RAILROAD WEEK IN REVIEW
MAY 25, 2007

"CN acknowledges that sustained pricing power can only come with dependable or even improving service." Morgan Stanley rail analyst William Greene

By all accounts Canadian National's recent Analysts Day in Toronto was a great success. Morgan Stanley's William Greene writes that the day "confirmed our view that it's the best run railroad in North America. After having improved service and margins to the best in the industry, CN is now moving into uncharted territory by focusing on growing its top line (volume + price). If any railroad can execute on this strategy, it is CNI, but near-term headwinds (economy, currency and congestion-related issues from the strike and in Chicago) are likely to weigh on earnings near-term."

"CN already has some of the fastest and most reliable service in the industry, but CN acknowledges that sustained pricing power can only come with dependable or even improving service. Harrison's vision is for CN to be the best transportation company (not just railroad) in the world and plans to offer a larger suite of services and reduce transit times further in order to make that happen. CN's plan is to bring its disciplined philosophy to other areas of transportation and serve as the single point of contact for customers' door-to-door transportation needs.

"Moreover, CN believes its service and connections will influence steamship routes and provide the railroad with additional import and export opportunities. The ultimate goal is to provide truly truck competitive service and recapture some of the US$150 billion of long-haul North American trucking market that railroads lost decades ago."

Bear Stearns' Ed Wolfe's note on the same meeting provides some valuable cultural and operating insights: "This was a quality management team on display. Twelve senior managers presented with each focused on improved asset utilization and ongoing productivity and cost reductions - the fabric of CN's culture. We found EVP of Ops, Keith Creel, particularly impressive in his first public appearance since his May 1st appointment.

"Management believes it has about $200 mm of potential cost/productivity improvement yet to realize from various engineering projects. We toured CN's largest hub, MacMillan Yard in Toronto, to see the recently-implemented smart yard technology and process. Through changing the hump system they have reduced people and improved train-sorting and reducing average dwell time to about 18 hours from 26 hours. Mac yard still likely has about 50% further productivity in front of it over the next few years.

"After Mac yard, CN, as a result of the process in rolling out Smart Yard to its Symington (Winnipeg) Yard, discovered it could reduce the number of trains switched in its yard by about 2/3 and a hump yard was no longer needed.[1] They will roll out the Smart Yard system-wide the next few years." Wolfe concludes by reporting that CN remains convinced that "its industry leading service capability will lead to increased volume growth above its historical 2%-3% range, driven by increased intermodal opportunities (both Prince Rupert and other, import and export)."

Over at JP Morgan, Rail Analyst Tom Wadewitz sees "meaningful productivity opportunities" coupled with CN's continuing strategy for growth. "A combination of yard productivity (Smart Yard

[1] See also Harrison's *How We Work and Why*, pp 79-87, Service Design Principles 1-3

rollout), longer train initiatives, and locomotive asset utilization provide meaningful opportunities for productivity/cost savings over the next several years. Cost performance is likely to remain strong over the next several years. In addition, their recent move to target 4%-5% pricing gains (vs. 3%-4% previously) indicates that their pricing story remains very solid. And while there may be risk to CN's near-term EPS performance due to a soft economy and weak volumes, we believe that CN is likely to remain on a path of significant EPS growth in the medium term."

All of which bodes extremely well for CN shortlines. Recall that among the Big Six Class I roads CN enjoys the highest percentage of revenue from the merch carload trade by a wide margin – 72.2% in 2006 vs. 57.9% for second-place UP. Moreover, CN's 2006 carload volume came to 3.1 mm units, up from 2.2 mm in 2001, a CAGR of roughly 8%. And since we all know most shortlines are paid a flat fee FAK, they are very dependent on volumes. Being able to raise revenues 8% a year because volumes are growing that fast looks pretty good to me.

Shortline carloads through Week 18 (May 5) were down 9% based on the 311 roads reporting for RMI's RailConnect Index (attached). Ex-intermodal (11% of units but somewhat misleading because of the number of port railroads reporting) the lumber and forest products group continues to be the largest decliner, off 22% YTD, and now represents only 5% of units. Coal, chems and grain account for 36% of units with all but chems showing declines.

Class I loads YTD through that week were down 3% with no signs of rebounding any time soon. Forest products (both STCC 24 and 26) remain the biggest decliners with auto a close second. Anecdotal evidence suggests the biggest part of this is auto parts as Big Three finished vehicle declines may be partially offset by gains from the transplants. The former is going to be most troubling for *some* shortlines – the few handling auto parts – as the group only accounts for 2% of shortline loadings. Even IM, grain and coal were off though very low single digits for the first two. Chems were up 9% mostly on ferts as more corn for ethanol requires more of the stuff. Shortline chems were up 7% YTD.

