RAILROAD WEEK IN REVIEW
DECEMBER 8, 2006

"In the end, fundamentals do matter." – Herb Greenburg quoted in the WSJ 12/9/2006

BNI and CNI were both downgraded by Merrill Lynch to Neutral from Buy this week. Their argument is these names are approaching *Merrill's* target prices (I'll make a number up and if you can't match it shame on you) and the outlook is for slower volume growth. How very odd. Third quarter volume deltas were nothing to write home about but as long as the eps rose nobody cared and prices gapped up. Now flattish volume outlooks are enough for a downgrade. Given that ops costs have been lagging revenue increases by several hundred basis points and on small volume deltas, by Merrill's argument more money for less work ought to be reason for an *up*grade.

The Street's BNI consensus is for $5.70 eps in 2007, up 14% yoy, for a PE of 13 at today's $76 price. That's a PEG of 0.9 meaning that BNI is going on sale. Similarly CNI's Street estimate is for $3.37, up 13%; at $47 the stock is trading at 14 times earnings, perhaps more fully-priced than BNI. However, rails are not your typical momentum plays and the five-year PEGs for BNI and CNI are 0.87 and 1.07 respectively, a significant discount to the sector's 1.44.

But then, the trend *is* your friend. Michael Kahn, tech guru at *Barron's*, wrote in his Thursday on-line column, "According to Dow Theory, both of these indices must make new highs in order for a bull market to continue. When one makes a new high and the other does not, it is a sign that the trend is peaking.

"No theory is perfect and indeed in 2004 the industrials did not confirm the stampeding bull market in the transports. Most of the market fell for another four months before the industrials finally broke out to a new high. Today's market shows that the transports, in addition to not confirming the industrial's breakout, have also made a short-term breakdown. The short-term trend from the September low has been broken to suggest that the index will not reach new highs any time soon. It is a possible bearish sign for the overall market but as we've seen before, non-confirmation by these two Dow averages is problem, not a guarantee."

BNI and CNI are the other two top-performing rails beside NSC with specific unique selling points: Velocity with a Capital Vee at the former; Precision Railroading at the latter. Once one grasps how these strategies create shareholder value, the more inclined one will be to include these and NSC in the rail portion of one's personal portfolio. I own all three and will load up the boxcar up on the dips.

The truckers continue to have their share of revenue problems as 2006 winds down. JPM's Tom Wadewitz writes that Werner has not seen the expected demand in Nov and Dec. Part of the reason is retailers have been keeping inventories close to demand levels, a shift from a year ago, making the comps a bit tougher. There is a glimmer of hope as slim inventories through Christmas may mandate restocking in Jan. The driver shortage may be easing up as local drivers let go during the housing slowdown are applying for jobs with the highway haulers.

There are also signs that truck yields may be weakening. Bear Stearns' Ed Wolf sees "weaker auto, housing, and manufacturing vols leading to excess capacity and lower rev/mile." The asset-based truckers are having a tougher time of it than the owner-operators as the former have higher equipment and other fixed costs where the latter's costs are more directly pegged to volume.

There is a trend for retail shippers to move to truckload from LTL and go from over-the road to intermodal. The net result is increased truck capacity and availability which in turn will drive trucking rates lower. One shipper in the Bear Stearns survey reports having received "calls regularly from TL carriers looking for business." This creates a potential challenge to rails using "market pricing" which is really trying to match the truck rate as closely as possible on the upside and improving the revenue/cost ratio in the bargain. As long as trucks were at capacity and had more business than they could handle their prices went up and the rails could trail them. With truck rates coming down so are "market rates." Could it be the inelasticity in freight rates of which we've written is finally coming home?

If so, woe to the RR that increases prices without increasing unit volume. Recall there are two parts to competitive advantage: the ability to raise prices *and* the ability to capture market share. So far we see a lot of the former and not much of the latter. In 3Q06 only BNSF increased revenue units at a rate greater than the GDP, six percent vs. three percent; revs were up 19%. Can you say "CA"?

Corn prices are hitting new highs as demands for ethanol, animal feed, human food ingredients, and the export market are converging. A report in yesterday's WSJ says that as a result of these competing demands there is likely to be more corn planted next year. The article says there are 53 ethanol refineries in operation with another seven plant expansions in the works; total production is more than 4.2 billion gallons a year. Exports are up 23% yoy.

