Railroad Week in Review
September 29, 2006

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"The voice of intelligence is drowned out by the roar of fear." Dr. Karl Menninger, as quoted by Arnold Van Den Berg, in Outstanding Investor Digest, August 30, 2006

We've written before about broken stocks vs. broken companies. The rail sector continues to trail the indices as institutional investors insist on viewing our favorite industry as entirely cyclical. Stock prices since May 2006 make this look like a broken industry. According to msnbc.com, analysts covering Union Pacific, for example, are evenly split between "strong buy" and "hold. The stock has been down as much as 15% from its May highs. Chart-watchers believe "the trend is your friend" and if everybody else is selling maybe you, lemming-like, ought to too, out of fear of being left behind. But perhaps that's not the right approach.

Maybe instead we ought to be looking at the impact of the $billions invested in capex and what's happening out on the railroad rather than what the near-term numbers and half the analysts are saying. Let me provide some recent intelligence on what's actually happening between two key UP cities as a mirror on what the rest of the system is capable of delivering.

Judging from the traffic volumes we saw from the UP's Shortline Special from Denver to Omaha last week the railroad is buzzing, trains are moving well and the money's being spent where it needs to be spent to increase velocity, improve asset utilization and add pointsto the Customer Satisfaction Index. Clearly, it's got to be the stock that was broken, not the company.

This is a merchandise railroad, and the amount of trackside industry proves it. We must have met at least two dozen trains between Cheyenne and North Platte and overtaken half that number. It's a much busier railroad than it was the first time I made this trip in 1999 and that's got to be good for shortlines whose bread-and-butter is the single-carload merchandise business.

And UP wants more of it, as made clear by Jack Koraleski's Sep 14 letter to customers (see also www.up.com). But UP also wants to help new customers site facilities where they will derive maximum value from their rail assets. Excerpts: "During the past year, there has been a record number of requests for rail service to new facilities being contemplated by the shipping community. Consistent with that development, there has also been increased interest in information on how Union Pacific determines the requirements for adding new connections to its network.

"Union Pacific welcomes new business opportunities and is willing to explore the feasibility of rail at new locations along our system. However, not every location along our rail lines is suitable for new rail service. Our ability to deliver on existing service commitments is a key consideration in evaluating new rail service opportunities. Union Pacific has posted the Guidelines for Rail Service to New Industry Locations (PDF File) to inform shippers, developers and governmental entities of the infrastructure requirements for new locations on Union Pacific.

"In general, the busier the rail corridor the more extensive the requirements are for customer infrastructure. For example, connections on the company's busiest corridors will require that an entire train be able to clear the main track quickly and without stopping to manually set switches. On less frequently used corridors, the requirements are less stringent but still require that the connection not cause trains serving that facility to block road and highway crossings.

"Union Pacific is committed to grow with our existing and new customers in a manner that supports operational fluidity throughout our network. While the final decision to provide service to a new location will be made on a number of factors, these guidelines provide the basic requirements for any potential customer to use in assessing their options for rail service."

This is the first time I've seen anybody come right out and say it: we'd love to have your new facility on our railroad but not enough to let it impede service to existing customers. CN has gotten close in its discussion about car turn times and BNSF's "Last Mile" initiative (WIR 10/28/2005) starts down that road. But Koraleski's letter does it right. Please see the PPT summary to get a good idea of what UP would like to do: http://www.uprr.com/customers/attachments/aar_forum.pdf .

This just in from CSX: The *2005 Corporate Profile* – 60 pages of facts and figures that show how CSX is "returning to its transportation roots" and adding value for shareholders, shippers and shortlines. In the opening Letter from the Chairman, CEO Michael Ward writes that "strategy and commitment have three parts: revenue impact from profitable growth, an operating discipline that yields consistent, continuous improvement over time, and a performance culture that sets new standards of accountability."

CSX, like UP, is predominantly a merch carload railroad with 58% of 2Q06 revenues from merch plus auto, about the same as UP and four points ahead of NS. The *Profile* breaks out traffic and revenue data for each commodity group as well as potential benefits and risks going forward. In chems, CSX expects plastics to outperform other STCC 28s. Phosphates and ferts will increase, though the market shifts in Florida's Bone Valley may take a short-term bloom of that rose.