FreightCar America (Nasdaq: RAIL) reportedly enjoys an 80% share of the US hopper car market. But, as noted above, coal loadings have been off a bit taking the OTH car market down with it. The downside for RAIL becomes inventory backlogs, which of course become worth less and less over time due to depreciation expenses. Orders are declining for RAIL and that hurts. For now.

A contributor (who confesses to being long RAIL) to seekingalpha.com writes, "Fortunately, the company is still making money and while the latest quarter operating cash flow was negative, it seems like the worst is here. Any book on coal will tell you that coal demand for the next ten years is bound to increase which would substantially help the share price of RAIL. With much of its market cap in cash, the company will not go bankrupt.

"One should also take note that the company has a very high return on assets due to a lack of capex. Every commodity company will face blips along the way (or in this case an industry directly correlated with commodities). The time to buy is when things are looking bad. This is a best of breed company at a bargain price. This does however drift away from my usual strategy of buying deep value stocks, ones trading below their liquidation values, etc. RAIL is a really well run company at a bargain price."

The Ohio Rail Development Commission (ORDC) has OK'd $1.2 mm in grants and loans for shortline railroad projects that will create and retain nearly 600 jobs for the state. Top of the list is a $925,000 grant and loan package for expanding the present 2,300-acre "Iron Highway" Industrial Park in Leipsig. Coupled with an over $3.4 million Ohio Department of Development grant, this

leveraging of funds will also enable the construction of the planned Poet Ethanol Plant, which will create 42 new jobs and up to 5,000 new carloads of freight each year. According to Village officials, it is the largest such industrial park East of the Mississippi to be served by three railroads: CSX, Norfolk Southern and the Indiana & Ohio (RRA).

A $100,000 ORDC grant goes to the City of Greenville for a rail spur project. The city, shortline operator RJ Corman and the Dayton Development Corp also contributed. The new track will serve Spartech (a plastics user) and the planned Andersons-Marathon Ethanol Plant and will generate 2,500 carloads of freight annually on what was formerly a marginal-use freight rail line. The project also opens up 75 new acres for commercial development.

A good example of good return on a seemingly small investment was a grant of $48,570 dollars for a rail spur into the Tuscarawas County Port Authority-owned "Southern Gateway Business Park". The project, near Gnadenhutten, will bring a much-needed rail connection for Plymouth Foam Company (a plastics company) and will allow the company to preserve 76 jobs and create 20 new jobs.

ORDC has approved a $200,000 grant to match a commitment of more than $3.2 mm by Fulton Railroad Company for a major trans-loading facility on the Ohio River at Cincinnati. The seven-acre site will allow trans-loading an expected 1.2-million tons of raw steel products (pig iron) from barges to rail and on to steel mills. The facility will save the Ohio steel industry an estimated $1.2 mm to $1.8-mm annually in shipping costs, generate 2,500 new carloads of freight and eliminate an estimated 15,000 truck trips on Cincinnati area highways.

The list of money-management funds taking positions in the Class I rails continues to grow. The $664-mm Hodges Fund has positions in BNI, UNP, CNI and NSC, some going back to 2004. The TCW investment fund started buying CSX toward the end of 2000, betting on the then-new management team's ability to turn the RR around. That it has done, bringing the FY 2006 OR down to a respectable 79.5 from 87.4 in FY 2001, a 9% improvement. Ops expenses all-in rose to $7.6 bn from $6.3 bn in the same period, up 20% however, so pricing power has played a huge role.

One must keep in mind that these "activist" owners are looking for improved results. As CN has shown repeatedly, superior asset management is crucial and the hedgies will be watching closely. This can be a blessing from some shortline operators and a nightmare for others. Well-run properties with strong franchises in what Iowa Pacific's Ed Ellis calls "agriculture and extraction" will do well because the farms and mines and quarries aren't going anyplace.

But the shortlines that depend on limited quantities of manufactured goods or low-value commodities will not prosper in this environment. Rather than send a carload to a shortline that holds the car for a week, The Class I might logically send it to a "Logistics Center" for transloading and truck beyond. The railroad (or shipper if leased equipment) gets better turns on the assets and the Class I saves the shortline allowance or division in the bargain. Revenues up, expenses down, ROA up. Exactly what the Amins and Icahns of the world are looking for.