Third quarter YTD ag loadings were up 7% on BNSF and 5% on UP; RMI's RailConnect Index shows shortline ag (STCC 01 only) loads up 4% YTD. We haven't heard much about capacity problems or car shortages in this STCC but two questions arise. With respect to the first, will the super shuttle centers be able to handle it all or will there be overflow opportunities for shortline-served country elevators? With respect to the second, are there enough jumbo covered hoppers around to fill the bill? Reader response will be most welcome.

(FWIW, stock prices of Bunge, Coke, Heinz, Hormel and General Mills all hit new highs on the NYSE last week. I would argue that these are the usual defensive moves when one expects a general softening of the economy – more eating at home, more cereal and soup, ketchup and canned ham – and portend a solid, non-cyclical rail traffic base.)

From Tom Murray's excellent *Rail Stock Watch* for December: "On November 30, credit agency Fitch Ratings issued an analysis of the transportation outlook that said, in part: 'With U.S. economic growth expected to moderate in 2007, Fitch expects surface transportation freight demand to continue softening across the industry in 2007, although the effect of lower demand will not be seen equally across all regions or across all types of goods transported...

"The moderation in demand growth will likely have a more pronounced effect on the trucking industry than on the railroads in 2007... Railroad demand will be mixed in 2007, with certain cyclical commodities, like lumber and forest products, continuing to decline, while less cyclical commodities like coal and *agricultural products* [emphasis mine - rhb] could show modest growth. Intermodal volumes on the rails are expected to continue growing, but not at the strong growth rates seen over the past several years, primarily due to continued increases in overseas production of consumer goods.'" Thanks, Tom.

What do merch carloads and computer chips have in common? Both are largely cyclical capital-intensive businesses. Both tend to be custom-process products that drain resources from an enterprise that's mainly in the batch-process business. A recent article in *Barron's* suggests that IBM (disclosure: I own IBM in my trading account) could increase its share price by getting out of the chip business and it got me to wondering whether the same might not apply to the railroads' merch carload business.

Then I turned to the "Rail Update" section in the November *Railway Age* where there is a short piece on electronically controlled pneumatic (ECP) freight train brakes. Evidently they're in use on the Quebec Cartier Mining railway in Canada and on South Africa's Spoornet. The results thus far – up to 70% shorter stopping distances, a 40% reduction in in-train forces, and a 9% improvement in the load-empty cycle time – are impressive.

The FRA-commissioned Booze Allen Hamilton cost-benefit analysis of ECP on PRB unit coal trains is complete and the next step is freight traffic that can be batch-processed – auto racks, intermodal, grain, metals, etc. The reality of ECP brakes in merch service will increase the viability of that service and will make the traditional air-only cars become custom commodities just like the computer chips that IBM wants to stop making. Thus we have yet another reason for the onesy-twosy shortline to take a serious look at its business model, where the 21st century info tech model has lessons to teach the 19th century goods-movement model.

Roger Nober will join BNSF as Secretary and EVP Law and Government Affairs, succeeding Jeff Moreland who moves to EVP Public Affairs with responsibility for Federal and State Government Relations, Corporate Communications, and economic regulatory policy. Both changes are effective January 1, 2007. Moreland and Nober will report to Rose.

Nober comes to BNSF from the Washington office of Steptoe & Johnson LLP, where as a partner he has been focused primarily on transportation law and legislative matters. WIR readers will recall that he was STB Chairman from November 26, 2002, until Dec. 31, 2005. Prior to joining the STB, Nober was the Counselor to the Deputy Secretary of Transportation. From 1997 to 2001, he served as Chief Counsel for the Committee on Transportation and Infrastructure of the U.S. House of Representatives, where he was the lead staff member on TEA-21, the ICC Termination Act and other transportation-related infrastructure and regulatory matters.

Railinc has tapped James Malcolm Clarke as Vice President of Corporate Services and CFO. Clarke comes to Railinc from High-Performance Technologies (HPTi) where as Controller he contributed to double-digit growth in revenues, profit and cash flow. HPTi is a leading performance-based architecture service provider for the information technology marketplace. HPTi focuses its efforts upon assisting its customers in reducing the risk of early adoption of technology to meet their mission requirements. Seems a particularly apt background for the continuing challenge of forcing 21st century transportation and supply chain processes on a 19th century business model.

Clarke has more than 10 years of experience in the IT Services industry and has held senior financial positions in several firms in the Washington, DC, area including Controller for Vista Information Technologies and DHL Global Mail, and Director of Financial Planning and Analysis for Analex Corporation. He began his career with AT&T, holding various positions including Division Controller and Director of Strategic Planning. Clarke is a CPA and holds a Bachelor of Science in accounting from Wake Forest University and an MBA from the University of North Carolina at Greensboro.

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