RAILROAD WEEK IN REVIEW
APRIL 13, 2007

"Improving railroad fortunes are seen by many as secular rather than cyclical." – Larry Kaufman in Argus Rail Business, *4/16/2007*

Before the bell Monday CNBC broke the news that Warren Buffett's Berkshire Hathaway now owns 10.9% of BNSF and appears to be building positions in two other rails. He refers to this in his annual Letter to Shareholders on page 15 under *Investments*: "We don't itemize two securities [with market values of more than $700 mm] because we continue to buy them. I could, or course, tell you their names. But then I would have to kill you."

I've long been a Berkshire/Buffett fan and, by way of disclosure, own some of Berkshire's B shares. Buffett's approach has always been to buy great companies at discounted prices. In his *Owner-related Business Principles* (2006 Annual Report, page 75 et seq.), Buffett writes, "A depressed market makes it easier for us to buy small pieces of wonderful businesses at attractive prices. Some of those same wonderful businesses are consistent buyers of their own shares, which means that they, and we, gain from the cheaper prices at which they can buy."

Regular readers will recall that WIR has several times broken out the rails' intrinsic value based on net present value of future cash flows. At the close before the BRK announcement the Big Six Class Is ranged from CN's 62 cents on the dollar (closing price as percentage of intrinsic value) to CP's 88 cents. BNSF is right in the middle at 80 cents. As one would expect, BNSF shares traded higher Monday and ended the week at $90.69, up 6% from Monday's open. CN and CP followed suit with gains in the 5% range while NS and UP managed gains of 2% and CSX was left unchanged. I no longer own any of these.

CNBC's "Fast Money Five" picked upon the rail theme this week with a segment entitled, "Your Ticket for the Buffett Express as Investors Clamor for a Ride with the Conductor Of Omaha." Host Dylan Ratigan opened by saying that with the 11% stake in BNSF Buffett becomes its largest shareholder and asks if there's still room on the train. Eric Bolling ops for CN on the strike recovery, Guy Adami prefers a Wabtec play for its industry-wide exposure, noting "the rails are ahead of themselves." Both Tim Strazzini and Jeff Macke recommend buying Berkshire's B shares "and get[ting] long the underlying company."

UBS' Rick Paterson asks what Berkshire's buying Burlington really means. "Over the last three years there has been considerable debate as to whether the rail 'renaissance' has been driven by short-term cyclical or long-term secular trends. We think the buy in of an investor of Buffett's stature so late in the cycle lends considerable weight to the latter.

"It's also ironic that Buffett bought BNSF as opposed to the local railroad around the corner in Omaha. Could make for some awkward conversations down at the pub after work." [IMHO the Fort Worth gang got the nod because they have a longer track record of operating consistency under the same leadership team whereas UP has a new CEO who is still making his mark.] Rick also suggests that that the other two rails Berkshire is buying might be CN and NS. "Both are high quality and cheap, rather than fixer-uppers, which appears to fit with Buffett's style."

The wider interest in rails, especially as it seems to confirm rails as more secular than cyclical, bodes especially well for shortlines. They are heaviest in the stuff that moves regardless of the economy – grains and mill products, coal, aggregates, paper, chems and processed foods. The STCC 24 group (lumber and panels mainly) is too closely tied to housing starts and remodeling, so, big as they are to short lines, we leave ‘em out. BNSF among the Big Six derives the smallest percentage of total sales from the merch group, but has probably the tightest focus on what works and does not. CN in contrast derives the largest percentage of total revenues from the carload sector and has an operating philosophy built around the merch business.

What perfect timing for short lines. As you know from the Fortress-RRA transaction, there’s a lot of interest in the short-line space among hedge funds – so much so in fact that the ASLRRA Annual Meeting’s “Short Lines as Hot Investments” breakout session scheduled for Monday afternoon appears to be filling up fast. My sense is that equity players are looking for opportunities where revenues are north of $20 mm and growing at a double-digit pace ex-acquisitions, where there are multiple Class I connections, and different names in the same house are geographically close.

The flip side is that the smaller names may not have a seat at this banquet. The equity guys tell me they are typically met with some resistance in this space and it’s just not worth it. One investor told me the target railroad owner was getting on in years but wanted to pass the business too his sons. Yet the railroad was in terrible physical shape because, as the opener put it, putting money in the track meant that much less cash in his estate. Others are in the business because they *like* being railroad owners and the one-to-one scale live diesel model railroad suits them fine.

Sixty percent of the shortline names out there today see annual sales in the $1-2 million range and many of them fail the hundred-cars-per-mile test. *Barron’s* estimates that private-equity funds are sitting on more than $300 of “undeployed” capital. With funds borrowing at a rate of $2 for every dollar of equity, the implication is there is a $trillion worth of acquisitions out there. Who’s gonna waste their time looking at a sub-$20 mm deal when for a little more effort one could be looking at $billions? Recall RRA went for a billion and change. I’m eager to see who will be in the room.

