RAILROAD WEEK IN REVIEW
JUNE 15, 2007

"The FRA staff actually recommended approval of the [DME] loan and the railroad's financial health has improved." – Fred Frailey in TRAINS June 12 Newswire.

I don't know if it's "official," but there are a number of signs that indicate the DM&E is for sale. This week alone I've fielded inquiries from reporters in New York, Washington and the Dakotas asking whether the rumors were true. Then Fred Frailey broke a piece on the *TRAINS Newswire* mid-week under the banner, "DM&E/IC&E Bidders Winnowed to Around Ten."

It appears the sale process was at least in part triggered by the FRA's denying the DM&E's $2.3 bn loan request to facilitate a 260-mile line extension from its present terminus in western So Dak into Wyoming's Powder River Basin coal fields (WIR 3/2/2007). The FRA's reason was that it doubted the railroad had the wherewithal to repay the loan.

Let's run some numbers. The combined DM&E and IC&E ran some 260,000 carloads a year when they were combined. Since then I've learned that business is up nicely and the ethanol trade in particular has been a boon to both, particularly the latter as it cuts through the middle of the nation's most concentrated corn-producing belt in northeastern Iowa (see Andy Cummings' IANR story in August *TRAINS*). Various press reports indicate ethanol plants are popping up along the DM&E as well. So let's say the combined roads are doing 300,000 loads a year on their combined 2400 miles.

Since these are ISS roads, they get divisions rather than allowances. According to usraildesktop.com the ICE probably gets about $1400 per ethanol car to Sewarren NJ via NS over Chicago. Crude bentonite (STCC 14511), another biggie for DME out of western SD, looks like a division of around $2300 per car to Texas via UP over Mason City, IA. So, depending on volumes, commodities and OD Pairs, DME/ICE could be averaging $1500 a car. Call it $450 mm in revs. With an 85 OR you get ops income of $68 mm. Regional RR depreciation can run as much as 10% of revs, or another $45 mm. If so, we can estimate EBITDA to be around $100 mm.

Fortress paid 12x EBITDA for RailAmerica and there's no reason to think DME/ICE could bring less, especially since it's all in one place and not spread around the country the way RRA is. Moreover, if there were buckets of Real Money in the form of a private equity buyer, the FRA's can't-pay-it-back argument suddenly loses steam. And, for the sake or argument, suppose the PE buyer has clout in Congress and with a little arm-twisting gets Members to encourage the FRA to change its mind. Now the PRB Extension has tangible net present value. What's that worth? Two more multiple points? Maybe we're looking at a $1.4 bn transaction.

Then there's LB Foster (FSTR). Their initial $9 mm investment in the DM&E is now worth about 13.4% of the company per the 10-K. So, if the railroad goes for $1.4 bn and by the time you skin it and clean it there's a cool $billion to be distributed to the owners, could be $130 mm for FSTR. As the 10-K notes, "if the [PRB project] becomes viable, management believes the company's investment in the DM&E could increase significantly." I'll say.

Frailey suggests that bidders represent a mix of PE investors and Class Is. My bet is on the PE guys and if that's the case then FSTR will probably be bought out. It may be a coincidence, but the pace of reporters' calls to this desk picked up on Wednesday and from late that day to early Friday FSTR traded up $4 to nearly $28, a 16% gain in two days. Maybe the game's afoot after all.

As of Mar 31, FSTR had some $58 mm in net LTD after paying the current portion and deducting cash. They own the concrete tie market and could well become a major supplier in the PRB extension regardless of who the winner turns out to be. Moreover, a sudden nine-figure cash infusion could provide the wherewithal to do many interesting things. Like Frank Zappa said, "Money gives you options." Stay tuned.

The decline in automotive loads has been making the news of late, however, at NS at least, it has more to do with auto parts than it has to do with finished vehicles. The three PPT examples below (following the disclaimer) tell the story. Total automotive revenue loads are down maybe 10% over the past five years with vehicles essentially unchanged and parts cut nearly in half. This is particularly bad for short lines as Big Three parts can come from smallish suppliers widely disbursed whereas transplant parts are either sourced close-in to the assembly plant or come from the parent-country by container.

So even as the Big Three downsize, the good news is that short lines have a shot at attracting assembly plants for foreign marques, viz. the Honda plant planned for Greensburg IN on RailAmerica's Central Indiana. This on the former NYC "James Whitcomb Riley" line between Indy and Cinci, spun off by Conrail and acquired by a short line operator based in Kokomo and subsequently acquired by RailTex and then by RRA.

May revenue units for Genesee & Wyoming declined modestly, as scheduled maintenance at two power plants in Illinois trimmed coal, coke and ore volumes. The company hauled 68,212 carloads in the month, compared with 68,415 carloads during May 2006. Coal, coke and ore volumes fell the most, dropping 22% to 13,047 carloads from 16,701 carloads a year ago. Forest products, pulp and paper, as well as other commodities were off due to rerouting after a trestle failure on its Meridian & Bigbee Railroad.

Commodity groups including farm and food products, minerals, stone and petroleum products increased during the month. Excluding carloads from its Australia unit, which the company began operating in June, and carloads from the Chattahoochee Bay Railroad it took over in August, same-railroad traffic in May 2007 decreased 10.1%.

The former SAL Main between Raleigh and Hamlet was off-limits to Amtrak's *Silver Star* for a week. The FRA inspected the CSX-owned line in late May and slapped a 10-mph speed restriction on the segment, causing Amtrak to reroute the *Star* via its former ACL route to Pembroke and thence over to Hamlet to resume the usual trek south on the Seaboard. Northbound did the reverse. In a press release Amtrak said simply, "Passengers holding tickets to stations in North Carolina and South Carolina that are unique to the Silver Star route will be provided alternate transportation." The detour ended June 8.

