RAILROAD WEEK IN REVIEW
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"We read and think. That is very uncommon in American business" – Charlie Munger in Kiplinger's *on the subject of investing*

The trouble with being constantly on the go is that you never get much time to read and think about what you've read. The best shortline operators manage to do both, however, and that's a good thing. Especially with all that hedge fund money sloshing around looking for a home.

If I had a shortline, I'd be thinking about whether I'd like to buy or be bought and I'd be reading about how to decide and position myself accordingly. WIR readers know my thesis: that there are 300 too many shortlines and the number will diminish through combination and attribution. Class I shortline liaison teams ought to be thinking ahead of that curve – what combinations are desirable, what weak properties might be better off dead, and are there any we might buy for strategic reasons.

Number One is competitive advantage, which in the railroad environment is achieved though a low operating ratio, a means to differentiate the rail service provided from other transport options open to the customer, and the willingness to focus on one or two transportation segments. The savvy shortline owner will focus on carload traffic as opposed to intermodal, will select the OD pairs where he can build volume, and will use the economies of scale to keep unit costs down. In other words, not all commodity-OD pairs are created equal and taking time to sit and think about one's customer list in terms of Competitive Advantage will prove most beneficial.

Also, were I a shortline owner, I'd be wary of the economy. Liz Ann Sonders, Chief Investment Strategist at Charles Schwab & Co, sees it this way: "The housing market remains a key focal point for us. Its unprecedented weakness and the adverse impact this could have on the consumer and the economy still pose significant risks to the economic outlook. We do not think we have seen the bottom in housing just yet, despite the rebound in many of the homebuilding stocks amid some stabilization in mortgage applications and a spike in the University of Michigan's *good time to buy a house* survey question.

"At the most, we believe this may keep the Federal Open Market Committee (FOMC) from cutting rates in the near term. Median home prices continue to fall and homes available for sale remain quite elevated, suggesting further pricing pressure. Inventory levels would need to begin falling before the supply-demand imbalances would likely correct and prices stabilize. In the meantime, consumer sentiment would likely suffer given the negative impact of people's sense of economic security that lower property values typically have."

But consumers still have to eat and do the laundry. Recall my "soup, soap, cereal and suds" thesis: raw materials for everything from Campbell's Cream of Mushroom soup to a bar of Dial soap to a box of Cheerios to a bottle of Bud are all home-grown and move on the rails. See where you can make a market in these consumer staples.

The merch sector is *still* the rails' best place to take business of the highways. Unit train coal is never going to be on the highways and intermodal boxes are always on the highways at some point in the journey. But the ingredients for consumer staples – oats for Cheerios, grain for bread and animal feed, e.g. – will always have a place on the rails if the price-service-value proposition works. Then the rails can truly take trucks off the highways.

But there's more. The rails have to grow their market share of the merch trade at a faster rate than the organic increase in the GDP. If that's 3%, then we need to see four from the rails. Anything less than that is either no-growth or shrinkage. Then the only question is how fast the railroad goes out of business. And for shortlines that have no intermodal or coal, that's a serious matter.

Taking a page from **Munger's** thread above, I've been sitting and thinking about the impact of the recent RRA transaction. Two themes emerge: (1) justifying paying 12x cash flow when the individual properties are collectively earning less than that and (2) what the Fortress transaction bodes for the shortline industry going forward.

As to the first, it's essential that Fortress and the RRA team consolidate resources and get more use out of each asset whether loco or track-mile or data warehouse. The savings CEO Charlie Swinburn highlighted on the recent call would seem to point in that direction. He also talked about some properties already tagged for sale. I'm looking at the ebitda multiples they might fetch and how the right buyers could make these properties immediately accretive by lowering overheads and improving asset management --- pay 10x and through combos work it back to eight. In this way Fortress works its own effective multiple back down a point or two.

As to the second, the speed with which Fortress seems to have moved ought to tell the astute student that Big Money doesn't spend a lot of time wringing its hands about what might happen at some time in the indefinite future. In an article on companies like Fortress, *Fortune* magazine's Nov 27 issue ("Private Lives," page 190) notes that "these companies have incentives to move quickly."

Just this week I learned of two shortline transactions that did not work because the players did not move quickly. In the first, somebody else stepped in out of the blue to steal the deal from under the noses of the ones who thought they had a wrap; in the second, so many snippets and codicils were larded on that the seller lost his appetite.

