THE RAILROAD WEEK IN REVIEW
SEPTEMBER 26, 2008

"If this plan fails to work, it's the stone age and if it succeeds we're going too be up a lot." – Jim Cramer's Stop Trading

It's not pretty out there. Retail analysts predict the weakest Christmas sales gains in seventeen years, with intermodal taking the brunt of it. Year-to-date sales of home repair and remodeling products are off nearly four percent from what they were in 2007: intermodal again plus the usual buildings goods suspects from lumber to aggregates. Market strategists at Goldman Sachs predict the malaise will spread from the financial and consumer discretionary names to firms in the materials industrial sectors with little chance for recovery before the second quarter of 2009.

On the brighter side, UBS' Rick Paterson sees a constant in the rails that is lacking elsewhere. "Although bruised, the rails haven't been badly battered in the current market meltdown. Bears fear the out-performance of the group may make it a target for selling given healthy valuations and the fact that it hasn't yet capitulated. On the flipside, the flight to US treasuries yesterday triggered an idea: what about an equity analogy in the rails?

"Big, simple, and financially unsophisticated regional duopolies. Here today, here tomorrow. These things have been around for 150 years for a reason (although the same longevity logic didn't help Lehman). There's also a precedent here: during the tech bubble implosion we'd be on the road and sometimes find ourselves across the table from a tech PM who knew nothing about rails and was just looking for somewhere to hide. Rails to the rescue again perhaps."

Ed Wolfe's "Inside Freight" note for September 22 suggests that the major rails will be unaffected by this credit crisis. On the other hand, he warns, "We expect increased risk for financially-constrained carriers as debt instruments approach retirement or as bank covenants need to be restructured. We expect the cost of debt to rise for everyone over time, which also would have the greatest negative impact on those least financially secure." And though he's talking about truck lines, the shoe certainly fits marginal shortline railroads.

Not to put too fine a point on it, Wolfe concludes, "Distressed private carriers will also find 'rescue capital' more challenging to find as cash is increasingly horded by financial institutions." Short lines with huge grant programs or RRIF loans may be particularly at risk. Any company facing deteriorating sales volume coupled with small operating margins and a ton of debt will struggle. That debt includes not only bank debt but also state grants that have expiration dates. Therefore in my travels I am going to be taking a long look at short lines with low ebitida returns as a percent of revenue plus bank debt plus grant money liabilities. The kindness of strangers comes with a price. It may be too high.

And not only on short lines, either. UP Chairman Jim Young has said it will turn down a forty-three million dollar grant from the state of California, roughly half the estimated cost of adding capacity and improving tunnels on the famed Donner Pass. UP says the strings tied to the funding include sharing of track space with passenger trains. Young, in a note to Governor Arnold Schwarzenegger, said "Union Pacific hereby withdraws the Donner Project from any further consideration for (state) funding and will develop and construct the project over time with its own resources."

Union Pacific shares surged on Tuesday on the announcement that they expect third-quarter earnings to be in the range of $1.28 to $1.33 per share, 28% to 33% higher than in last year's third quarter. The new estimate, based on lower fuel costs and improved operating efficiency, exceeds the company's original earnings projection of $1.10 to $1.20 per share. It also exceeds analysts' projections of $1.21 cents. UP said falling diesel fuel prices and rising efficiency "more than offset the impact of recent hurricanes and lower volumes."

On the other hand, CSX had to take its third-quarter estimate down eight cents due to the combined impact of Hurricanes Ike and Gustav due to track damage in the Gulf region plus lost chemicals business out of Houston. Just two weeks before the storms CSX raised full-year guidance for 2008 to the range of $3.70 to $3.75 from $3.60. I think it's safe to look to the low end of that range even with the storm impact.

Says Ed Wolfe, "We can't imagine there are many opportunities to buy a company growing earnings-per-share by 20% at under 13x forward PE. We expect the current CSX opportunity to be short-lived and we recommend buying the stock on any weakness today." Good advice. I started adding to my position in the mid $50 range against an intrinsic value of $75. Measured as current price against intrinsic value CSX is the most steeply discounted of the railroads.

Week 37 Class I carloads YTD ex-intermodal continued their southerly drift ex-BNSF and UP, up 2.2% and even respectively. However even with the shortfall there remain positive trends for short lines that are trying to increase their merch carload non-unit train business. To begin, CSX generates more revenue (86%) from its carload sector including agriculture and coal/coke/ore than any other Class I with UP and CN tied for second place at 81%. BNSF is dead last at 66%, though -- thanks to its AIM program and other carload initiatives -- it is a leader in making the carload side work better.

