RAILROAD WEEK IN REVIEW
MARCH 16, 2007

"To succeed, management must apply capital efficiently. – Mike Haverty, KCS Financial Analysts Meeting, 3/14/2007

KCS held a well-attended and very informative meeting for analysts and investors at its Kansas City headquarters Mar 13-14. The theme, "The Vision has Become a Reality," was surely appropriate. CEO Mike Haverty opened by noting that now, after ten years, all the pieces are in place for running a "rapidly-growing highly profitable, long-haul, cross-border network." Putting KCS and KCS-Mexico under one commercial, financial and operating roof, so to speak, was essential (WIR 2/9/2007) and with that in place it's off to the races.

The presentation was one of the best I've seen, largely because the speakers followed the same format so you could easily compare the various messages. In the commodity group discussions this was invaluable because you could see the historical and future trends in one glance, see the growth drivers and the strategic initiatives with commodity maps so you can see what's coming from where.

KCS is making some hard choices. Chief Commercial Office Dan Avramovich noted that their focus on contribution (more on that below) allows him the opportunity to segment KCS' commodity groups into "growth" and "slower growth" segments. In the former are intermodal, auto and coal; the latter group is the merch carload business: chems, agriculture, minerals and forest products.

There are three steps to the process. First is to maximize contribution – no sense paying a buck and quarter in costs to generate a dollar in revenue. This seems a daunting task, and one not all class Is do equally well. At KCS, the *Eyeris* costing workbench lets managers model the causal links between operational events and financial outcomes. From this it allows the user to create a multi-dimensional profitability analysis based on facts, not opinions.

Armed with this data one can now drill down into each marketing relationship and directly link the costs of a single carload move to the actual movement costs associated with its train. A chief benefit is the ability to place the cost burden on the appropriate business unit. For example, take two boxcar moves for manufactured metal products on pallets. One originates on a branch line, takes two core trains and cars spend three days at the destination. The other originates as terminal switch, uses one core train, is delivered by a branch line local and the car is released empty in 24 hours. *Eyeris* lets KCS take apart the costs to and this identify the move with the better contribution.

The Mexican port of Lázaro Cárdenas anchors the south end of the newly integrated KCS system and therein hangs the tale. The outlook is for continued traffic growth in the Trans-Pacific trade and the US mainland is running out of places to put it. The so-called Lázaro Cárdenas Hinterland is about half again as big as California, supports a population that much bigger than California's and is not laced with Interstate highways. So there's a rail-served local market to support, as well, unlike what we have close-in to the ports in the US where the trucks own it all.

Then there's the US market for goods flowing through Lázaro Cárdenas. It's pretty much a straight short north to the Border, a jog right to Houston and Shreveport, hang another right and you're in Atlanta on he 7th morning. Get Rosenburg fixed (WIR 2/9/2007) and it's even better. Add the evolving auto trade with Mexico's worldwide distribution network, the expanding channel partners in automotive logistics and you've got what could well become "the main artery of North America," as Avramovich put it.

So with all this commercial activity coming on stream, can KCS handle it? COO Art Shoener says they can move enough freight to increase revenue by 10-14% and reduce the OR to the low 70s by 2011. The ticket is more long-haul business, yield management and matching capex to the places they need it most – seven line capacity improvement projects in the US 2007-2010 and three in Mexico.

They're adding new power at the rate of 150 units this year and 60 more in 2008, retiring three units for every two new, reducing the average fleet age to 14 years from 21 years by the end of 2008. Shoener estimates the combination of newer power with lower operating costs and better availability will generate an internal rate of return as high as 20%.

There wasn't a lot of prognosticating about eps and so on, however The Street consensus is for $1.39 in 2007 and $1.79 in 2008. At a share price of $35, we're talking a PE of 24, ten points higher than your average rail and 8 for GWR, perhaps a closer comp than say BNI or CNI. First Call puts the five-year eps growth rate at 17.5% , implying a PEG ratio of 1.38 when the other rails are largely sub-one. What I suspect is that much of the Good News we heard on Wednesday may already be priced in. But if the yield management and other new systems kick in as advertised, it may be a different ball game. Stay tuned.