For an example of the potentials, look to Alberta, where Savage industries has just spun the former RailNet line it acquired in April 2005 to CN for C$25 mm. The 345-mile line was operated as the Savage Alberta Railway and handled about 35,000 revenue units annually. CN said in a press release that it intends to upgrade the track to improve operations and customer service and to maximize its potential for transporting greater volumes of coal, grain and forest products. CN began operating the line this week, following the close of the transaction with Savage Companies. CN is offering employment to SAR's approximately 75 employees and will honor the existing collective labor agreement at SAR.

Recall that in Jan 2006 that CN bought RRA's Alberta properties for C$26 mm, bringing back into the fold properties that CN had once shortlined. Once again, asset utilization had to be a critical factor. Where CN had one set of assets to serve the province, the shortlining of those properties put three sets of assets in play: CN's own for the core system that remained -- RailNet's and RailAmerica's.

The two transactions eliminate the need for separate support systems and add back tremendous operating efficiencies to CN. It was one thing for CN to spin off marginal lines when its OR was in the 90s; it's something else to buy back properties serving the now-prospering oil sands territory and CN has an OR is in the 50s.

Two weeks ago I wrote that I would be buying more NSC if the PE fell below 13. Recently it's been languishing at $48-49 and so I struck. Now comes Bear Stearns' ED Wolfe who writes, "Our large-cap rail index is now trading at 14.0x our forward-year EPS estimates, compared with the group's 1-, 3- and 5-year average forward P/Es of 14.5x, 14.0x and 13.6x. The historical twenty-year average range is 11x-15x the forward P/E. Our thesis on the rails remains that this is going to be a long and strong up-cycle and that we are only at the mid-point of that swing.

"As one would expect, less volume in the network has translated into improved train speeds and other productivity metrics. We continue to weight the rail sector Overweight both for near and longer-term strong fundamentals and *advise aggressively buying the stocks when they dip below their historical mid-cycle range of 13x forward P/E (emphasis added).* Accordingly at valuations above that range currently, we recommend owning the names but not chasing them. At current levels, we want to hold rail stocks and buy them as pair trades against the truckers over the next several quarters. As the valuations over time catch up with the stock we would aggressively buy new positions and add to existing ones at 13x.

"While we like owning all the large cap rails and recommend buying any of them at mid-cycle valuation or better, our favorites remain Outperform-rated CSX , BNI and NSC. NSC continues to trade more than 1pp below the group based on forward P/E and we continue recommend buying it aggressively under 13x forward P/E." Well, 12 is surely less than 13 that's part of my rationale.

It's also my belief that NS has tremendous potential and capacity still to realize. The integrated Thoroughbred Operating Plan, Operating Plan Developer and Local Operating Plan Adherence tools, combined with NS' unique Automatic Blocking and Classification system, are opening up new and better ways to do more with less and do it faster every day. Combine these assets with an aggressive capital program and we have in NS a company with serious competitive advantage stemming from its ability to provide superior service in the eyes of the customer and charge a premium price, and the ability to add market share in the bargain.

Also at NS, my good friend Dan Mazur is VP Strategic Planning effective today. He reports directly to Kathryn McQuade, executive vice president planning and chief information officer. Mazur, a veteran of more than 35 years in the railroad industry, began his career as a summer intern with Penn Central. He served with the Grand Trunk Western Railroad, then joined Penn Central (later Conrail) in 1973 and Norfolk Southern in 1998. At Conrail he held various marketing positions including operational supervision of Conrail's coal terminals. Congratulations, Dan.

Vermont Rail and Pan Am Rail (nee Guilford) have begun a dedicated 40-car slurry train for Omya, the world's largest calcium carbonate supplier, to serve its Maine customers out of its Proctor (VT) facility. VTR will pull loads as released, block, and build run-through trains for Pan Am to forward to Portland where the blocks will be separated for delivery to the customers.

Transit times run 4-5 days, cutting previous transit times in half or more, and proving once again the faster railroad is a cheaper RR to run. It's an excellent example of how shippers and railroads can collaborate to minimize first-mile last-mile congestion and delay, improve asset utilization (these are Omya's leased cars), keep the railroad fluid and do it all profitably.

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