RAILROAD WEEK IN REVIEW
NOVEMBER 17, 2006

"As the US economy cools the business climate in Europe and Japan is expanding where they buy industrial goods and tech from US manufacturers." – Abby Joseph Cohen, Chief US Investment Strategist, Goldman Sachs

Barron's recent "Art of Successful Investing" conference brought together a number of leading investment strategists. Video interviews are on its website, www.barrrons.com, and are worth a look. In addition to Cohen, who sees the US economy expanding "for several more quarters," we hear from John Neff who sees the economy expanding at a 2.5% rate with housing stocks coming back with particular strength in "heartland" markets. The downside, says Fed Hickey, editor of the *High Tech Strategist* newsletter, is that "mortgage rate resets are hitting harder each month" and this may slow consumer discretionary spending on high tech items like MP3 players and big screen TVs.

Neff notes that part of the American dream is "to have one's own piece of turf" and middle-America is where it's happening. In fact, one of the panelists said "Texas is the new Florida" in terms of housing demand and new construction for everything from highways to highrises. All of which would seem to point toward fresh opportunities for the railroads' merch carload sector.

Cohen's "industrial goods" include everything from DuPont chemicals to CAT tractors to GE transformers and Otis Elevators, all of which use rail at some point or points in the process from raw material receipt to finished goods output. Unfortunately, feedback from my recent shipper poll (WIR 11/10) indicates that higher rates and lower service reliability are forcing some formerly pro-rail industrial goods makers away from rail.

Further Class I diminishment of the single-carload trade is bound to hurt small shortlines, especially those that work on the margins, have no ISP, do not meet industry event reporting standards and depend on government largess to fix their track. This is a shame if only because operating rights-of-way are a non-replaceable asset and once gone they are gone forever. The good news is the leading shortline operators see opportunity in the rail space. They are well-positioned to preserve and protect the asset and use internal cash flows and private equity to do it. Consider…

RailAmerica has agreed to sell itself to Fortress Investment Group LLC for $16.35 per share, a transaction valued at roughly $1.1 bn according to the press release. I do the math and get $1.035 bn on 39 mm shares outstanding; Yahoo's Key Statistics page for RRA shows EBITDA at $90.35 mm (ttm) so we're looking at something like 12 times. This is a pretty robust number, given that previous shortline sales are closer to 7 or 8 times.

RRA had total 2005 revs of $425 mm which says the property is going for 2.4 times sales, again an aggressive number. Sixteen smackers and change represents a 32% premium on RRA's Tues close before the deal was made public. The stock had been creeping up from the $10 range starting in late Sep, indicating that somebody knew something. The Fortress price is about a 50% premium to that range. The deal is expected to close in 1Q2007.

Fortress has about $26 bn under management. According to the website, Fortress is "an asset-based investment management firm with a fundamental philosophy premised on alignment of interests with the investors in its funds. Fortress's managed funds primarily employ absolute return strategies.

Investment performance is Fortress's cornerstone – as an investment manager, the firm earns more if its investors earn more."

More important, Fortress has filed for an IPO. They had 1H06 sales of $878 mm, earned $186 mm in fees from funds and had a net income of $88 mm. According the Prospectus, the IPO will allow Fortress "to have capital, currency, people and permanence" and that "we expect that we will be able to selectively and opportunistically pursue acquisitions that will add to our investment team's expertise and product offerings."

As the NY *Times* put it, the offering will provide money "to invest in the business, a stock to use to make future acquisitions, stock to use as incentive compensation and a ticker symbol on the New York Stock Exchange — FIG — that elevates it from yet another big hedge fund to a permanent institution." Goldman Sachs (which I own in my IRA) is lead underwriter.

My sources tell me the Fortress team behind this deal has considerable asset-based, high fixed-cost transportation experience and their pattern is to acquire and build as opposed to acquire and spin. Thus it seems to me a go-forward model that assumes the exit of underperforming properties and heavy investment in lines with the greatest potential may not hold water. In fact, the Hartford (CT) *Courant* quoted RRA's Mike Howe, CFO, thus: "I'm not aware of any one of our 42 properties that Fortress is targeting for immediate sale. They really want to grow the business. This is their entree into the rail sector. They like the long-term fundamentals for demand for rail service."

