RAILROAD WEEK IN REVIEW

MARCH 9, 2007

"Over the years, however, we have focused more and more on the acquisition of operating businesses." Warren Buffett, Letter to Shareholders, Feb 28, 2007

As regular WIR readers know, one of my roles in life is finding money for shortline acquisitions and enhancements. These are satisfying projects. Every one of them adds value to the shortline because the acquisitions or improvements add value to the products shortlines can offer their customers. Moreover, a trip to the money store forces the shortline owner to take a long hard look at his financial position in terms of EBITDA as a percentage of revenue, gallons of fuel per revenue carload, car hire expense per train-start, mean time between loco failures and so on.

On the other hand, I don't do start-ups well. Putting up eight figures of debt for an idea is not something I can get my arms around. Show me an operating business with some cash flow and I get interested. And with so many buying opportunities for operating railroads out there right now I don't know why anybody would ante up significant cash for something untested in the marketplace.

Take the DM&E, There's an operating business with cash flow and an operating plan. Yeah, the FRA loan failed but there are other ways to skin that cat. Ed Wolfe of Bear Stearns ran some numbers a couple of weeks ago and suggested that there may be $25 mm of EBITDA. At a Fortress/RRA multiple the DME could bring $250 mm-plus. *Without* spending $6 billion to create a PRB route. If I were Warren Buffett this might be of interest and I'd want Kevin's team to run it.

RailAmerica has announced that Charles Swinburn, chief executive officer, will retire, after eleven years serving with the company as a board member and for the last two and a half years as CEO. John E. Giles has assumed Swinburn's responsibilities at RailAmerica.

John and I first crossed paths nearly 20 years ago when I had just spun this consulting practice out of a larger firm that was heading in other directions. He was with CSX and needed some help with some new products he was developing. We stayed in touch over the years and he became a regular name in WIR with successful new service designs for CSX – like the first unit trains of aggregates in the west Florida market (WIR 11/7/1998).

He retired from CSX in 1999 only to pop up again as President of the newly-formed Great Lakes Transportation Co when the DMIR, B&LE, Conneaut Docks and the Great Lakes steamers were spun out of US Steel's Transtar group. They in turn went to CN in mid-2004 (WIR 10/24/2003) and I lost track of John once again.

So imagine my delight when he came back into view as the rail adviser to Fortress on the RailAmerica transaction. Welcome back to the shortline and regional railroad world, John. Charlie Swinburn and his team have left you a great collection of lines with a lot of potential.

Big Six Class I revenue unit volumes continued to drift south yoy in Week 9 ending Mar 2. BNSF was least damaged by the slowdown with no change yoy in total YTD units though forest products (both STCCs 24 and 26) were off 23%. CN was hit hardest with YTD loads down 6.7% with intermodal and grain off 3.7% and 5.5% respectively. In the east, CSX fared better than NS in five of eight commodity groups and in the west BNSF did better than UP in six of eight. CN and CP each won four categories.

We knew this was coming. Every fourth quarter presentation we heard told us units and revs would be down in 1H07 with better days beginning in July. All the other tea leaves are lining up that way as well. My message to the merch-heavy shortlines remains the same: find a competitive advantage against the trucks and turn the cars. For the most part, the Class Is' velocity improvements indicate they are following this model and as part of the network shortlines must follow the fold and sin no more, to quote a Salvation Army tune from *Guys and Dolls*.

NOTE: There still are locations where Class I service to interchanges and customers does not turn cars promptly, where cars are CP'd because pulls are irregular, and where trucks bring in say 40% of commodity because inadequate Class I rail service can only satisfy 60% of the raw material requirement. Please e-mail me chapter and verse of your experience so when the Class Is ask, "Who, Me?" I can respond with facts.

Bear Stearns has downgraded the rail group to *Market Weight* from *Outperform*. In a note to investors Ed Wolfe writes, "We remain very positive about rail fundamentals over the next 1, 2 and 10 years. We continue to believe the rails can generate double digit EPS growth during 2007, even in the case of a recession (and we believe domestic freight is currently in one), by offsetting weaker volume growth with pricing and productivity.

