RAILROAD WEEK IN REVIEW
SEPTEMBER 7, 2007

—

"Of all the candidates we chose CP in large part because of its demonstrated knowledge of our company and shared vision in our PRB project." – Kevin Schieffer

Canadian Pacific has emerged as the winner in the DM&E saga, bringing up the markers on a train of events that began last March when the FRA turned down the smaller road's request for a $2.3 bn loan to build a brand new rail line across western So Dak to access Wyoming's Powder River Basin coal reserves. For the next three months the rail wires were rife with rumor and by mid-June it was clear that selling the railroad was the only way to finance the PRB build-in. So I ran some pro forma numbers and came up with a sale price of around $1.4 bn (WIR 6/15/2007).

Now come DM&E and CP late Wed to announce they've shaken hands on a $1.5 bn transaction that includes the combined DM&E and ICE railroads. Once closed, the deal includes "future contingent payments" of about $1 bn assuming they start on the PRB build-in by 12/31/2015 and certain volumes of coal actually come out that way.

For its cash, CP is getting about 2500 miles of railroad serving eight states with 7200 rail cars and 150 locomotives with access to all seven of the North American Class I roads, Chicago, the Twin Cities, KC and key river ports. The attached CP/DME Fact Sheet shows some interesting parallels between the commercial profiles of each road. Bulk products (coal, grain, ferts) accounted for 43% of 2006 revs for CP and 45% on DME/ICE, so there are no new learning curves for either party. But industrial products (chems, aggies, forest prods -- both 24 and 26 -- and metals at CP) were 14% of CP's 2006 sales vs. 48% for DME/ICE, indicating a nice shot for CP to build a greater franchise in this key group.

The parties are to be applauded for structuring the transaction this way. CP is buying a functioning railroad with a healthy and growing business, and the $1.5 bn is for that. Tweaking my June numbers, using a less generous RPU and taking the OR down 15 points (kudos to Kevin for that alone!!), you still get roughly $100 mm in ebitda meaning CP is ponying up about 15x ebitda *vs.* the 12x FIG paid for RRA but *without* any PRB premium. Seen in that light, this is a simple stand-alone acquisition and the potential for PRB coal is an option with a very long strike. The transaction is expected to close within the next two months with STB approval within the next 12-month period.

During the conference call the two themes were "CP is the natural buyer as we've been working the BD angles with these guys for years" and "we're buying the DM&E because of the organic railroad fit and the PRB is the icing on the cake." In other words, the $1.5 bn is for the DM&E as-is plus the option to build the PRB expansion if and when it meets key hurdle rates. The deal will be immediately accretive, adding more than $100 mm ebitda right away with the potential to double that in relatively short order – two-thirds from organic growth and one-third from operating synergies such as asset utilization, longer hauls, etc.

There are also benefits beyond. KCS in particular stands to gain from this transaction thanks to its pre-existing marketing agreement with the DME/ICE (see the dotted grey line on the KCS map). Coal, ag and IP accounted for 81% of KCS revs in 2006 and with the integration of TFM the combined roads offer significant customer benefit in terms of commercial talent and routing. Then there are short lines like RRA's Dallas Cluster off the KCS at Ashdown AR or the TCWR and RRVR where the combined CP-DM&E will provide further competitive strengths.

Wall Street was generally supportive. Bear Stearns' Ed Wolfe called it "a big price for a large potential." Jason Seidl at Credit Suisse notes that "DM&E's existing focus on bulk products as well as the PRB option for coal volumes fits with CP's business mix and expertise." Over at Morgan Stanley William Green drills down to the competitive aspects of a third player in the PRB: "Although it's unclear today whether CP will move forward with building a rail line extension into the PRB, any increase in competition in a duopoly such as this would not be good for the pricing and margins of the incumbent carriers, in our view." JPM's Tom Wadewitz takes the position that "we see potential for the DM&E to be a long-term positive which adds a new source of growth." And independent analyst Tony Hatch wraps his note thus: "Even at these multiples the [DM&E] core railroad is likely to be a winner for CP."

For my part this is a good ending to a fight that began 20 years ago when the Soo Line, CP's US subsidiary, got into a bidding war with the Chicago & Northwestern over the remains of the former Milwaukee Road's Twin Cities-Kansas City Line. I can remember my friends at the Northwestern heaving huge signs of relief when at last they *lost*, as the weaknesses of the line became evident. Then in 1997 Dennis Washington, owner of the ex-NP Montana Rail Link, bought out the Soo and formed the I&M Rail Link only to sell same to the DM&E in 2001. Now it's back in CP control where it belongs and all's right with the world. (*Disclosure: I own shares in CP*.)

