RAILROAD WEEK IN REVIEW
OCTOBER 26, 2007

"The results (particularly pricing) from our recent shipper study underscore our thesis on the sector that the growth story is secular rather than cyclical." – Jason Seidl, Credit Suisse

Genesee & Wyoming filed an 8-K on Tuesday morning announcing its offer to buy the majority interest in the Maryland Midland (MMID), a short line operating over the former Western Maryland between Emory Grove and Highfield, both points on today's CSX. According to the filing, "The Merger consideration consists of approximately $29.1 mm in cash, with adjustments for working capital at the time of closing. Following the Merger, GWR will own 87.4% of Maryland Midland. Lehigh Cement Company, currently Maryland Midland's largest stockholder, will retain its current 12.6% ownership in Maryland Midland." Look for the deal to close in 4Q04.

This is a fitting close to one of shortlinedom's more interesting stories. Paul Denton, a career B&O Man, started in 1980 with 17 miles of ex-PRR and ex-Ma&Pa track between Walkersville and Taneytown, crossing under CSX' ex-Western Maryland at Keymar. There was one loco and maybe a couple hundred cars a year. The stock was worth "pennies a share" according to the MMID website www.mmidrwy.com , worth a visit before they take it sown.

The present MMID handles more than 16,000 cars a year (90% cement and aggregates) on its 63 route-miles for a very respectable density of more than 250 revenue loads per mile per year. The railroad's largest customer is Lehigh Cement's recently upgraded facility in Union Bridge, Maryland. The railroad owns ten locomotives, owns or leases more than 400 freight cars and for the fiscal year ending April 30 2006 had sales approaching $8 mm.

If GWR is paying $29 mm for 87.4% of the company, that implies full value of around $33 mm and a price-sales multiple north of four. That's a bit rich (we used to think in terms of 2x) but GWR has a habit if paying up and then working down the effective multiple by spreading the overhead out over more railroads. So Congratulations to all the MMIDers who made it possible and to the GWR gang for what appears to be a quickly accretive buy.

Canadian National's operating income for 3Q07 declined 9% yoy to C$768 mm on essentially flat revenues and a 3% decline in revenue units. The operating ratio gained three and a half points to 62. There wasn't much of a pricing story as system RPU inched up a mere point – both metals/minerals and forests products car counts were down and they make up half the merch units on CN. Intermodal was a bit of a surprise, down 2% in revs, a point and a half in vols, and less than a point in RPU. During the call CEO Hunter Harrison said they expect to see continued softness in forest products and construction materials.

Operating expense increased 6% due in part to increased comp and benefits, fuel, car hire and casualty expense. Of these, fuel provides some valuable insight as to how the railroad is actually running. True, revenue unit counts slipped 3% yoy but GTMs and fuel burn didn't budge, nor did ton-miles per gallon of fuel. Same ton-miles, fewer revenue units equals bigger cars and potentially fewer train starts as train lengths are limited as much by passing track lengths as by trailing tons per horsepower.

Net income was C$485 mm, down 2% and diluted eps also fell 2% yoy. Absent expected Q4 gains from the EW&S and CN's *Gare Central* on Montreal, CN guidance is for FY 2007 eps to be unchanged at C$3.40. Further on this theme, Bear Stearn's Ed Wolfe observes, "CN has struggled more than most of the rails over the past four quarters with weakened volumes driven primarily by above-average industry lumber exposure and a declining U.S. dollar. While these likely remain as material headwinds for the next several quarters at least, we believe y-o-y volume trends for CN may have reached a bottom and will face by far the easiest y-o-y comps in the group during 4Q."

BNSF posted an all-time quarterly revenue record of $4 bn, up 3% yoy, on 5% fewer revenue units and no change in RTMs (there's that bigger cars theme again). Operating income gained 9% (17% without the one-time enviro expense) to a $billion even (another record) as ops expense gained less than 2% thanks to the company's relentless cost-control measures; COO Carl Ice said on the call that cycle times were the "best in years." GTMs came down 1% but fuel burn dropped five times that. The OR fell 122 BP to 75.4.

The building products slowdown is a continuing major drag on Dave Garin's Industrial Products group, though revenue gains in STCCs 28 and 29 as well as construction products offset its 10% revenue decline. The precise definitions of the IP groups are on page 9 of the 10-K for 2006 but for the nonce suffice it to say Building Prods is all forest products plus government, machinery and waste and accounts for a third of all IP revenues. Construction Prods is everything to do with steel plus minerals and aggregates for another third of the IP group revenues.

