THE RAILROAD WEEK IN REVIEW
JUNE 20, 2008

"All the rails are suffering fallout from the flooding, but UP has been hit the hardest followed by BNSF and then CN." -- Bill Greene, Morgan Stanley

The extensive flooding in Iowa and other parts of the plains states has been called the worst since 1993 and has the transportation networks in a shambles. This on top of $4 gasoline and $7 corn will surely cascade throughout the economy as the flood waters recede. The National Weather Service called flooding in Cedar Rapids a "historic hydrologic event" as the river over-topped its banks at 500-year flood levels, forcing the evacuation of nearly 4,000 homes. Cedar Rapids locals said the flood that hit Iowa's second-largest city is far worse than the deluge of 1993. About 25,000 residents have had to leave, and hundreds of homes and businesses have been damaged, many severely.

The Cedar Rapids & Iowa City Railway Bridge downstream from the Eighth Avenue Bridge in downtown Cedar Rapids collapsed into the river even though the railway had placed 20 rock-filled hopper cars on the span in hopes of weighing the bridge deck down and keeping it in place. The whole railroad was shut down because of losing this key link. In Waterloo, a third of the Iowa Northern Railroad bridge that crosses the Cedar River was wept away by raging floodwaters. The IANR uses this bridge to transport tractors from the John Deere Tractor Works down to Cedar Rapids for interchange beyond.

In the Quad-City area, the Iowa, Chicago & Eastern Railroad was taken out of service in Davenport, Muscatine and Columbus Junction due to water over the tracks. Union Pacific had at least six of its lines out of service at some point over several days. Rail damage also limited the railroad's ability to reroute cargo and advised customers with shipments moving through the region should continue to expect delays of up to 72 hours.

Amtrak's California Zephyr was shortened to Omaha with bus service beyond due to flooding at Ottumwa. Putting up the floodwalls shut down the Keokuk Junction Railway (KJRY) mainline operations, limiting the usual switching for customers. Wisconsin & Southern (WSOR) had to close eight subdivisions. And flooding along lines in Hannibal, Mo., forced Norfolk Southern to close a 211-mile line between Illinois and Missouri, but the railroad was able to reroute its traffic.

Off the rails, Iowa DOT suspended the issuance of oversize permits that would involve routing east of Interstate 35 in Iowa from the Minnesota to the Missouri state lines. At one time, long stretches of Interstate 80 and surrounding roads were shut down, creating a 300-mile detour north for drivers crossing the state. In the afternoon, officials also closed a short portion of the interstate south to Iowa City. Authorities closed a nearly 300-mile stretch of the upper Mississippi River to all traffic. The Army Corps of Engineers listed at least 11 locks closed along the upper Mississippi River system, principally in Iowa and Missouri, which will essentially close the river to commercial traffic between St. Louis and Minnesota for two weeks.

Losing access to the river will be a major headache for shippers. Each 15-barge commercial "tow" -- stretching over many football fields in size -- carries the equivalent load of 870 trucks. Typically, as many as two dozen such massive tows flow through the locks in a day. Each tow carries 22,500 tons of cargo, which would require 200 railroad cars to replace.

From Wall Street Morgan Stanley rail analyst Bill Greene writes, "While most flood effects will be temporary, we worry that damage to the corn crop and track signaling may have longer-term implications for 2H08. Grain volumes will face tough comparisons by 4Q08 and export loadings will be off. Wheat was generally unaffected by the flooding with production expected to be higher than the 2007/08 crop year. BNSF has an outsized exposure to US wheat relative to other railroads, and should therefore see greater relative strength in agriculture volumes if the corn crop is badly hit.

"All the rails are suffering fallout from the flooding, but UP has been hit the hardest followed by BNSF and then CN. The [infrastructure] constraints should only last a few weeks though any significant damage is still unknown at this point. Rail traffic and operating metrics will be down over the next week or two. 2Q08 expenses will see an impact as well. The USDA already reduced production estimates modestly for weather, but another large reduction is likely as it is too late in the season for many farmers to replant crops. (We've heard rumors of up to 1 billion lost bushels.)"

All of this comes at a time when Iowa's short lines are undergoing significant upgrades. Iowa Interstate has ordered 12 new locomotives at $2.2 mm a copy and has upgraded much of its 373-mile main across southern Iowa to 40 mph (some spots were down to 10) using RRIF loans for part of it. IAIS President Dennis Miller said the railroad expects a 30% increase in volume over the next two years, primarily from ethanol plants coming on line at Atlantic, Council Bluffs and Menlo.

The ethanol shipments will come on top of Iowa Interstate's service to the ADM plant at Cedar Rapids, which is next door to IAIS' headquarters on the city's southwest side. Iowa Interstate also serves Penford Food Ingredients in Cedar Rapids, Merchants Warehouse and Beisser Lumber in Des Moines and numerous grain elevators, every one right in the middle of the worst flooding.