Collateral benefits go to Pittsburgh's LB Foster (FSTR) for its roughly 13% interest in the DM&E. The acquisition will result in a payment of approximately $151.5 mm at closing plus another $42 mm if and when PRB construction begins and as much as $84 mm upon CP's achieving milestones related to PRB coal tonnage thresholds.

Six months ago some of us estimated the deal would be worth $200 mm in cash or $20 a share to FSTR. Prescient stock watchers who could see the DM&E sale handwriting on the wall bought FSTR at $20 or so and it continued to go up even through the present unpleasantness, hitting $40 this week for a clean double, so the $20 per ticket guess was right on the money. FSTR expects to use the proceeds to pay down debt and "help fuel key long term strategic growth initiatives."

CSX held an Analysts Day at the Waldorf Astoria in NY Thursday and I think the team did a great job of showing how their long-term focus delivers customer and shareholder values not only in the long-term but also the short term. Following some very upbeat introductory remarks from CEO Michael Ward, VP Strategic Planning Les Passa did his usual excellent job of positioning the railroads' (and specifically CSX') role in meeting the exponential growth in transportation demand over the next quarter-century. (All these presentations are under the Investors tab at www.csx.com and the serious student of short line rail transportation will pay close attention -- especially in terms of impact on their own short line railroads.)

Les' remarks set up the ops story as told by Chief Transp Officer David Brown: how service reliability unlocks customer value. After walking us through some of the service metrics David introduced the Total Service Integration (TSI) process that aligns customer needs with operating capabilities, doing on a Class I level what short lines like Watco have done with their Annual Operating Planning process that drives *profitable* growth, not just cars for cars' sake. (This in turn goes to recent short line discussions about the need to address Class I profitability needs before proposing a new move to a connecting Class I.) David drills down to specific lanes and here again the astute short line operator will glean new insights as to how best to fit local ops to CSX service design objectives.

Next up was Kyle Hancock, VP Sales and Marketing, to build on the Les Passa view of market facts of life and David Brown's remarks on how the CSX transportation product will meet the market requirements. Kyle's message is simply that strong service plus capacity constraints equals pricing opportunity. And rather than bore you with a blow-by-blow across commodity lanes, suffice to say that Kyle weaves a picture of specific opportunities, most of which are open to short line participation. To get a good feel for where CSX is coming from, listen to Kyle's remarks on bottled water and ethanol (slides 28 and 29). And observe how he dispels the notion that aggressive pricing is driving off business. The facts are quite the opposite; for proof, read the Railex story.

Of course, doing all that David and Kyle talked about takes money. So it was appropriate that Fred Elaisson, VP Financial Planning and Analysis, took the floor at this point to lay out CSX' thinking on cost of capital, capital planning and capital expenditures going forward. The capex budget through 2010 runs about $5 bn over four years to be spent 60% on infrastructure, 20% on equipment and 20% on strategic items such as IT support and capacity expansion. What's changed from past practice is that users of capex need to "earn the right to spend" and those expenditures will be evened out over time. Past practice was to spend it when you have it, don't spend when dollars are down.

Of particular importance to short lines is CSX' determination that some car types fail to meet reinvestment hurdle rates – box cars, gons and some covered hoppers among them (see reference to profitability needs in Passa remarks above). Fred put it this way: the strategic ownership value is a function of whether taking title to a piece of equipment enhances or takes away from CSX' ability to attract *profitable* new business.

From here Fred gave some color on how CSX approaches infrastructure expansion with a particular nod to Public Private Partnerships. Examples include double-stack clearance programs in Phila and Boston (returning Beacon Park to Harvard and building a replacement intermodal someplace near by) plus a new I-4 corridor between Orlando and Tampa.

The final presentation of the morning was Oscar Munoz' summary of financial performance and direction. What CSX has going here is a classic "UPOD" (under-promise, over-deliver) story. Two years ago CSX set 2006-2010 growth goals in double-digits for operating income and EPS, an OR in the 75-80 range and ROIC at or better than cost of capital. To date the ops income and eps goals have been beaten handily and the other two are on track to meet or exceed. Investors have taken notice, too. In Aug 2004 you could buy a share of CSX for $16 split-adjusted vs. $40 today, a gain of 150% whereas the S&P has inched up maybe 20%. In fact, said Oscar, S&P puts the rail group's projected LT growth rate north of 18% yet the group trades at 14 times earnings for an industry PEG of 0.77, an attractive proposition for value players.

