RAILROAD WEEK IN REVIEW

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"CSX has created significant shareholder value." Oscar Munoz, Chief Financial Officer for CSX, at Bear Stearns Transport Conference

The Hedge fund feeding frenzy continues. Monday's *WSJ* featured Atticus Capital LP, a $15.5 bn NYC firm making "big, concentrated bets and dismissing the notion of cashing in through an IPO." Atticus is named for the Gregory Peck role in the 1962 classic, "To Kill a Mockingbird" – the crusading lawyer Atticus Finch – and like its namesake, crusades for names that have "fallen out of favor" among investors. Like the rails not that long ago.

Now, according to the *Journal*, Atticus has about of a fifth of its funds in rails – UP and BNSF are named – and founder Tim Barakett has owned CSX, like his Harvard Biz School chum, Chris Holm, who runs The Children's Investment Fund (TCI, WIR 5/11). What attracts Atticus to the rails is their renewed pricing power, the "moat" around the business, the growing need for transport services that work, and the improving infrastructure picture.

Also this week it was revealed that the "other two" rails in Berkshire's portfolio are NS and UP with 4% and 2% of the outstanding shares respectively. TCI also has stakes in these two – 1% of shares in each. In a May 16 Bear Stearns note we learn that TCI now holds 4% of CSX shares – 17.8 mm shares worth roughly $864 mm at Wednesday's close.

And there are others. Bear Stearns writes that five different entities own from 7% 10% of outstanding shares of BNSF, CSX, NS and UP. We already knew about the Buffett and TCI positions, to they are already baked into the stock price. But NS and UP were news and both hit new 52-week highs Wed. And now that the hedge finds are filing their Q1 13-Fs to the SEC, we're seeing futher activity. On Thursday *Seeking Alpha* picked up the fact that Daniel Loeb's Third Point LLC has taken large positions in BSF, KCS and NS. As for CN, Canada's *National Post* says Bill Gates is a player.

There is a difference among players, though. Buffett buys good businesses with good managements and boards and lets them do their thing. The activists buy businesses they think are not being run right and look to force turn-arounds that in turn will generate increased value for shareholders.

I've had a number of calls this week asking whether I thought this bodes ill or well for our favorite industry. I think it bodes *very* well. Just as we've seen with the Fortress acquisitions of RRA and now FEC, the goal is to extract maximum ROI from the assets at hand. I think TCI's Snehal Amin got it exactly right last week, and I'm not alone in this assessment.

In a hard-hitting five-page paper on the topic, seasoned rail writer Frank Wilner writes, "The warning issued by Amin to the current crop of railroad CEOs at a May 8 transportation-investors conference was blunt, dramatic and foreshadowing: 'If you don't understand the potential of the business, if you don't have the conviction in it, or don't have the talent to realize it, you should question, as we will, whether you should be running it.'

"'Railroads are earning barely 2 percent on invested capital,' Amin said. 'Raising rates is not wrong' and he sees an ability – and duty to shareholders – for railroads to double current freight rates over the next 10 years and 'stop subsidizing customers.' Railroad managers, he said, 'are complacent, don't understand the value of their property, and forget they operate for the benefit of shareholders.' They have 'a tendency to stick with familiarity and comfort. They have turned a deaf ear on our request for dialogue.'

Wilner notes that TCI has a history of forcing management changes in firms where it has significant cash at stake. He notes that Amin told his NYC audience last week, "We will not be apologetic in changing that culture, changing their thinking." You can see where this is heading.

So what about the shortlines whose very lives depend on the kindness of strangers – the Class I market managers, financial types and ops guys who may or may not even know the Class III carriers exist? The fact of the matter is the merch biz – include auto and ag but not IM or coal – still accounts for more than half of total revs for all but BNSF where it was 44% in 1Q07. It's more than 70% on CN and they had the lowest 2006 OR in the biz by as much as 19 points.

Carload revs for the Big Six came to $8.6 bn in 2006 – 55% of the total. The Class Is say shortlines touch roughly 20% of their carload business so we're talking nearly $2 bn in revenues. And the way some market managers talk, you'd think paying a shortline was akin to taking mothers' milk away from children. What's wrong with this picture?

The proper role for the aggressive hungry shortline operator is to learn from every word during the Class Is' earnings calls and other public utterances and go out of their way to design products and services that will do what the Class I says it wants to do. If paper and forest products are down, find a way to move other commodities at higher prices and lower avoidable cost. If it takes five days to turn a car, shoot for three. Offer blocking for the distant node. Encourage customers to work weekends to get cars moved faster. Work toward real-time Internet event reporting. Do all this, the Class Is will love you, and the money will flow.