CSX shares spiked Friday ostensibly on rumors that some hedge fund may have "Fortress-eyes" for the railroad. The stock roared through my target price of $38 and by the close hit $40.11, up 6% on the day. Reuters reported that April 40 and 45 calls were getting snapped up while the shares were still at $38. The idea is to buy out-of-the-money calls so if there *is* a transaction north of the strike price the intrinsic value increases, making holders even more money. The downside is that rails typically do not produce the kind of returns the hedgies seek.

The regulatory and other hurdles of such a move are going to be considerable. As I've written before, the best way to invest in rails is to take a large position in one that trades at a low price relative to its intrinsic value, at a PE below the rail's historical multiples, and where management has a clear goal of where it's going and how it's going to get there. At Friday's close CNI is cheapest relative to intrinsic value, trades at less than 12x forward eps and its direction can be summed up in two words: "Precision Railroading."

Second place goes to BNI where the corporate philosophy can be summed up in one word: "Velocity." It's fourth from the cheapest in terms of discount from intrinsic value but trades at 12x the forward eps estimate, and supports a sub-one PE. Want proof of velocity? While in KC this week I saw a lot of container trains and the BNSF trains had the fewest voids. I think I saw one void in several hundred-plus platform trains. And for every train that passed there was another one on its markers plus another set in the opposite direction. That railroad is *full*.

The surcharge dust seems to be settling down. The Class Is have announced changes to their FSC programs to comply with the STB's recent decree (WIR 2/2/2007). To review, the requirement is for the Class Is to stop basing their FSCs on freight rates for their non-contract, non-exempt business. Shortlines are not really affected because so much of the carload traffic is exempt, but for what' left they would be well-served by knowing what their Class I partners will get.

There seems to be some concern among shortlines that if Class Is go to a mileage-base FSC the shortlines will get short shrift due to their short haul. Not necessarily. The STB specifically address the matter thus: handling allowances "are based on negotiated agreements between the carriers involved and indeed such agreements often provide for a fixed per-car handling fee. Carriers may continue to agree to divide revenues on through movements in any reasonable manner." That says to me that if a shortline knows what the Class I is getting on a mileage-based FSC then it can negotiate a share for its handling allowance.

So how's the short line to know how much the Class I is getting? By using the same tools they do. It's beginning to look like the majority of Class I rails will adopt ALK Technologies' *PC*Miler/Rail Mileages* for their new FSC programs. The advantages are several. *PC*Miler* for rails provides specific and accurate North American rail mileages all over North America, is universally accepted by both railroads and shippers and has been the industry standard for more than two decades.

Moreover, *PC*Miler* for rails is already a key component of the USRail.desktop tool that many short lines use to sanity-check rail rate quotes for their shippers. Now, as it's become clear that the Class Is will have to use miles for their FSC charges, USRail.desktop is re-working the software so that it will automatically calculate FSCs by commodity O-D pairs. See usraildesktop.com for details.

On a related note, NS has announced that it will "discontinue assessing fuel surcharges on its local (non- intermodal) public rates." Moreover, "Future adjustments to public prices will reflect ongoing market conditions. In this regard, current local (non-intermodal) public prices will be adjusted downward by one percent effective April 1. Traffic moving under local (non-intermodal) public rates comprises approximately five percent of Norfolk Southern's total revenue base."

This is really the best approach. With the computing power at our fingertips one can change a rate computation with a few key-strokes. It's not all that different from market-based pricing where the parameters are always subject to change. In my experience NS short lines are rarely asked to share on the downside and the opportunities to participate on the upside have always been reasonable. The present announcement simply removes the FSC matter from the rate discussion. It's about time, too.

Short line carloads through Week 9 (3/3/2007, attached) were not the greatest picture of health. Chems were the only positive, up 4.5%, while the usual short line stalwarts – forest products, grain, metals and coal were off by 24.4%, 6.7%, 9.6% and 9.9% respectively. The Class Is as one might expect fared about the same. Volumes declined in forest products (down 17.5%), metals (4.9%) and aggregates (5.8%). Coal loadings decreased 0.5% y-o-y while grain was down 10.2% into very weak wheat business that we expect to continue through 2Q. Chems increased 7.2% y-o-y into easy comps and improving export potash vols. from CP.

My Class I contacts continue to stress the need for their short line connections to bring on new customers or new lanes from old customers that offer better yields through better equipment management that minimizes dwell, train handlings, and admin costs. It's entirely possible that by doing so we could see short line commodity gains where Class Is are flat to down.