The housing bubble will have less of an impact on the southeast, giving CSX an opportunity to tweak STCC 24 mix and yield to the better; paper remains a challenge though "increasing stress in the trucking industry may create opportunity for CSX." Metals and ag both are looking good as construction and exports support the former and feed grain and ethanol help the latter. Lastly, food and consumer will benefit from a consolidation of smaller producers into bigger competitors, making rail volumes and prices more attractive. In short, it looks good for the shortlines.

And to show customers just how easy it can be to Ship CSX, the Tony Ingram-Clarence Gooden customer presentation on Sep 15 is a great help. It's at www.csx.com under customers and bears checking out. The wrap is very timely, showing customers what they can do to get more value from their rail transportation resource. At the top of the list is accurate forecasting of shipment volumes and lanes, backed up by frequent traffic pattern updates. Then are four things customers can do to increase equipment velocity and reporting accuracy, where errors can only add to delay, the cost of which inevitably shows up in rate increases.

Also, in a report just issued, JPM's Tom Wadewitz rates CSX "Overweight" based on his recent visit with CSX management in NYC. He writes, "The turn-around momentum continues. We still believe that CSX is positioned for strong margin expansion and EPS growth in the medium term which should drive upside for the stock. Management clearly indicated they see strong overall demand *in spite of* (emphasis added) softness in certain segments (automotive, forest products). We believe that this view reflects improved service at CSX as well as the defensiveness of certain rail segments (coal, agriculture) which are contributing to growth.

"We believe that CSX' strength in coal volumes is driven by fluid rail operations and demand from SE utilities to build coal stockpiles. If coal volumes slow in 2007 without a boost from inventory build, we expect re-pricing of several large utility contracts in 1Q07 will drive coal revenue growth. [Achieving] further pricing gains is a high priority for CSX management. We believe that the recent

reversal of volume growth rates between CSX and NSC is unlikely to drive deterioration in the Eastern pricing environment."

Tom concludes, "CSX has been the best performing major rail stock in 2006, but we believe there is still more room for out-performance. While it is difficult to turn a large railroad, once heading in the right direction, momentum tends to persist for more than just a year." That's encouraging.

Florida East Coast (NYSE: FLA) is next on my buy list. It was the first of the rails to break out of the post-May funk and (quoting WIR 8/11/2006) "2Q06 operating income was up 26.5% to $20.2 mm on revs of $70.0 mm, up 18.8%, and holding ops exp to a 16.0% gain. Carload revs in 2Q increased $4.7 mm with rate/mix accounting for $2.6 mm and mix the rest. FEC continues to be the lowest-cost supplier among US roads with an OR of 71.2, beating out second-place NSC by 50 BP.

"The 2006 outlook calls for continued strength in both the national and Florida economies. FECR revenue estimates have been raised to a range of $265-$275 mm, up as much as 16% yoy. Operating income ought to be $75 mm plus or minus for an implied OR of 72.2. Capex will be right around $50 mm and includes four new locos plus 11 more miles of run-around track to support additional volume while still maintaining RR fluidity.

"The railroad is, of course, part of Florida East Coast Industries (NYSE: FLA), contributing 66% of total revenues, 56% of operating expense, and 109% of operating income as the Realty side of the lost $1.6 mm in Q2. Happily, Railway drives the business and share prices are down only 10% since May." That said, FLA has started three new real estate projects since the 2Q report. I can see no reason why the railroad should not continue the 5% quarter-to-quarter revenue growth rate seen for the past three quarters.

FLA has a record for taking care of its investors. Over the past five years revenues per share have increased 66%, operating income per share has grown by 62%, and eps ex-items is up 46%. In the same period the share count is down 11% and dividends per share have more than doubled. On 12/31/2005 shares changed hands for $42.37, up 83% over five years. As a result of this performance FLA has enjoyed an expanding multiple as the PE rose to 27.9 times CY 2005 earnings from 22.3 times CY 2001 earnings.

People on the move: Charlie Moore, late of RailAmerica's Atlantic Region, has joined RailCom as VP for Business Development. This is the company that supplied the computerized dispatching system RRA has installed in St Albans to run not only the NECR but also several others (WIR 9/22/2006) and which I think has a great future with the largest shortlines and regional rails. I had lunch with Charlie on that Vermont trip and he told me to expect something like this. Nice going, Charlie, and best wishes. Do keep WIR posted.

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