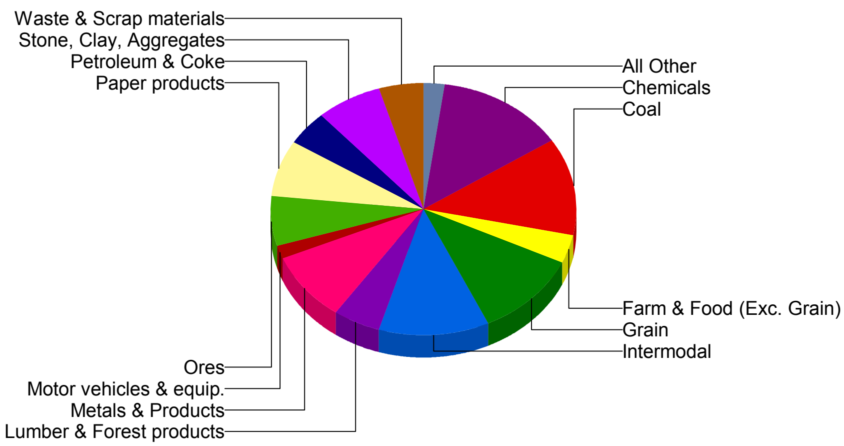
For the week ending: 2/10/2007

Week Number: 6

	Current Week			Year-To-Date		
Carloads Handled	**2007**	**2006**	**% Change**	**2007**	**2006**	**% Change**
Coal	15,082	16,284	-7.38%	88,316	95,246	-7.28%
Grain	11,922	13,567	-12.13%	78,185	84,378	-7.34%
Farm & Food (Exc. Grain)	4,489	4,732	-5.14%	26,851	28,969	-7.31%
Ores	6,544	7,942	-17.60%	45,409	48,821	-6.99%
Stone, Clay, Aggregates	8,360	9,816	-14.83%	49,684	59,846	-16.98%
Lumber & Forest products	6,187	7,869	-21.38%	35,040	46,834	-25.18%
Paper products	7,876	8,619	-8.62%	51,355	55,235	-7.02%
Waste & Scrap materials	5,610	6,254	-10.30%	32,982	35,014	-5.80%
Chemicals	16,051	15,154	5.92%	96,640	93,276	3.61%
Petroleum & Coke	5,185	5,944	-12.77%	31,671	32,983	-3.98%
Metals & Products	10,769	11,769	-8.50%	62,520	69,464	-10.00%
Motor vehicles & equip.	2,375	1,954	21.55%	11,343	12,109	-6.33%
Intermodal	14,407	18,605	-22.56%	83,633	105,525	-20.75%
All Other	2,681	2,971	-9.76%	15,129	18,583	-18.59%
Total	**117,538**	**131,480**	**-10.60%**	**708,758**	**786,283**	**-9.86%**

RailConnect Index

Year-To-Date



All Other	2.1%
Chemicals	13.6%
Coal	12.5%
Farm & Food (Exc. Grain)	3.8%
Grain	11.0%
Intermodal	11.8%
Lumber & Forest products	4.9%
Metals & Products	8.8%
Motor vehicles & equip.	1.6%
Ores	6.4%
Paper products	7.2%
Petroleum & Coke	4.5%
Stone, Clay, Aggregates	7.0%
Waste & Scrap materials	4.7%
Total:	100.0%