RAILROAD WEEK IN REVIEW
SEPTEMBER 14, 2007

"Increased highway congestion should support CSX volume growth and pricing momentum over the longer term." – Ed Wolfe, Bear Stearns

The analyst notes from last week's CSX Investors Meeting in NYC were instructive. The overall message was one of not much new but an education on what CSX is trying to do to improve results in an environment of uncertain volumes and congressional interference. However, what JPM's Tom Wadewitz calls "the most meaningful negative news" was CFO Oscar Munoz' FCF 2007 update, reducing the original $500 mm forecast by 80% to $100 mm (see slide 80). Considerations included $50 mm for "market softness," a $230 mm capex increase mainly for new locos, $60 mm more in divs and $60 mm more for "all other."

Wadewitz continues, "While CSX's analyst meeting provided helpful granularity on potential drivers of growth and their investment strategy, we walked away without much conviction or visibility to how they will transition from several years of no volume growth to meaningful volume growth in the future. Our sense is that CSX still has a solid pricing story and margin expansion opportunity, but the weak volume trend may be a strong headwind that limits upside for the stock."

William Greene or Morgan Stanley zeroed in on stock prices and earnings: "At 13.7x our 2008 EPS estimate, CSX is the most expensive railroad in our universe. Thus, we see more upside at other railroads over the next 18 months, and prefer NSC and UNP. Despite easier comparisons starting in 4Q07, we are choosing to be more conservative in our volume forecasts…We are shaving $0.10 and $0.14 off our 2007 and 2008 EPS, respectively, but only $0.09 off 2009 as near-term weakness should have a limited impact on our long-term forecast. We anticipate an improving freight environment going into 2009."

Over at Bear Stearns Ed Wolfe took a more upbeat note, suggesting that "despite continued weak [carload] volumes, CSX remains excited about long-term growth opportunities from global trade and growing consumption in the Southeast. Increased highway congestion should also support volume growth and pricing momentum over the longer term. CSX continues to show solid improvements in safety and service metrics. The company's Total Service Integration plan should drive further utilization and efficiency gains."

Jason Seidl at Credit Suisse drilled down into revenue-unit counts. "While the crux of the presentation focused on long-term expansion initiatives, growth opportunities and financial targets, management did provide a brief update on the short-term operating environment. Specifically, the company has yet to see a peak season materialize (consistent with channel checks from its trucking counterparts) and more importantly, does not anticipate a robust increase in volumes. Indeed, management referred to the upcoming few months as more of a 'bump' than a peak.

"Management's commentary does not bode well for the sluggish volumes ailing the rail industry as it does not appear that conditions will improve in the near term. CSX carloads are down 5% for the quarter, driven by weakness in Intermodal (-8%), Coal (-6%) and Forest Products (-13%) — the latter attributable to the broader housing slowdown (particularly in the Southeast where CSX has significant exposure)."

Canadian Pacific's DME venture drew more Wall Street analysis this week. Seldl cites this note from Credit Suisse Canadian Transportation & Industrials Analyst Cameron Jeffreys who writes, "While financially not a significant transaction in our view, strategically this acquisition is a good fit with CP in several respects. First, DM&E's existing focus on bulk products as well as the PRB 'option' for coal volumes fits with CP's business mix and expertise. Second, the DM&E line fits geographically with CP as it bolts on end-to-end with CP's line at Winona, MN. Third, it provides a growth opportunity for CP in an area well known to the company, coal, and will be a decision left to the company given that the approvals have already been granted to the DM&E with respect to building out the project."

Moreover, continues Jeffries, "The ramifications of the DM&E purchase should undoubtedly be felt by the Western US rails in the coming years. Assuming the project is successful and that operations commence in 2012, DM&E could potentially handle 25 million tons in its first year — which would give them a 4.5% market share and would account for slightly more than 25% of the projected growth in PRB tonnage. Eventually, we believe that the DM&E's line into the PRB could accommodate as much as 100 million tons of coal annually" and that could affect coal pricing at BNSF and UP.

FP Trading Desk, the blog of Canada's *Financial Post*, took a different tack. "When investors are given a choice between company share buybacks and an acquisition, they prefer the buybacks. That, at least, is one conclusion that can be drawn from Wednesday's bid by Canadian Pacific Railway Ltd. for privately-held Dakota, Minnesota & Eastern Railroad Corp.

