

THE RAILROAD WEEK IN REVIEW

APRIL 4, 2008

"A combination of better pricing and harvesting remaining productivity could reduce operating ratios by another five to ten points by 2015." -- Bill Rennie in Railway Age, March 2006

The outlook for new railcar builds according to Economic Planning Associates does not look good near term for boxcars, mill gons, non-intermodal flats or small-cube hoppers, exactly the car types that move low-rated commodities found so often on short lines. Beyond the short lines, the present economic picture suggests a slowing of imports and thus intermodal volumes, potentially freeing up capacity for anticipated gains in grain, coal, ethanol and DDGs.

By 2010 or 2011 we ought to be past the lump in the python as older cars fall out of service and have to be replaced. But that still does not mean all boxcars or mill gons or small cube hoppers. Conversations this week continue to point toward reinvesting in car types where utilization and strong pricing warrant investment in these 40-year assets. One problem area could be automotive. Though automotive represents less than 2% of short line volume according to RMI's RailConnect Index, YTD loads are off 9% from 2007 levels, roughly 2,000 units.

The *Wall Street Journal* this week ran a table showing what's moving and not. Comparing yoy vehicle sales for March and YTD, autos of all sizes were down 5% and 3% for March and YTD respectively. Within the group, small cars were unchanged in March and actually up 3% YTD. Light-duty trucks were off 18% and 12% for March and the year while SUVs were off 27% and 20% for the month and year. And there has been a shift in mix as well. So-called light trucks accounted for 53% of March 2007 sales and less than half of March 2008 sales.

The impact on rail volumes hits three ways. One, because small cars are, well, smaller, you can put more of them on one auto rack than you can, say Chevy Tahoes, ergo total carload volume will continue to shrink. Two, because total sales are off 12%. Third, because fewer cars mean fewer parts moving in boxcars and intermodal containers. It's so bad on the carload side that one Class I is reported to be pressuring paper shippers to use high-cube jumbo boxcars designed for auto parts even though they will weigh out before they cube out in paper service.

From Baird's Jon Langenfeld comes this note on trucking volumes: "Overall demand trends remain weak across transportation modes both domestically as well as inbound U.S. import volumes. Additionally, elevated fuel prices and severe winter weather have added further pressure to asset-based transport providers' results. When coupled with ongoing weak pricing [not good for keeping price-sensitive shippers on the rails -- rhb], we believe asset-based truckers will miss 1Q results unless estimates move lower into the reporting season.

"The industry freight tonnage index published by the ATA shows four consecutive months of positive year-over-year tonnage growth. Regardless of the anecdotes, the fundamentals of consistent business trends and improving supply imbalance suggest we are now past the bottom of this cycle. We believe excess capacity conditions have peaked and the trucking capacity supply/demand imbalance is improving from trough levels experienced in mid-2007.

"As evidence of the improving supply picture, new and used truckload exports are at elevated levels (unique to this cycle), new truck sales are at risk of further downward revision, and existing truckload carriers are reducing capacity. In fact, based on our data which dates back to the early '90s,

this is the first time that the combined public truckload fleet has meaningfully contracted. We expect further fleet reductions and failures from small and mid-sized carriers, driven by the tough operating environment and elevated fuel prices.

“While pricing remains under pressure, we have seen multiple signs that spot market pricing firmed through 1Q08, which we attribute to ongoing carrier struggles with rising fuel. While still favoring the shipper, the pricing pendulum has started to swing and we now expect minimal rate concession among trucking carriers in 2008. [Since] we do not expect demand to improve until 2009, we suspect meaningful pricing gains are not yet upon us.” Thanks, Jon.

The Spring 2008 BNSF Short Line Newsletter once again zeroes in on short line asset utilization – equipment turn times, to be exact. I am reminded of Katie Farmer’s most excellent presentation at the October 2005 meeting where she went into some detail on short line dwell times -- see attached excerpt from her slide deck. The red line is average short line dwell of just over 10 days). Progress has been made but there’s still opportunity for improvement.

Says BNSF, “Based on feedback from the most recent ASLRRA Survey (discussed at our October 2007 short line meeting), we have developed a pilot program to improve the interchange process with our partner short lines. Although BNSF was rated as highly as it has been in the past four years, our rating was still considered just satisfactory. We would like to improve that and have identified 21 short lines we will be working with throughout the year to test and develop processes to improve our interchange performance.

“In April [that’s now, folks – rhb], we will begin analyzing interchange data for the participating short lines. As we progress with the program, we will provide periodic updates on the results and findings. As many of you will recall from previous years’ BNSF Short Line Conferences, the AIM initiative deals with reshaping the carload network to increase delivery reliability and consistency, and asking customers to play a part as well by examining their own operations and infrastructure for the purpose of identifying inefficiencies.

“The BNSF AIM Team is currently working with a number of short lines and our mutual customers to *Assess, Improve* and *Maximize* the first and last mile of our three-part process - customers, short lines and BNSF. Specifically, we are currently working with the Louisiana & Delta and the Rock & Rail to improve our service to customers and help them better address their ability to grow.

