THE RAILROAD WEEK IN REVIEW
AUGUST 15, 2008

"We would warn against shorting the rails here, as Q3 and Q4 look strong to us based on continued pricing strength and falling fuel expense in the face of a peaking fuel surcharge. Don't do it." Rick Paterson, UBS

Seekingalpha.com is my number one source for what people are saying about companies. Here is one about why Warren Buffett is buying railroad stocks: "Last year, Buffett started buying up railroads such as Norfolk Southern Corp and Union Pacific. And now he's building his largest railroad position - Burlington Northern. He now owns 18.4% of the company - a massive $5.5 bn endorsement.

"Why is he betting big on the railroad industry? It seems to go against common thinking that the rail-freight shipping industry is doing well. After all, the economy is stumbling, to wit: GDP is almost at a standstill at 0.6% growth, inflation increased 2.2% in the Q1, freight volume [yoy is off by] 3.4% and fuel prices are [high compared to this time last year].

"So what's missing here? Plenty. The rail industry has seen its overall volumes decrease slightly over the last year. But railroads, considered to be behind the times, slow innovators, and in an industry that had little power to increase profit margins, are proving just the opposite." Yet there are those (and I am sometimes among them) who will tell you the rails are doing well in spite of themselves.

There are two things at work. First, the rails are running larger cars so revenue ton-miles can go up even as car counts stagnate. Two, the steep highway diesel fuel prices are shrinking truck bottom capacity as marginal players move to the sidelines. My bet is a lot of this comes from shippers using rail as a fallback as the preferred vendors – the truckers – are getting scarcer and hungrier. As truck capacity increases and prices moderate, these shippers will be back on the interstates AQAP.

I just had lunch with some guys who monitor rail freight rates and customer satisfaction and they're seeing a fair amount of discontent with the price hikes the rails have been taking. Maybe so but the rails are finally catching up with the rest of the world and charging what the traffic will bear. The ones who are really lagging are the short line railroads who get paid a fixed number -- almost FAK -- per carload.

I suggested to my lunchtime friend that he start showing short lines the revenues the Class I connections are getting on the short lines' commodity OD pairs. Moreover, he must convince short lines they must be more aggressive in selling their version of customer service to the Class Is. I mean, what's it worth to a Class I in terms of added revenue per customer when the short line can move 50 individual boxcars through a transload in three days?

There can be no doubt the rail industry now has more power to increase margins. They also have a short line network of hungry hunters and gatherers and who have capacity to spare. Put their customer focus to work and there is loyalty to be gained such that the shippers using rail as a backup will stick around and make rail their primary. Railroading is a team sport -- let the short lines play the infield for the short hops and leave the long balls to the outfield. Buffett will thank you.

Need more ammo to pull the trigger on some rail stocks? Read what Tom Wadewitz of JPM saith. Based on the intra-day prices, railroad stocks have pulled back 5.4% from the closing prices last Friday (8/8), but the group is still up significantly in 2008. We believe that negative sentiment regarding commodity stocks has spilled over into the rail stocks and is a primary factor causing profit taking and a *technical* (emphasis added) move down in this group.

The Fundamentals Story has not changed. Rail transport pricing is not directly linked to commodity prices [maybe not but CP's Fred Green might take exception] and the recent pullback in commodity prices should not have any direct impact on rail earnings. In addition, we note the rails have a diverse customer mix and lower commodity inflation could drive an improving outlook in their economically sensitive segments such as intermodal, automotive, and forest products. Coal and agriculture make up 26%-38% of total revenue for the major rails with the remainder from more economically sensitive segments.

"Gauging the impact of the commodity trade unwind and apparent derivative concerns about rails is difficult. Nevertheless, we continue to have a high degree of conviction that the US rails will remain on a path of strong EPS performance, and we view the sharp near term pullback as providing a buying opportunity. UP and NS are our top picks among the major railroads, and we would focus on buying these two names amid the current pullback."

Wadewitz believes the stories for both are "compelling" as UP operating efficiency continues to improve and NS has done an extraordinary job of winning price hikes in the merch sector aided and abetted by its improving intermodal and coal stories. The short lines in particular stand to gain as NS expands on its corridor strategy and looks for new ways to use shortline capacity to extend reach and frequency. The Empire Link in NY and the Pan Am Southern in New England are Exhibits A and B.