It was indeed refreshing too hear a railroad CFO talk in terms of industry values and PEGs. For that matter, the whole morning, even if some Wall Street analysts complained that there was little new in the numbers, gave a lot of credibility to the CSX story. Any first-time listener could not help but come away with a sense of confidence that these guys really know what they're about and that everything they do is calculated to enhance shareholder value. Short liners take note.

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 are $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.

DM&E
Dakota, Minnesota & Eastern Railroad Corporation

IC&E
Iowa, Chicago & Eastern Railroad Corporation

FACT SHEET
September 2007

Key Financial Data

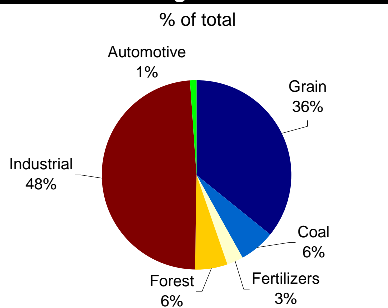
	2007T	2006	Change
Total Revenues (USD millions)	290	265	9%
Freight Revenues (USD millions)	280	258	9%
Carloads (thousands)	275	260	6%
Operating Ratio (%)	67.6	70.2	260 bps
Locomotives	150	150	
Rail Cars	7,400	7,200	

Highlights

- Largest Class II railroad in the US
- Only Class II railroad with interchanges to all seven Class I railroads
- 2,500 miles of track serving 8 states; Illinois, Iowa, Minnesota, Missouri, Nebraska, South Dakota, Wisconsin and Wyoming
- Access to Twin Cities, Kansas City, Chicago and key water ports
- Approximately 1,000 employees with 375 unionized
- Improved train accident and personal injury performance

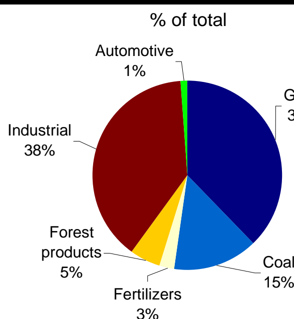
2006 Freight Revenues

% of total



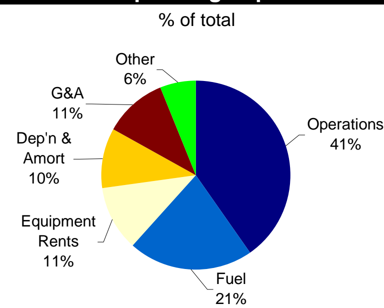
2006 Carloads

% of total

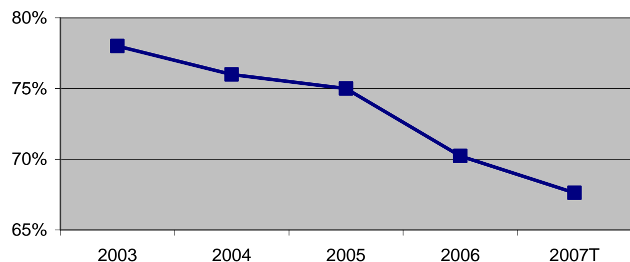


2006 Operating Expenses

% of total

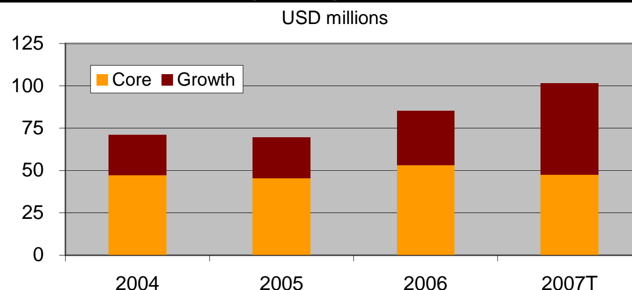


Operating Ratio



Capital Expenditures

USD millions



NOTES: All data is provided by DM&E/IC&E
T denotes target; positive change is favourable; negative change is unfavourable.
Operating Ratio is the ratio of total operating expenses to total revenues and has been calculated excluding non-recurring and other items.
Locomotives and rail cars are owned and leased.
This Fact Sheet contains certain forward-looking statements relating but not limited to the anticipated financial performance of DM&E and its subsidiaries. Undue reliance should not be placed on forward-looking information as results may differ materially.