J P Morgan guides JBHT down. Transport analyst Tom Wadewitz reports, “We expect most of the major TL companies to report earnings next week including JBHT. Weakness in the truckload market is well-documented, and we believe the most important information which may be revealed are initial signs of how pricing will turn out on contract bids for large TL customers. We see downside risk to 07 EPS for most TL carriers due to soft pricing and margin downside.”

I drove across half of Iowa and all of Illinois this week and the trucks outnumbered the autos two-to-one. Shippers I spoke with on the trip tell me some railroad pricing practices combined with erratic transit times and hungry truckers mean more business for the latter. I also should note that most of the trucking cabs I saw were *not* Hunt’s or Schneiders but that private owner-operators dominate. These guys will go home for gas and price-conscious shippers can find them easily.

On the other hand, says Wadewitz, JBHT intermodal sales could grow at a rate of 21% which, combined with a 7% improvement in dedicated operating income, could largely offset a 50% fall in truckload operating income in 1Q. Moreover, “a combination of continued intermodal share gains and a strong transload market to drive accelerating intermodal growth through 2007 should overwhelm the weakness in TL which may persist for a few more quarters.”

To which Bear Stearns’ Ed Wolfe adds, “We believe the oversupply of trucks in the U.S. generally remains rampant and that pricing will weaken materially over the next few quarters as large bid packages are just being decided (mostly negative y-o-y) in April and May and will continue to come up throughout 07. Our sense is the dedicated market may also weaken going forward as a result.”

Elsewhere, Wolfe writes in his 4/13 *Friday Freight* letter that there is a lot of excess truck capacity. "Carriers and shippers are trying to maintain longer term relationships while reflecting the reality of the current supply/demand situation. A privately-owned truckload provider told us that while demand picked up modestly at the end of March seasonally, he does not believe year-over-year there was a pick up from the past six-month demand funk. Early April thus far has been disappointing again. He noted particular continued weakness in Texas and the East coast, while the Midwest has shown some recent modest improvement. We continue to hear a very loud and consistent story of overcapacity in both the TL and LTL markets."

What concerns me from a short-line perspective is that boxcar business the class Is eschew for "capacity" reasons or try to price out of the market will go to the owner-operators and swirl around there, never to return to the rails. Thus the most successful short lines are the ones with a good chunk of on-line business where they enjoy a competitive advantage over truck. I'm seeing truck direct to millers losing out in favor of the country elevator that offers the same price per bushel and no waiting to unload. I'm seeing short-haul unit trains of aggregate running over two short lines with lower landed cost and more reliable transit times than truck.

Short takes: The *Twin Cities & Western Railroad Company* has promoted Mark Wegner to President, effective May 1, succeeding Bill Drusch, who's hanging up his steel-toed shoes after a distinguished 38-year railroad career. Wegner will also serve as president of Minnesota Prairie Line, Inc., a TC&W affiliate, and has 16 years of rail experience having joined the TC&W in 1991 as accounting manager. TCWR began operations in July 1991 operating between St. Paul, Minn. and Milbank, S.D. The Minnesota Prairie Line operates between Norwood and Hanley Falls, Minn. over track owned by The Minnesota Valley Regional Railroad Authority.

Patriot Rail L.L.C. is seeking an exemption from the STB to acquire control of Rarus Railway Co. The parties reached an agreement under which a wholly owned Patriot Rail subsidiary would purchase all of Rarus Railway's outstanding stock. The 25-mile Rarus Railway operates a line between Butte and Anaconda, Mont. The parties plan to complete the transaction on or about April 25, according to a STB filing. Patriot is a holding company formed last year by RailAmerica Inc. co-founder and former CEO Gary Marino and currently owns the 118-mile Tennessee Southern RR.

Covered Hoppers for Sale. As a result of its 2001 Quaker Oats acquisition Pepsi is desirous of finding new homes for some cars that may be approaching the end of their useful lives. My sources seem to think there has to be a market for the cars, whether it is for scrap or cannibalization for parts. I do not know how many there are or where they are, exactly how old they are or whether they have ever been rebuilt. The thought occurs however that cars that are past their prime for general use can find new lives in short-line short-haul service that never leaves the owner's road. If interested, send me an e-mail or call me.

The Railroad Week in Review, a weekly compendium of railroad industry news, analysis and comment, is sent via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $125. Corporate subscriptions $500 per year. A publication of the Blanchard Company, © 2007. Subscriptions are available by writing rblanchard@rblanchard.com . Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned here.