Agriculture sales for the western roads and the Canadians run 17-21% of total revenues while NS and CSX lag at 11% and 8% respectively. Western wheat is the name of the game in Canada while wheat, corn and ethanol are huge revenue sources for BNSF and UP. The eastern roads are more tied to the domestic broiler markets, have little export trade, and do not yet have the ethanol volumes (corn and chems in, ethanol and DDGs out) of the western roads.

Industrial products plus chemicals account for more than a third of revenues at UP and CSX followed by CN (33%). Automotive can cut both ways. If you're dependent on the US big three, you're toast. However, to the extent you can shift your focus to the transplants as has NS, perhaps having ten percent of revs here ain't too bad. BNSF has only 3% of sales in the auto group.

If I had a short line in the east, another in the west and a third in Canada I'd want to connect first with CSX, UP and CN because each has the stronger carload franchise based on YTD results and for their respective approaches to the carload business. Moreover, in terms of economic transparency to short lines among all Class Is, I'd have to rank CSX number one for its junction settlement process and fuel-surcharge sharing program. (This just in: CSX interline traffic with short lines through August is up by some 11,000 units, roughly 2% yoy. The major commodity plays are coal, metals, phosphates and fertilizer.)

Norfolk Southern made the *Kiplinger's* "Ten Stocks for Ten Years" list. Here's why: "North American railroads are sitting in the sweet spot -- business is brisk and they can raise prices freely for the first time in many decades. Norfolk Southern occupies the sweetest spot of them all. Its forward-looking management has initiatives under way to greatly increase capacity and gain new customers -- particularly truckers operating between the Northeast and the South and between the mid-Atlantic ports and the Midwest.

“Balancing Norfolk Southern’s many partnerships with truckers is its thriving business hauling coal to power plants and to ships at the ports. And the company’s network of routes that honeycomb the U.S. east of the Mississippi is run more efficiently than that of chief rival CSX. Put it all together, and it’s hard to see how a long-term investment in this railroad could go wrong.”

I happen to think this could be the opportune moment to add to one’s carload franchise, and, if this be the case, one might best look to the Class Is that do it best. Here’s why. It’s clear that oil prices are changing the way companies manage their supply chains and by targerting one’s efforts accordingly there is new money to be had. US logistics costs (everything associated with moving goods from plant to plant and plant to customer) increased by more than half 2002-2007; transportation costs are up 47% and inventory carrying costs grew 62%. What to do?

The special “Customer Complaint” section in Monday’s *Wall Street Journal* suggests three ways shipping strategies are changing and there is a role for rail in each. First, look for larger lots shipped less frequently, say a train a week rather than four trucks a day six days a week. Second, there is a shift to cheaper -- albeit slower modes. Remember the old two out of three rule: cheap, good, fast.

Cheap and fast won’t be good, good and fast won’t be cheap while cheap and good won’t be fast. This last is the batch process where the rails excell. Good and fast is customized service -- think Fed Ex as the extreme. Finally, the *Journal* article says manufacturers that need to ship large quantities to take advantage of economies of scale may switch to a “push” mode. The difference is they push goods to the customer per long-range forecasts rather than shipping smaller quantities on request.

Just this week I learned of two short lines that together converted a truck move of green ties from the wood lot to a treater. The unique sales proposition was having more product arriving at once with lower transportation cost and less unloading and inventory management cost. Thus the wood mill pushes product to the treater, and in this case the treater is even supplying the cars.

However, it is essential to add that the short line market manager knows the treater’s supply chain intimately because they’ve been doing business together for years. Moreover, both short lines are NS-only and according to Ed Wolfe “NS appears best positioned to take market share from truck.” And knowing customer supply chain management goals has to be a major plus. (The players in the green tie move are RJ Corman/Pennsylvania originating, Lycoming Valley terminating. Koppers is the customer.)

Shortline tidbits. RailAmerica wants to cease operations over its Siskiyou Summit line in Oregon and is exploring its options. Regular serviced ended last January and there have been no trains on the line since May. Iowa Pacific and Yreka Western are said to be interested…. Iowa Pacific now controls the Mount Hood Railroad and has restored tourist and freight service to Parkdale… Patriot Rail has applied to purchase the company slated to operate the restored Virginia & Truckee Railway. In Ogden, Patriot has opened a new car shop for The Andersons on its Utah Central.

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