This could have positive implications for the shortline business. The $16 price looks like a huge premium until one realizes that it was at the top end of the Yahoo price target summary. But what it *does* mean is that there is money out there looking for properties that may not be living up to their potential. If I had a shortline railroad that was marginal but fixable and somebody offered me 12x EBITDA, I might just be tempted to ask, "Where do I sign?" From a buyer's perspective, I see several ways to skin this cat. Give me a shout if you'd like to discuss.

There is an opportunity for RRA to build on the core routes in each of its three business units (West, Central, East) to create more contiguity and take a few points off the OR (and add cents to eps) in the bargain. In fact, Fortress CEO Wesley R. Edens told bizjournals.com that they are "excited to have the opportunity to invest in the North American rail industry. RailAmerica has assembled a well diversified portfolio of short line railroads throughout North America and we look forward to working with the management team to grow the company." Charlie Swinburn and his RRA team have to be congratulated for developing this much shareholder value and WIR wishes them and Fortress all the best in this new partnership.

Norfolk Southern stock prices fell Tuesday nearly 8% to $48.69 from Monday's $52.65 close creating in my mind one heck of a buying opportunity (which I took). Speaking at the 21st Annual Citigroup Transportation Conference in NYC, Jim Squires, NS Sr VP for Financial Planning, said his firm sees "mixed business conditions for 3Q06 and into '07."

Squires painted an accurate picture, IMHO, saying, "Overall GDP growth is expected to be below 3%, reflecting weakness in housing markets and declining auto production and sales, among other factors. Carloads in the fourth quarter to date are down modestly from last year, and, accordingly, we expect revenue increases to moderate, reflecting tempered volume growth and tough comparisons with a strong fourth quarter in 2005. While we still see some economic expansion ahead, it may be less robust than what we experienced in the first half of the year."

As WIR readers know, many investors still view rails as a strictly cyclical business so “tough comps” in Q4 mean it’s time to sell NSC. I disagree. NSC is cheap relative to other rails, trading at 13 times 2007 estimates for a 16% five-year growth rate. Tuesday’s low took the PE to a dirt-cheap 12 times, which is below the rails’ usual 13-15 forward PE. And although we are concerned that merch carloads are lagging, it must be noted that a faster railroad (which NS is by dint of the TOP and other aggressive operating systems) makes more money on the same volume. As a shareholder, I find that worthy of note.

Squires concludes, “We expect continued challenges to intermodal growth in the fourth quarter, but remain very confident in future growth. We are investing not only to improve service levels, but also in strategic capacity initiatives such as the Heartland Corridor, Columbus Rickenbacker Logistics Center and a planned expansion at Cleveland in the coming year.”

Patriot Rail Corp has made its first buy, the 118-mile Tennessee Southern just south of Nashville. Primary commodities are wood products, fertilizer, steel, slag, soapstone and LP Gas, roughly 9,000 car a year. CEO Gary Marino says, “The TSRR offers significant opportunities for growth beyond its existing traffic base and we intend to invest the new capital to accommodate this growth. The economic climate in Tennessee and Alabama is robust. The railroad recently attracted three new major shippers to its rail line including two Fortune 1000 companies, and we are engaged in negotiations with a number of other prospective customers.”

Marino’s firm has an agreement with “a large international private equity fund” and has “an ambitious strategic plan to make a number of select rail acquisitions throughout North America over the coming years.”

Providence & Worcester reported third quarter operating revenues of $7.8 mm, up 4.5% yoy. Ops income as reported was $1.3 mm though that included a $500,000 gain from property sales. There was also a $50,000 operating expense item for profit-sharing directly attributable to the gain. Absent these items operating income was $730,000, down 25% yoy due mainly to higher track usage fees, MOW and MOE expense. The adjusted OR was 91.6, up from an adjusted 88.5 a year ago.

Net income (putting property sales and profit-sharing below the line) was $927,000, up 32% yoy and eps grew 31% to 20 cents from 15 cents in 3Q05. Cash from ops was $2.2 mm, down 11% yoy and free cash flow before divs was minus $580,000 vs. minus 614,000 last year. Divs were $545,000 or a hefty 58.8% of net income, so FCF after divs was minus $1.1 mm vs. minus $1.2 mm yoy.

There will be no Week in Review next week. It is one of my two weeks of respite each year (the other is Christmas week). With any luck I can use the time to get the third quarter WIRs posted to my home page. As a reminder, the User ID is “wirsubscriber” and the Password remains “sd40” all lower case. Have a Happy Thanksgiving and be safe out there.

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