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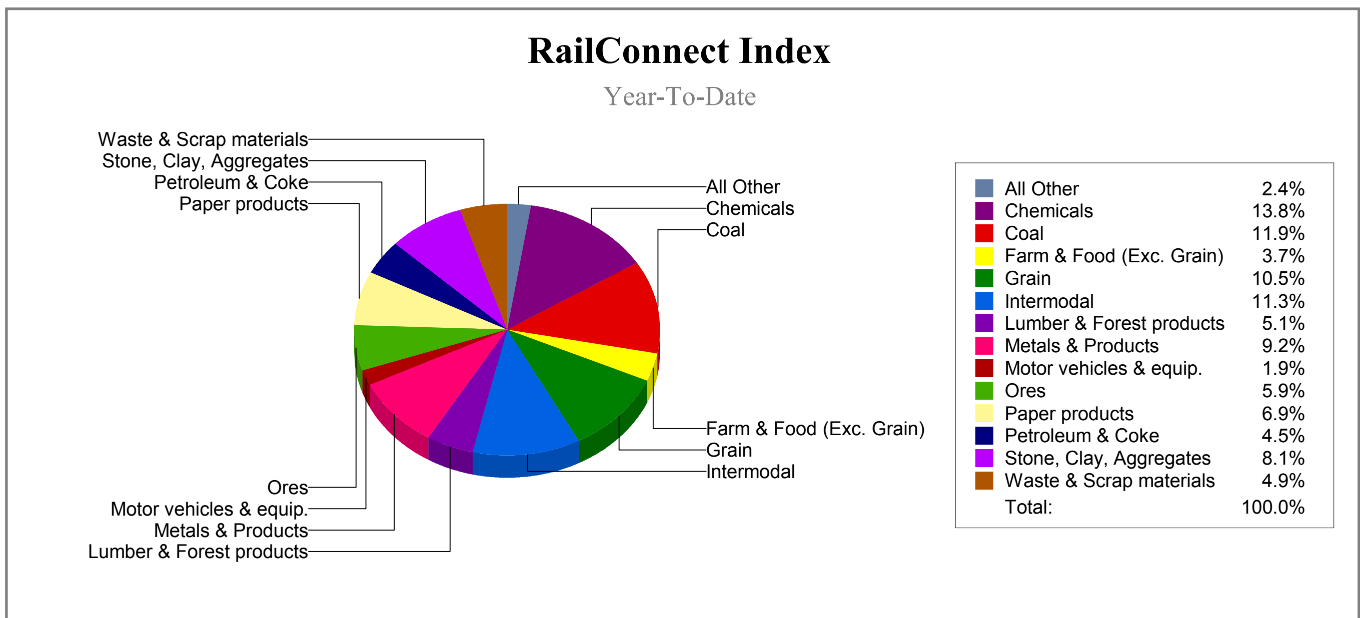
RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 5/5/2007

Week Number: 18

Carloads Handled	Current Week			Year-To-Date		
	2007	2006	% Change	2007	2006	% Change
Coal	12,770	17,019	-24.97%	258,765	281,697	-8.14%
Grain	11,829	13,959	-15.26%	228,690	245,542	-6.86%
Farm & Food (Exc. Grain)	4,669	4,749	-1.68%	79,468	84,594	-6.06%
Ores	5,200	8,717	-40.35%	128,026	151,635	-15.57%
Stone, Clay, Aggregates	12,409	11,926	4.05%	176,312	190,531	-7.46%
Lumber & Forest products	6,463	7,813	-17.28%	111,523	142,530	-21.75%
Paper products	8,186	8,621	-5.05%	148,853	159,097	-6.44%
Waste & Scrap materials	6,208	6,239	-0.50%	107,044	109,480	-2.23%
Chemicals	17,065	15,300	11.54%	298,551	277,845	7.45%
Petroleum & Coke	5,242	5,424	-3.36%	97,902	103,025	-4.97%
Metals & Products	11,470	11,922	-3.79%	199,096	216,434	-8.01%
Motor vehicles & equip.	2,441	2,518	-3.06%	40,286	41,771	-3.56%
Intermodal	14,758	19,646	-24.88%	244,572	316,420	-22.71%
All Other	3,350	3,542	-5.42%	51,898	59,521	-12.81%
Total	**122,060**	**137,395**	**-11.16%**	**2,170,986**	**2,380,122**	**-8.79%**



This report is comprised from 311 roads.

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