Perhaps the biggest surprise was the 10% drop in intermodal units and the accompanying 4% decline in revenues from the group. BNSF positions itself as a high-speed, heavy-haul, high density railroad. The merch carload sector (everything ex-coal and IM) is generally perceived as anything but. Yet the non-BNSF carload sector including ag and auto brings in more revenues than coal and IM combined. Among the Big Six BNSF merch carloads represent the smallest portion of the total revenue pie.

The WIR focus is on the carload sector for two reasons. First, the mdse trade, as noted above, brings in more Class I revenue than either IM or coal. Second, it is the short lines' bread-and-butter business and doing it well can make one quite rich (see MMID, DM&E sales for two). As noted last week (WIR 10/19) BNSF carries more short line cars than any other Big Six Class I and has the and highest merch RPU of the lot. So here for the first time I can recall IP posted a revenue gain to IM's loss and took half the percentage hit in loadings than what IM saw. I'd say the IP outlook for BNSF's merch biz – and its shortlines – is most promising.

Getting back to the Big Picture, Bill Greene of Morgan Stanley writes, "Headwinds may limit near-term upside relative to other railroads. We like the long-term story at BNSF, especially if the company can resume its former industry leading volume growth. The company offers a nice mix of pricing power and volume growth potential, and we see roughly 15% upside through year-end 2008. However, we feel investors may be able to maximize annualized returns by waiting until 1Q or 2Q08 when the company laps a number of near-term headwinds and resumes a trend of margin expansion."

Norfolk Southern shoulda been a contendah but sadly missed the mark. Revenues skidded 2%, the largest drop of the five Big Six roads reporting to date. The only revenue-unit gainers were ag and auto with mets/construction and intermodal bringing up the markers at negative 9% and 6% respectively. Revenue units were off 4%, second only to BNSF. And although NS touted its 20 consecutive quarter of revenue growth it was less than 3% and lagged its US peers by one to six points, depending.

Said EVP Marketing Don Seale during the call, "Traffic mix was impacted RPU growth as unit volume declines in some higher-rated commodities such as utility coal, iron/steel, lumber and auto parts were offset by growth in lower-rated coal aggregates and MSW." Interesting. More than a few short line guys have suggested that NS took some rate increases too far and one result would be greater negative deltas in the higher revenue/cost lanes. The one bright point was agriculture revs, up 10% on 2% more units.

Operating expense was down four-tenths of a point leading to a 5% drop in ops income, exceeded only by CN's 9% dip. The operating ratio increased 94 BP to 71.1, still as highly respectable number and indicative of what NS can do when the Thoroughbred gets its legs. Net income dropped 7% to $386 mm or 97 cents a share vs. $1.02 a year ago. Back out the nickel-a-share Illinois Tax hit and you get a buck-two, unchanged. Surely NS can do better.

In his remarks before and after the call, CEO wick Moorman stressed the theme that the "long-term fundamentals favor the market for our customers and NS' superior levels of customer service. Internal metrics point to better asset velocity and we see further operating ratio improvements as we focus on new products. Our volume growth over the past five years shows what NS can do in a strong economy." Sounds good to me.

The House version of the Rail Safety Bill (HR 2095) was passed 377-38 this week. A note from Bear Stearns says that the bill "would revise hours of service rules, reduce limbo time, establish training standards for all rail workers and implement positive train control regulations. While not draconian, we believe this bill would likely increase hiring needs for the rails and limit future productivity gains."

The BSC note continues, "The companion legislation in the Senate (S. 1889) was introduced by Frank Lautenberg (D-NJ) this past July and currently has 4 cosponsors. The bill has moved out of committee, although the timing of a full Senate vote remains unclear. The Senate version is less severe with regards to limits on limbo time. Our sense is that a modified and likely watered-down version of the bill (probably closer to the Senate version) will pass in the next 6-12 months." The view from here is that there abounds a sense that "cooler heads will prevail." I sure hope so

Kansas City Southern reported 3Q07 revenues of $444 mm, up 7% yoy, record ops income of $98 mm, up 27%. Ops Expense held to a 2% gain and the OR improved 3.5 points to a respectable 77.9. Diluted eps jumped 50% to 48 cents. According to the press release, revenue gains were primarily attributable to volume growth in select commodity areas and a continued favorable pricing environment even though vols were off 3%.

Unfortunately, I missed the call Thursday owing to other commitments and was out of the office Friday. Let me give it a listen over the weekend and include my KCS notes along with my CP Investors Day observations next week.