RAILROAD WEEK IN REVIEW
JUNE 1, 2007

"We are in a just-make-money game in which those who can construct the best portfolios win the game." – Ray Dalio, Chief Investment Officer, Bridgewater Associates, quoted in Barron's

The quote above was made in the context of long-term investing performance but it fits just as well in the shortline railroad world where the quality of customers that construct the franchise (portfolio) will in large measure determine the long-term success of the operation. Just as the investment business is finding new ways of breaking up investments and turning them into higher-yielding building blocks, so must today's short line operators think differently than they did ten years ago.

Fortress paid 12x cash flow for RRA against a more "usual" short line valuation in the 6x to 8x range. The Fortress model, laid out by Managing Director Joe Adams at last April's ASLRRA Annual Meeting, is to take an existing business base and put in capital (at a reasonable cost) to add value in terms of better track, locomotives and services – transloads, e.g. -- that will improve the service offerings in the eyes of the customers.

Tom Judge, Editor of *Railway Track & Structures* writes in the May issue, "The railroad industry is poised on the cusp of a radically different future" with the potential for "incredible prosperity for the railroads and their suppliers." And, like the investment business, "the business has become much more technologically intensive and people intensive (Dalio again). In other words, the Fast Money crowd is looking for exceptional returns and they see opportunity in the rails.

But at the end of the day the guy moving the most revenue units at the best margin will provide the best shareholder returns. Commenting on CN's recent analysts meeting (WIR 5/4), *Seeking Alpha* blogger "FP Trading Desk" writes, "While CN management continues to push productivity initiatives so the company can contain costs while dealing with growth, cost reductions and acquisitions are no longer the main drivers for earnings. These days, volume growth is key."

Fair enough, given the continuing mantra in these pages about how the ability to increase car counts at higher yields depending on service quality as measured by the customer. But then, "Trading Desk" adds, "Upcoming legislation from the Canadian government expected to be passed by the end of June will likely make it more difficult for mergers and acquisitions between railroads in Canada and elsewhere in North America. *This does little to encourage private equity investors looking to buy a Canadian railroad.* [emphasis assed]

"If Bill C-11 passes, which UBS thinks it will, M&A deals will require much more than just approval from the Canadian Competition Bureau. The Ministry of Transport will need to review the transaction, consult with various stakeholders to evaluate the impact and then decide whether it is in the best interest of Canadians, according to UBS. Then the Minister will submit a recommendation to cabinet." He may be onto something. I suspect any attempt to take CSX or any Class I private will meet with a lot of opposition from shippers, labor, congress and the STB.

The private equity positions in the major US roads will doubtless force a greater focus on the *profitable* carload business lanes. And here's where our friends at usraildesktop.com (***.dt,*** or simply "Desktop") can help. Take STCC 327 – concrete, gypsum or plaster products -- not one of your high-yielding commodities on the Class Is. Much of it moves in railroad-owned equipment, in single-carload lots and along low-density long car-cycle lanes. So if your short line has a sizeable stake here it may be time to come up with better service design to take costs out and increase the revenue-cost multiple.

Using Desktop's quarterly traffic summary sort on your connecting class 1 and the three-digit 327 STCC, I sorted on NS and found the traffic trending down over three years even as rates were up 40% per car in the same period. From here you can pick an existing commodity lane in which your line participates and get the avoidable cost of the move. Plug in the going rate and Desktop will give you the multiple – with or without fuel surcharge. If under one-three, look out.

So far I am not aware of any short line railroad operator applying this technology to rate and lane management, yet it's part and parcel of the "technologically intensive" railroad industry to which Dalio, Adams and others allude. Please correct me if I'm wrong.

Reporting on the recent NARS meeting in Washington, Credit Suisse rail analyst Jason Seidl writes, "The mood was far less confrontation than any rail shipper meetings we have attended in the past. While several shippers said they were not happy with pricing hikes, they acknowledged that service has improved somewhat and, moreover, the rails seemed more willing to work more closely with them.

"From the rail side, a panel of CEO's drove home the point that the railroads were spending record amounts on capex and would spend more if the proposed 25% tax credit is passed (an event that we do not see likely for 2007). Several rail CEOs also warned against regulation that is not cost-justified." Which fits with what we heard at the Bear Stearns conference two weeks ago (WIR 5/11). Shippers are clamoring for better service and it takes more infrastructure to deliver it. Revenues drive operating income and that drives cash flow from operations and that in turn funds capex. Regulate or challenge away the opportunity to charge market rates and the ability to fund better service vanishes.