“Over the next several months, the BNSF AIM Team will be working jointly with short lines in the PNW to improve our joint service to customers in the area. We will be contacting area short lines in the near future regarding the process. At last year’s Short Line Conference, Dave Garin, Group Vice President - Industrial Products, extended an invitation to each of you to become involved in the AIM process. The invitation still stands. Please let us know if you would like to become involved and we will get you on the list.” Man, if it were my short line I’d be there in a heartbeat. What an offer.

The unit train vs. single carload discussion continues apace and I’m constantly on the lookout for places where short lines play a significant role. There are several on the ag page of the CSX website: the Albany Port Railroad serving Cargill with 110-car wheat trains, 90-car trains out of Reynolds (TP&W) and Edinburg (LIRC), Indiana, and Oblong, Illinois (INRD) as well as the new 50-mm gallon ethanol facility at Shelby NY on GVT Rail. The CSX page also links to a list of “certified 90-car facilities,” most of which are on short lines.

That does not mean a short line customer that can’t take a whole train at once is automatically left out. At the recent CSX Short Line Meeting (WIR 2/22/2008) I made sure to query the grain guys

and others about unit trains vs. single car shipments and whether non-unit train origins and destinations could even use CSX. The answer was a resounding and universal YES. The chief consideration is whether a unit can be turned within the maximum dwell time that can be allowed and still make the economics work. If not, run singles but know the per-bushel price to the customer will not be the same as the unit-train user.

KCS' stock price "has rallied more than \$10 over the last few weeks and closed to within 7% of our \$44 price target last night," writes Rick Paterson of UBS. (This is the same outfit that opens its Sixth Avenue lunchroom to the KCS management team for a meal and additional Q&A following the formal earnings presentations over on Park.) However, writes Rick, "Given recent operational efficiency improvements our conviction in the story has increased, although not by enough to offset the recent surge in valuation. We therefore downgrade our rating from Buy to Neutral.

"We still love the KCS story [and] our long-term outlook on the company remains unchanged. We expect at least 2% operating margin expansion in 2008, driven by efficiency gains as the locomotive fleet renewal program continues. We expect a strong first quarter result despite high fuel prices and a weak US economy. While we don't have any operating efficiency data for the Mexican half of the network in 2007, the US network saw a 3% yoy increase in average train speed and 9% improvement in terminal dwell time in the first quarter.

"We value KCS using a 50/50 blend of the current sector EV/EBITDA multiple and a takeout multiple of 11x, which gets us to our \$44 price target (unchanged). On a PE basis the stock currently trades at 19x forward, which we regard as a little rich." Maybe so, but the take-away here is that KCS is taking positive steps to improve results and today's larger short lines and regionals could do worse than pay attention to what KCS is doing and how Rick and others perceive those steps in terms of company valuation for investors.

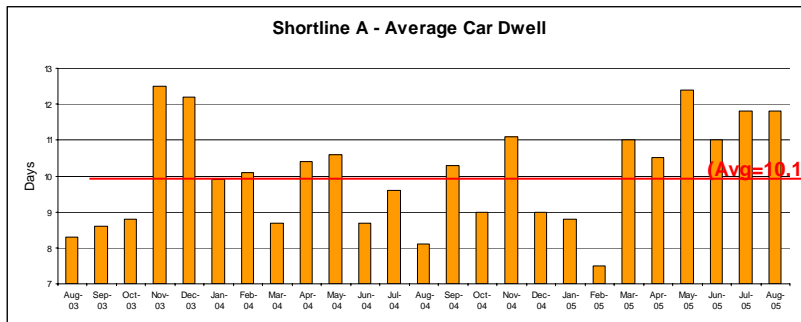
The passenger push evidenced by the recent expo in Providence (WIR 3/28/2008), support for Lautenberg's \$2 bn Amtrak bill, and record results for Bombardier can only be good for the freight rails for the added capacity and public caché contributed by enhanced commuter services. Only yesterday I was talking with a large regional railroad president who called to report record inquiries for both carload and intermodal services.

Unfortunately there are still callers who simply want the rail rates to beat up on the truckers. But four-dollar diesel fuel is still just that and one wonders how long that game may be played. As my caller said, it's a great time to be in the railroad business.

Corrections Dept. Providence & Worcester's Frank Rogers notes that the depressed FRIP track segment (WIR 3/28/2008) "is the so called boat section and is equipped with large sump pumps and we have not had, nor do we anticipate, any service interruptions due to flooding."

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than \$12 mm annual revenues \$150. Corporate subscriptions \$550 per year. To subscribe click on the Week in Review tab at www.rblanchard.com. A publication of the Blanchard Company, © 2008. Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned in WIR. Specifics available on e-mail request.

Utilization/Capacity Improvement



Reasons for Excessive Shortline Dwell

- Prepositioned cars for storage
- Railcar Equipment Request exceeding actual loading
 - Plant shutdowns / slowdowns
- Cars arriving prior to want date
- Bunching