Comments on the rail aspects of the drubbing the market took a week ago are just now emerging. UBS' Rick Paterson pithily puts it this way: "The rails were caught in a perfect storm (market down, oil up, downgrade) resulting in the worst trading day in six years. Reactions that violent are typically evidence of substantial pre-existing anxiety, given big question marks on the economy and fuel.

"We think valuation is more of a concern. The big four US rails are up 35% YTD, the charts scream "pullback", and the May 30 peak P/E was the highest in at least 15 years. Since 1992, the average PE has peaked, briefly, above 16 only seven times, with an average pullback of 11% over the following 30 days. Will history repeat itself yet again?

"There is an emerging view that it's different this time given the secular pricing story. Maybe. We're in the 18th consecutive quarter of the pricing story, so why re-rate now when core price is about to decelerate as legacy contract opportunities diminish, rather than in quarters three or four when it was still in its ascendancy? We don't buy it. More likely, the rails have re-rated due to increasing scarcity value as the "rail story" has remained strong relative to diminishing investment opportunities in other sectors." See for example FSTR coverage below and here last week.

JPM's Tom Wadewitz says they are "adjusting 2Q rail EPS forecasts to reflect softer than forecast volumes and a greater than expected rise in fuel prices in 2Q." FSC should be an accelerating factor by a factor of 10-15 basis points vs. the 7-10 basis points at this time last year. Of critical importance to short lines paid handling fees, Tom sees volumes remaining in the doldrums: "We have revised our volume adjustments downward to reflect slower than anticipated volume growth in 2Q:08."

Common Carrier obligations will be the topic of the STB hearing July 16. This hearing follows a similar hearing the Board held in April on the general topic of the common carrier obligation of railroads. The Board said the July 16 hearing will provide a forum for a more detailed discussion of issues specifically pertaining to the railroads' common carrier obligation regarding the movement of "toxic by inhalation" hazards (TIH) and other hazardous materials. Notices of intent to participate and each speaker's written testimony should be filed in the same document no later than July 2.

Short lines are in a particularly tight spot. Insurance is tough to come by and one TIH incident could put a marginal carrier out of business. Yet the local water company wants their chlorine, and the neighbors don't want the stuff on their streets. The FRA is very specific about the kind of track you need to haul hazmats, and not everybody has the revenue base to support $5000 per mile per year to keep FRA class 2 track in T&S. I'm sure the ASLRRA will be well represented on this one. The stakes are too high not to get it right.

L B Foster (Nasdaq:FSTR) is the subject of a new report from Janney. Excerpts: "We are initiating coverage on L.B. Foster Company with a BUY rating and a fair value of $43.00. With its established base of railroad, government, and industrial clients, L.B. Foster is positioned to capitalize on several underlying demand drivers, such as the railroad's efforts to increase safety and efficiency in the face of record traffic volumes and the upgrade of the public infrastructure.

"With increasing profitability and declining capital expenditure, we believe L.B. Foster will increase its free cash flow generation and ROIC. In addition to excellent fundamentals and a strong balance sheet, FSTR shares are trading at significant discount to historical valuation metrics. Foster is positioned to generate improved revenue performance with higher gross margins for the balance of 2008. In terms of company fundamentals, the company has delivered positive operating leverage, high returns on invested capital (ROIC), and an improving cash flow profile."

From Wolfe Research comes this note about the pending sale of Weyerhaeuser's short lines: "We spoke with a private short-line rail operator who believes Weyerhaeuser's lines are some of the most attractive in the industry. Of particular interest is the De Queen & Eastern Railroad (DQE), which is a 45-mile line in Arkansas with roughly 70,000 carloads annually. Our contact believes there will be several interested buyers of the short-lines properties, including private equity players. As a result, the Weyerhaeuser properties could receive a premium valuation upwards of 10x EBITDA (versus historical averages for short-line rails closer to 8x).

"We also spoke with an industry consultant about the pending Weyerhaeuser sales. This contact believes there will be several interested buyers, with RailAmerica (currently owned by Fortress) perhaps making the most sense given their existing properties in Arkansas and Mississippi where three of the four Weyerhaeuser lines are located."

This just in: At the Merrill Lynch Transportation Conference on Wednesday BNSF took down its 2Q08 estimated EPS to $1.30 from its previous guidance of $1.42, citing the negative impacts of flooding and fuel. UBS' Rick Paterson was quick to respond. Quoth he, "Last night BNSF issued the profit warning we were expecting when we introduced our short-term Sell rating last week. With the issuance of the profit warning, we're now removing our short-term Sell, [though] we frankly can't see why anyone would want to own BNSF over UP, given valuations are similar and we expect UP to simply grow earnings faster and in a manner less reliant on demand and the business cycle."

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