"However, we also continue to believe that investors should buy the rail stocks prudently, at mid-cycle valuations or below at this stage of the cycle. [See also my Intrinsic Value Table, WIR 3/2/2007 -- rhb]. Along with our sector downgrade, we also reduced our already lower-end estimates for the large cap rails for 1Q:07 by 3%-4% on average…We did not reduce the remainder of our 2007 or 2008 EPS estimates although admittedly we have less conviction in them at this time… We still would own any of the railroads trading below 15x-16x forward P/E and we would aggressively add to positions below 13x forward P/E…

"We believe the next catalyst for the rails is to get through the many downward EPS revisions that are likely over the next few weeks and through the tough weather comparisons for volumes and productivity. Once estimates come down and weather starts to improve in the U.S. and Canada, we would expect volumes and productivity to improve for the group and sentiment to follow. More importantly we expect pricing to remain firm, with the likely exception in domestic intermodal pricing where the rails compete directly with truckers (whose pricing continues to fall quickly)."

Let me (rhb here) interject that firm pricing is good for all shortlines -- switching roads, handling lines and ISS properties alike. As rates go up the S&Ts and Handling Lines can argue for better allowances while the ISS roads are already at the table.

Back to Bear: "Currently two railroads – NSC at 11.7x and CNI at 13.0x (each rated *Outperform*) – are trading at or below historical mid-cycle 13x forward P/E on our low-end estimates. We advise investors to buy aggressively and to add to positions in these names right now and to be prepared to own the rest of the group – particularly our favorite longer-term name BNI (rated *Outperform*) –especially on pullbacks below 13x forward P/E should that opportunity arise during the current period of expected earnings reductions for the rails and general market volatility."

***Fortune* magazine has named** Union Pacific the most admired railroad in its America's Most Admired Companies list. For the second consecutive year, Union Pacific was named the U.S. railroad industry leader in key attributes of reputation on *Fortune's* annual list of Most Admired Companies: innovation, people management, use of corporate assets, social responsibility, quality of management, financial soundness, and long-term investment. The rankings are determined in a survey of industry analysts, boards of directors and corporate and railroad executives. (For my part, I like UP because I'm a shortline advocate and UP continues to move more merch carloads than any other Big Six Class I, 4.1 million in 2006 on with merch RPU up 14.9%, the largest increase among the entire Big Six crowd. – rhb)

Both CSX and UP continue to rank among the Top Ten Value Plays at TheStreet.com. The former has "displayed compelling improvements in its top line and continued momentum in its surface transportation business, reflecting better operating limits in its fiscal year 2006. Growth in the agricultural market, demand for coal exports and continued growth in imports offset the soft housing and automotive sectors. Potential threats to the buy rating include continued weaknesses in the housing market and the automotive markets, as well as lower profit margins." Please note that CSX is at the high end of my Intrinsic Value rating at 76 cents on the dollar (WIR 3/2/2007).

Union Pacific gets Street's nod because "the company has shown a wide range of strengths, including revenue growth, significant EPS improvements and net income growth that has towered over its industry peers. Given its wide range of impressive financial strengths, the company's low profit margins are no threat to the buy rating." Also, UNP ranks third on the IV Scale at 67 cents.

Reuters reports that new regs are being proposed on "diesel particulate emissions" aimed specifically at the railroad and ocean shipping industries. The new regs would start to roll out next year with final rules hitting the street in 2015. Not missing a beat, CSX issued a press release the same day announcing its support of "the EPA's goal of reducing diesel locomotive emissions," showcasing two of its "new low-emission locomotives that have helped CSX reduce CO2 emissions by 330,000 tons over the past five years."

According to the press release CSX has since 2002 taken significant actions "to reduce loco emissions and fuel use." (In its 2006 financials CSX reported 790 MGT per gallon, up 1% yoy. By way of comparison NS got 747 MGT per gallon, unchanged yoy.) Moreover, again per the press release, "CSXT has spent more than $1 billion to upgrade its fleet with new, more efficient, low-emission locomotives. At a time when traffic levels have increased, new technology and these new locomotives have allowed CSXT to reduce fuel use by 30 million gallons." The 2006 fuel burn was unchanged yoy at 598 mm gallons on a 2% gain in GTMs. Fuel expense was up 42%, all price.

Which is all well and good for CSX and its Big Six Brethren but the implications for shortlines are serious. A good friend is the CMO of a regional railroad that runs a fleet of 40 locomotives that are, in his words, "just *old*." There are a lot of first- and second-generation EMDs that came off the assembly line before the word ecology had even been invented and diesel fuel was a dime a gallon.

Yes, billion-dollar Class Is can afford to buy new power and retrofit older power to meet emission standards. But sticking shortlines – especially the mom-and-pops -- with the same rules as CSX is ludicrous. Measure the *real* risk and control that. I'm hopeful the ASLRRA will step up to the plate on this one.

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