Another contributor just returned from NARS was somewhat more critical. This from a recent e-mail: "The ACS [American Chemical Society] people are completely irrational on the subject; UTU is busy fouling its own and others' nests; and the sense I got from the NARS meeting is that if the Oberstar bill ever is passed, it won't look anything like it does now. Oberstar is not considered a wacko, and his support of labor will not extend to destroying an industry (railroads.) Brokenrail (UTUNLD) has to run for re-election this year, as UTU elects its chief lobbyist." Reminds me of the ancient Chinese curse: Be careful what you ask for… you might just get it.

Bear Stearns rail equipment analyst Peter Nesvold writes, "We spoke to a contact at a small railcar leasing company that specializes in covered hoppers to get his thoughts on the current demand environment. Our contact said that while ethanol demand has been driving an increased need for high-cube covered hoppers to carry distillers dried grains and solubles (DDGS), this same demand is having a modestly negative effect on smaller covered hoppers normally used to carry corn and other types of grains.

"As we're written in prior channel checks the tremendous demand for ethanol is consuming a significant amount of normal corn production. However, our contact pointed out that normally these corn crops would be shipped by rail to other parts of the country. Instead, we're seeing a significant amount of local corn production being trucked into local ethanol plants. In fact, our contact said that he believes that as a result the industry currently has excess capacity in smaller covered hoppers. [Look for more on this in the August 2007 *TRAINS* piece by Andy Cummings, sidebar by yours truly]

"Offsetting this weakness in smaller hoppers is continued growing demand for bigger cars to carry DDGS. Interestingly, our contact noted that because of delays in the construction of some new ethanol plants many of the new DDGS cars being manufactured are actually being placed directly into storage as well. That said, our contact said he isn't concerned about the production delays seen at some ethanol plants yet, as it appears to be strictly a timing and construction issue.

"Going forward, our contact said his biggest worry is the possibility of excess capacity in higher cube cars as we see more ethanol plants being built closer to where DDGS are consumed (rather than plants being built near corn fields). In that scenario, the DDGS would likely be trucked from the plants directly to farms for livestock feed, while the corn would come in by rail. Since it is harder to find alternative uses for larger covered hoppers our contact is concerned that we could end up seeing some of these cars underutilized."

To which Nesvold adds this note: "Because of its light density, DDGS tends to cube out rather than weigh out when loading for transport. In other words, a 5,150 cubic foot covered hopper can transport roughly 110 tons of corn but can only transport roughly 80 tons of DDGS. As a result, when using these larger cars to ship goods other than DDGS (or plastic pellets) you end up with a significant amount of wasted space." True enough, though I saw trainloads of DDGS in new 6300-cf covered hoppers on my Iowa trip. If what Nesvold says comes true the words of a dear friend at a major poultry process or may ring true: "Is there a life for these 6300s after DDGS?" *Caveat emptor*.

Coal hopper car specialist Freightcar America has seen orders drift south of late and the outlook for 2007 earnings is headed in a similar direction as the backlog is about a third of what it has been. Still the company boasts a strong balance sheet ($15 a share in cash with a $49 stock price and no debt) and is broadening its product line. Management is making the right cost-cutting moves and margins should level out around 10% for the remainder of the year. Freightcar America continues to generate solid cash flow, which makes it a potential takeover target for a private-equity firm or a larger industrial manufacturer looking to make a tuck-in acquisition.

CSX Intermodal is building a new facility at Chambersburg, Pa., scheduled to open in September. The 114-acre terminal will have access to warehousing, logistics parks, I-81 and is a short hop from the PA Turnpike. CSX Intermodal's business currently consists of 66% international and 34% domestic traffic and I expect this push is partly to increase the domestic share.

Pennsylvania is mostly NS territory and outside the Philadelphia area CSX' transload presence is limited to short line partners such as GWR's York Rail plus a handful in the southwest corner of the state. Look for CSX to market this facility rather aggressively to carload customers now served by NS shortlines within a 100-mile radius or so. See my earlier WIR comments re shortline commodity lanes at risk.

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