Meanwhile, on the other coast, California riders are returning to the rails in droves. May ridership on the Capitol Corridor was up 18.2% pushing ridership to the highest totals seen since the service began with revs up 30% to boot. Fiscal year-to-date ridership was up 13.3% with revs up 21.7% due to eight consecutive months of substantial growth. Average trip length is holding at just under 70 miles, so that's getting close to 10,000,000 passenger miles per month, miles that were on Capitol Corridor trains and were NOT on California's highways." Meanwhile, back in NC for eight days it was business as usual and then some on I-95.

One part of the NS story left untold last week had to do with operating metrics – data points such as yoy deltas in GTMs per available locomotive horsepower and employee, car miles per day, GTMs

per train-mile, GTMs per gallon of diesel fuel. Steve Tobias touched on some capacity matters and STB measures in the 4Q06 call back in Jan, but the last time I can find that he went into any detail was four years ago on the 2Q02 call.

At that time Steve gave a very complete picture of the railroad's performance from the usual STB measurements to percent on time by commodity service (merch, intermodal, multi-level), including bell curves showing early-OT-late distribution. It therefore would have been helpful if the Analyst Day presentations provided some inkling of just how well the railroad is actually running. Fred Ehlers did a great job telling the tech story and putting some performance metrics at the end would have provided a nice wrap: we said it works and here's how well it works.

A good friend who knows rail ops inside and out having spent a good many years at the UP in Omaha writes, "I too found the NS material most interesting. The slides and the strategy discussions were excellent. So far I've listened to Wick's and McClellan's audio. I applaud the 'Crescent' corridor. It is the short-route miles and could take a lot of southwest originating intermodal traffic out of the Chicago and St. Louis Gateways that is headed for the Northeast (and vice versa). It will be interesting to see if UP and BNSF will want to play. It is a solid public private partnership opportunity. I hope they can sell it.

"However, I don't know if it is great fit for carload. BNSF and UP would be short-hauling themselves (the old division's bugaboo) and the terminals may not be a great fit. Think of the roles that North Little Rock, Pine Bluff, Sheffield, ALS, and Conway play in that traffic mix for long-haul blocking over the Memphis, St. Louis and Salem (Sidney) Gateways.

"In the case of UP and NS, Livonia and Birmingham would be the two primary humps. I know I'm old school, but you've got to have some places to gather and disperse this stuff, that have enough capacity to handle the volumes that you will need for long haul blocking. Nothing's impossible, but it is an interesting Service Design opportunity, *if* the marketers will support it."

All of which is true with respect to yards and capacity. My point is simply that if you speed up one part of the railroad everything on it will move better, viz., UP's own triple-track across Nebraska, CN's 10,000 ft siding initiative and BNSF's double-tracking the entire ex-ATSF route between KC and LA. Just one more train a day with 100 merch cars at $1500 apiece adds $55 mm in new revenue to the top line. NS has a net margin of 16% so that one added train every day is worth $8.8 mm in net income or two cents a share. NS earned $3.57 last year; two cents plainly adds 3% to EPS. Is that extra train a day worth it? I think so.

Notes from All Over: *Union Pacific* (UNP) made the Top Five All-Round Value Stocks list on Thestreet.com on Tuesday. It has been on their Buy list since April 2005, showing a wide-range of strengths including growth in revenue, net income and eps….*Trinity Industries* (TRN) was cited on The Motley Fool as meeting "the Benjamin Graham Test" for investment: a stock that "upon *thorough analysis*, promises *safety of principal* and a *satisfactory return.*" (emphasis added)… *Greenbrier* (GBX) made the T. Boone Pickens Top Dividend Picks list thanks to its having paid quarterly divs for 12 years and though the yield is only 1% they trade at a meager 10x cash flow.

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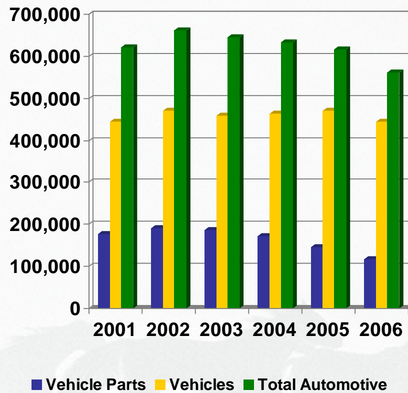
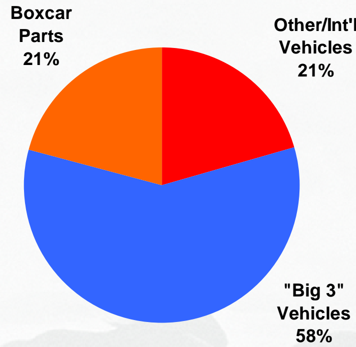
Automotive
Volume History and Mix

2001 – 2006 Volume

2006 Volume Mix





Automotive
Environment and Outlook –

- Low point of production in North America in 2007
- Financial and share pressures on "Big 3"
- Pending "Big 3" plant closings
  - Ford St Paul, MN Mid-2008
  - Ford Wixom, MI May-07
  - Ford Norfolk, VA Jun-07
  - GM Doraville, GA Mid-2008
  - DCX Newark, DE Mid-2009
- Continued interest in new plant development in U.S. by foreign manufacturers

Automotive

Business Growth and Improvement Initiatives

- “Unilevel” Program Launch
  - Transportation of Class 5 – 8 vehicles
- International parts business growth
- New plants/production in NS territory:
  - Toyota – Lafayette, IN 2007
  - Honda – Greensburg, IN 2008
  - BMW – Greer, SC 2009 (second plant)
  - Toyota – Tupelo, MS 2010