The Private Equity guys are gunning for results. Shortliners can either hand them the ammunition or freeze like deer in the headlights. When Staggers was passed in 1980, there were 39 Class Is. Now we are five ex-Canada. Staggers spawned countless shortlines to the point where the count now stands north of 500 different names. The Class Is, if they pay attention to their new stakeholders, will find ways to run better railroads; shortlines can either be part of the process or wind up like those other 34 Class Is.

Oscar Munoz, CFO at CSX, did a superb job telling the company's investor story at the Bear Stearns conference last week. The PPT is downloadable at www.csx.com/investors and I'd strongly recommend you follow along. It's one thing to have good fundamentals, trade at a decent PE that is in line with or even less than your 5-year eps growth rate and at volumes high enough to insure liquidity. But it's quite another to tell the story in such a way that listeners leave with the take-aways you intended.

Oscar's PPT does just that. Every slide has a sell line: "CSX has created significant shareholder value"; "Stock performance reflects improving results"; "Earnings power continuing to improve," and so on. You'll notice he carefully accentuates the positive and avoids any mention of first quarter results that reflect any softness in the market or slippage in ops metrics – revenue units off 6%, intermodal RPU off 4%, OR up 80 BP and second highest after UP, ops income down 2%. The focus was on the *financial* and Oscar made sure it stayed there. To be sure, every Class I can tell a strong financial story but thus far only CSX gets an A for the way its story comes across.

Debbie Butler becomes Norfolk Southern's new Kathryn McQuade effective June 1. She moves to Norfolk from Atlanta to take on the mantle of EVP for Planning and CIO, leaving Fred Ehlers to follow her as VP for Customer Service in Atlanta, also effective June 1. Deb is an excellent choice for the job. Not only did she have regular customer (and shortline) contact but the service planning and design team was in her charge as well, so she knows how the railroad works and where the real strengths lie.

Fred comes to his new job from that very service design and planning area and is as good a customer service guy as you'll find. My sense is that Fred and Debbie will bring a level of energy and commitment to their new assignments that will strengthen Norfolk Southern's product and service package and will, with Rob Robinson's shortline guidance, create an environment that will make the new PE shareholders glad they chose NS. (By way of disclosure, I'm still long NSC. Ditto UNP.)

Responding to my service theme from last week, long-time WIR reader Brian Holtz writes, "You concisely outline continuing poor performance in operations and commercial areas. Can you imagine Fed X or UPS missing their overnight connections with 'railroad-like' statistical performance? They both do it consistently, flying through poor weather with packages costing $25 or less. Railroads can't perform as consistently with private rights-of-way and 'packages' (i.e. railcars) averaging in the thousands! Maybe it is time railroads start hiring UPS and Fed X employees."

Brian then suggests a few relatively easy fixes that could go a long way to improve reliability and consistency. He asks, "When will railroads redesign operating jobs so the employees will be home at the end of each shift? The CN can do it. Most railroads' Human Resource Departments complain that people today don't want their jobs and have a difficult time hiring people because railroad jobs are not as attractive as other companies lesser paid jobs." Here's a way to make it less unattractive. I've done it on the couple of shortlines I've run and FEC is doing it today.

Brian again: "Why do Class Is insist on interchanging through Chicago, instead of going around it? Now they want to build bridges and fly-overs in highly congested areas. Bypassing Chicago could reduce overall trip miles, increase train speeds, avoid the commuter train networks and facilitate elimination of duplicate Chicago yards. The TPW could be rebuilt into a high-speed, double-track interchange route connecting almost all Class Is complete with bridges and interchange tracks."

And reader Vin Terrill, a guy who's probably forgotten more about track than most of us will ever know, writes, "Roy, I was pleased at Mr. Amin's comments, to wit: 'Pricing practices that cover the costs of replacing the wasting asset as well as the avoidable costs of running trains.' I'm a bit surprised however, that Mr. Amin doesn't know that some RRs do consider replacement costs within their pricing practices but do not apply the additional monies to replacing the asset. The funds go to the bottom line to help meet Wall Street's expectations.

"Thanks for your continuing cutting-edge RR education over the last 10 years in particular. You have my vote for Railroader of the Year when they run out of RR moguls and start looking for those people who really do make a difference. Vin."

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