Ed Wolfe of Wolfe Research suggests that even though rail share prices may have gotten a bit rich of late, "we believe visibility to pricing, productivity and earnings remain exceptionally strong – especially compared to other industries. Besides, from strong visibility into sustained double-digit EPS growth through 2009 even in a continued poor volume environment, we see upside to near term (2H:08) EPS estimates from recently declining fuel costs and surcharge make-up.

"Our favorite names remain UP, NS and CSX as well as small cap GWR (each rated Outperform), although at current valuations, we are warming up to the Canadian rails which have underperformed both financially and as stocks year to date relative to their U.S. counterparts." I have to agree and once again extend the theme to the carload sector specifically. All three have strong short line groups that have the ear of senior management.

UBS' Rick Paterson takes the position that "the rail stocks are the one remaining industrial group that hasn't yet capitulated to the bear market...and their time is up. Albeit fundamentally flimsy, if enough investors believe this it could become a self-fulfilling prophecy. Whatever the reason for the negativity on the rails, short interest appears to be increasing. We would warn against shorting the rails here, as Q3 and Q4 look strong to us based on continued pricing strength and falling fuel expense in the face of a peaking fuel surcharge. Don't do it."

Closing the thread on overloaded scrap cars, the AAR has issued an "Early warning," saying in part, "The AAR Open Top Loading Rules Committee has approved revisions to Figure 87, Section 2 of the Open Top Loading Rules. The major revision is to restrict loose scrap metal to be loaded below the top of rail car sides and ends at any point of the load. These revisions are being finalized and will be formally circulated for comment throughout the industry."

This can only benefit short lines that are paid "handling allowances" on a per-car basis. The scrappers' trade group acknowledged having to load an extra car for every nine previously mounded up above the gunwales. Railroaders have sent me horror stories of 140 tons in a 110-ton car –

roughly four loads in three cars. The age of entitlement (thanks, Larry Kaufman) is coming to an end, and none too soon. If Congress and the STB want to beat up on the industry from not following the rules, then let the railroads insist on shippers following the lading rules and pay accordingly.

In the mail: From time to time I get review copies of railroad books and I have to admit they've been piling up un-read (you can see past reviews at www.rblanchard.com – there's a link). Two more from the Voyageur Press "Railroad Color History" series are Tom Murray's *Chicago Northwestern Railway* and Richard Borkowski's *Norfolk Southern Railway*. Both are lavishly illustrated, beautifully printed tomes written by folks who know how things work and how to tell the tale.

Also from Voyageur Press are *Railroads of Pennsylvania* by Brian Solomon and *The Railroad Never Sleeps*, edited by Solomon. The first book does a great job covering the diversity of rail operation in Penna, from the ex-PRR Middle Division to the East Broad top to the long-defunct Johnstown Traction Company. Solomon's photos are breathtaking. The latter is a national view of what *TRAINS* did on the Wheeling in their July 2008 issue. The present volume is another great how-things-work treatise, devoted exclusively to what's there now and why.

In a slightly different vein, Christian Wolmar's *Fire & Steam, A New History of the Railways in Britain* comes from Overlook Press. This is a reader's book, not a picture book, and it traces the development of the UK rail system from the 1830 beginnings on the Liverpool & Manchester to the Channel Tunnel Rail Link that opened just last year. Finally, the Fifth edition of the Simmons-Boardman classic, The Railroad: What it is, What it Does" is out. *Railway Age* Editor Bill Vantuono has brought together a group of railroad writers "to present a comprehensive overview of the railroad industry in North America as it currently exists and functions." Contributors include Tom White, Allan Zarembski, Frank Wilner and others including, well, yours truly.

If you're still on the fence about the *RailTrends* conference next month, here are a few tidbits that you may find helpful. First of all, the conference is presented by, with and for investors and others with skin in the railroad game. Independent analyst (and good friend for lo these many) Tony Hatch not only emcees the whole show but also plays a big part in developing the content and recruiting the speakers. As readers of these pages know from his quotes frequently cited here, Tony has a way of getting to the point of making more money with the tools at hand.

Of course, holding an event like this takes money, and content attracts sponsors. Heading the list is Miller Tabak, an institutional trading firm that's been around for more than 20 years, taking the lead as platinum sponsor. GATX is a gold sponsor while RailSolutions (equipment finance) and Gross & Janes (wood ties) are silver sponsors. *RailTrends* is presented by *Progressive Railroading* magazine, which celebrates its 50th anniversary this year. To register, go to the website, www.railtrends.com . You'll be the richer for it.

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