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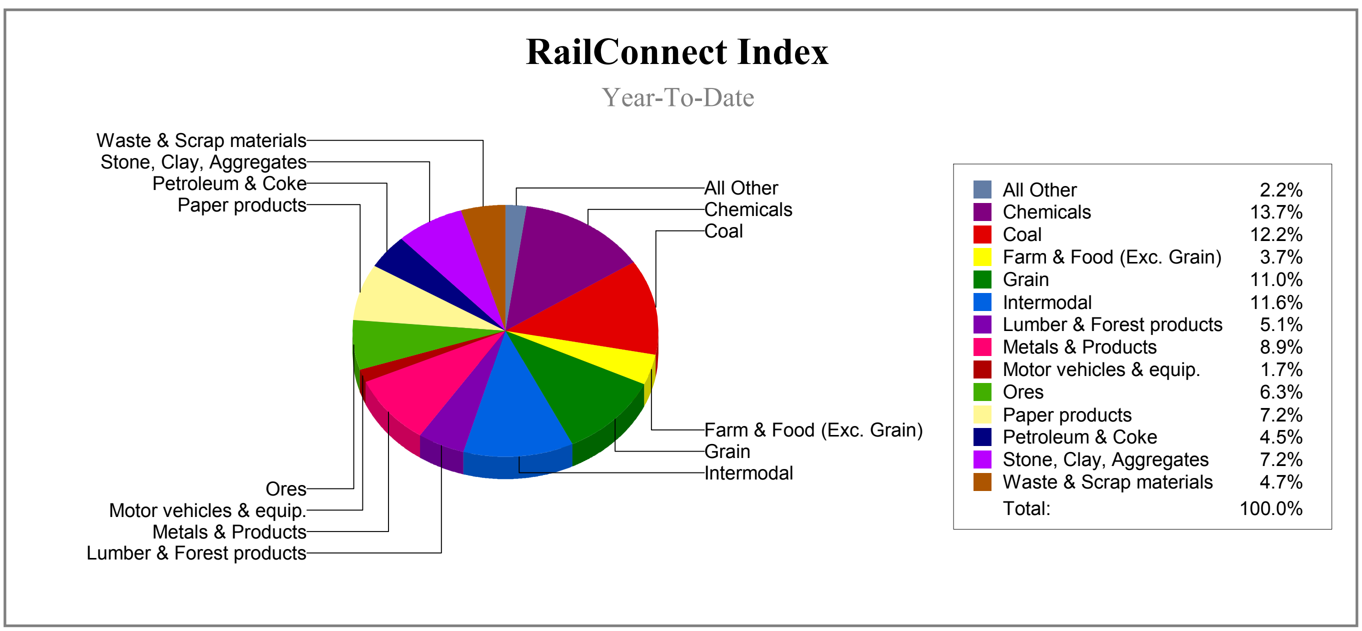
RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 3/3/2007

Week Number: 9

Carloads Handled	Current Week			Year-To-Date		
	2007	2006	% Change	2007	2006	% Change
Coal	12,058	15,396	-21.68%	128,807	142,948	-9.89%
Grain	13,217	13,386	-1.26%	116,336	124,720	-6.72%
Farm & Food (Exc. Grain)	4,345	4,951	-12.24%	39,733	43,345	-8.33%
Ores	7,270	9,033	-19.52%	67,038	74,375	-9.86%
Stone, Clay, Aggregates	10,366	10,211	1.52%	76,786	90,067	-14.75%
Lumber & Forest products	6,189	8,280	-25.25%	53,602	70,887	-24.38%
Paper products	8,502	9,004	-5.58%	76,290	81,723	-6.65%
Waste & Scrap materials	5,430	5,839	-7.00%	49,476	52,879	-6.44%
Chemicals	16,923	15,666	8.02%	145,252	139,041	4.47%
Petroleum & Coke	5,031	5,753	-12.55%	47,567	49,937	-4.75%
Metals & Products	11,324	12,036	-5.92%	94,507	104,535	-9.59%
Motor vehicles & equip.	2,384	2,775	-14.09%	18,163	19,265	-5.72%
Intermodal	14,435	16,284	-11.35%	122,908	155,443	-20.93%
All Other	2,851	3,581	-20.39%	23,263	28,799	-19.22%
Total	**120,325**	**132,195**	**-8.98%**	**1,059,728**	**1,177,964**	**-10.04%**



This report is comprised from 307 roads.

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