"The deal with DM&E, which could involve another US$1-billion in contingency payments tied to expansion projects in the Powder River Basin coal-mining area, effectively puts Canadian Pacific's share buyback program on hold, a move that investors do not take lightly. Their concerns stem in part from the belief that Canadian Pacific could be buying DM&E for too much money just as the economic cycle is about to turn. The impact of unwinding credit markets could hit the global economy and the U.S. economy in particular.

"A slower economy would likely translate into lower commodity prices and a downturn in global trade -- the lifeblood of railways, and Canadian Pacific is no exception. As well, some analysts are not convinced the deal will result in any meaningful cost savings, or synergies, for Canadian Pacific anytime soon." Of course, WIR readers know we've taken the opposite side of that bet.

A broader market view comes from Tom Murray's excellent *Rail Stock Watch* for Sep 3. "Railroad shares underperformed the broader market in August, with the Dow Jones index of large-cap North American railroads falling 4.6%, in contrast to a 1.3% gain in the S&P 500. The disparity might have been even larger if it hadn't been for the rail investor's new best friend, Warren Buffett, whose Berkshire Hathaway added to its position in BNI late in the month, helping rail shares rally on the last day of August.

"We can only speculate," Tom continues, "about what makes investors buy and sell shares in specific companies and sectors, but our guess is that some of August's softness in rail stocks relates to the current top story in the financial arena - the credit crunch. In July, those who hoped that one or more large railroads might be the subject of private-equity takeovers were heartened to learn that Brookfield Asset Management had taken a long and serious look at doing exactly that with CP.

"But the distress signals from the sub-prime lenders, which soon worsened to a more generalized liquidity shortage, made the markets realize that the easy money that has been fueling ever-larger private equity deals in recent months is no longer out there [which is one reason I suspect the PE guys withdrew from the DM&E field - rhb]. Most longtime observers of the rail industry have felt that the railroads weren't very good candidates for leveraged buyouts anyway. [See also how CP's Fred Green handled this in the conference call, WIR 7/27/2007 page 2].

"Perhaps it's just as well that this phenomenon has now run its course so that we can get back to looking at the railroads in terms of their long-term fundamentals. Still, it is encouraging that new investors, including both buy-and-hold people like Buffett, and a slew of potential activists (including various hedge funds) have become owners of rail shares. The quality of railroad management is, on average, better than it was a decade ago, but every CEO can benefit from having a few shareholders who have the motivation (and the moxie) to ask tough questions." Thanks, Tom.

RW Baird's Jon Lagenfeld provides us a glimpse of trends on the trucking side, always important for folks in the merch carload business that is so susceptible to diversion to truck. Says he, "Domestic trucking demand remains weak and peak season volumes have not materialized. Truck pricing pressure persists and we do not expect a positive turn in contractual pricing until 2H08, placing added pressure on asset-based truckers.

Capacity is expected to remain relatively loose into 2008, but shippers are concerned about capacity availability over the longer term." This leads to a more favorable environment for intermodal (still cold comfort to the merch guys) as "contacts confirm intermodal trends have improved seasonally moving off the West Coast resulting in tight capacity and planned peak season surcharges. There has been some aggressive pricing on secondary lanes."

UBS' Rick Paterson has upgraded KCS to a Buy following its 29% pullback noting that "our positive long term view on KCS's financial performance remains unchanged and the stock's valuation no longer looks prohibitive. Volume growth is running negative and network efficiency is flat y/y as poorly performing old leased locomotives inhibit fluidity. KCS will likely miss its 6% revenue-growth target for the year and possibly its 80% operating ratio goal. However, the long-term story remains compelling.

"The Lazaro Cardenas port expansion opens on 9/26, the old locomotives have started being switched out for new ones, and by year end both Mexico and the US will be on the same IT platforms. The latter two should revive the cost side of the margin story. Looking at the worst case, our $1.81 2008 EPS estimate would fall to $1.48 under a recession scenario – but still implying a respectable 7% EPS growth. In our view KCS is ultimately a takeout target, and below $30 we expect the stock to find support as the odds of being acquired increase exponentially. Our slightly lower price target of $40 (from $41) is based on a 50/50 blend of the sector (8.2x) and potential takeout" [of 11x ebitda], a discount to the most recent known takeout, RailAmerica at 11.7x."

Things the spell-checker misses dept. WIR 9/7/2007, page 3: CSX capex is $5 bn *over four years*, not per year. WIR regrets any inconvenience and the copy to be posted to www.rbanchard.com has been changed accordingly.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $125. Corporate subscriptions are $500 per year. A publication of the Blanchard Company, © 2007. Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned.