THE RAILROAD WEEK IN REVIEW
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"A mild recession could be a good thing for Kansas City Southern's shares -- it could make them a better deal." -- Anne Kates Smith, kiplingers.com

She's absolutely right. She writes further, "Even though they may be platitudinous, analogies are sometimes hard to resist. On February 5, Kansas City Southern reported fourth-quarter earnings that blew past what Wall Street analysts had been expecting. On a day during which the Dow Jones industrial average fell 370 points, and despite an analyst's downgrade of KCS' railroad-industry competitors, shares in Kansas City Southern gained nearly 2%. Look at that performance as kind of like, well, a locomotive hauling heavy cargo up a slippery mountainside."

I had the good fortune to be at the call, held in the comfy JP Morgan/Chase conference center on the 17th floor at 277 Park at the civilized hour of 10 AM. Yes, before the call Zacks had taken a rather pessimistic tone, citing "inadequate fuel price hedges, evidence of a slowdown in economic activity, and rising interest rates." However, from a railroad operating standpoint, and looking mainly at what's happening above the line, I find there's a lot to like here.

Total freight revenue increased 4% in the Q and 6% for the year even as vols drifted south 2% in the Q and 3% for the year. However, if we're talking "core railroad," we exclude the overhead moves because they come online regardless of what the sales guys do in the field -- it's nice but you can't bank on it to pay the rent. Said EVP marketing and sales Dan Avramovich, "Take out the haulage that we actually lost towards the end of March 2007 and our vols actually grew 5% and we expect to improve volume ex-haulage from quarter to quarter." The IM haulage thus laps in 1Q08 and will be gone from the 2Q08 numbers.

Quarterly car-counts for the chemicals and automotive groups were both up 13% and system RPU gained a respectable 7% for the Q and nearly 9% for the full year. The auto growth comes of the fact that a lot of auto manufacturing is moving south to Mexico and KCS is exceptionally well-positioned with three new plants coming on line. Intermodal units ex-haulage were up 27% in the Q aided by a 38% bump in loads out of Lázaro Cárdenas. This is a growth story: KCS has picked up about $100 mm from the new business pipeline they talked about a year ago for a conversion rate of 75%.

Out on the line, running a faster, smarter railroad took 3.7 points out of the quarterly ops ratio, to 76.4, a record low and beating the five-year plan presented last March. Total ops expense was actually down seven-tenths of a percent, which, against the modest 4% revenue gain, levered KCS to a 23% ops income gain. For the year, the OR was 79.2 on a 5% revenue gain and a mere 2% ops expense increase.

How'd they do it? As I said above, by running a faster, smarter railroad and locomotive fleet management has a lot to do with it. Consider this Q&A exchange between UBS' Rick Paterson and COO Art Shoener. **Rick:** "Can you talk about exactly when the loco fleet changes will be fully implemented and how the improvements will run through the income statement?" **Art:** "We'll get 150 new units and we're retiring or turning back 200+ units now through 3Q08.

"We've developed a plan modeled after Southwest Airlines. We looked at how quick they turn their airplanes; we want to do the same thing. We want run the trainsets alike, particularly for the merchandise and intermodal networks, and we nicknamed it *The 737 Plan*. Basically, a pair of AC [six-axle units] will handle just about everything except for the some of the bulk trains that we shove over the hills with D-P units in various places. With quick turnaround and a commonality of power, we are going to get away from having to do a lot of slicing and dicing of locomotives at terminals. The basic concept is to move quickly through the terminals and turn quickly at the endpoints." [Later, Art told me the D-Ps let them double the train speed to 15 mph from seven or less on the ruling grade southbound from KC, thus freeing up capacity on the single-rack main and increasing GTMs per loco and crew hour.]

The thought occurred as I sat there listening to all this is that KCS is a good example for the Span of Control debate that comes up regularly in these pages. You get the feeling that the guys up on the dais really know every nook and cranny of their railroad and there are no local operators out there doing things their own way because that's they way it's always worked. For example, KCS has gotten the bugs worked out of the MCS so that supervisors can let the railroad run itself without having to poke at it constantly – and needlessly.

CEO Mike Haverty said in his opening remarks that KCS in 2007 hit the first-year objectives for OR, EBITDA, ROIC and EPS set down in the Five Year plan announced last March. Revenue was a bit of a miss, coming in at 6% (vs. the 9% plan) before tax law changes in Mexico that affected some inventory projections and taking volumes down. Looking out into 2008, Haverty said in his wrap that revenue will increase 8-9%, the OR will come down another "point-plus" and the new business pipeline will be robust. This last is key. If KCS can keep a pipeline of $100 mm or so and convert 75% a year, that's a lot of new revenue and volume. I must once agree with Kiplingers' Anne Kates Smith: "For investors in for the long haul, this rail stock is definitely worth a look."

Shares of Greenbrier (GBX) and American Railcar (ARII) turned sharply upward as news emerged that during the month of Jan billionaire investor Carl Icahn had scooped up 1.5 mm shares of GBX for a 9.5% stake in the company. The AP reported that Icahn acquired the stake through ARI Longtrain Inc, wholly-owned by ARII, where Icahn owns 53.7% of the company. A note at secinvestor.com suggests, "The news comes as shares of GBX sat near 52-week lows, beaten down by poor earnings and growth. Many shareholders are hoping that the billionaire activist will be able to unlock value in both companies through strategic alternatives" and that "many are speculating that the activist is moving quickly to acquire GBX at bargain-basement prices. It will be interesting to see how ready shareholders will be to sell at these levels."

In an 8-K filed at the time GBX said only that "The Greenbrier Board of Directors confirmed it has received a Schedule 13D filed with the Securities and Exchange Commission on February 4, 2008 by Carl C. Icahn and Reporting Persons affiliated with him. The Board is committed to acting in the best interests of Greenbrier shareholders and other constituencies. The Board and Company have no further comment at this time." This could get interesting if only because Icahn is not shy about being aggressive in unlocking the value of companies he owns.

Peter Nesvold, the Bear Stearns rail equipment analyst, wasted no time in sizing up the situation. He writes in his Feb 5 note, "We believe a transaction makes sense. Assuming an estimated $425 mm lease fleet divestiture and $37 mm of cost saves (which we believe is conservative), we estimate ARII can pay $35 for GBX (>40% upside from Monday's close) and still see 12% EPS accretion in 2009E. Without an asset sale, the purchase price would be less -- possibly around $30, depending on cost saves.

"Accordingly, we are upgrading GBX to Outperform from Peer Perform on these developments as we believe there remains material upside on a takeout — even after yesterday's 19% spike. Our year-end 2008 target price is $32.50 (31% upside), the mid-point of our two scenarios: one with a lease fleet divestiture (or $35), the other without (or $30), as outlined below. We view consolidation in the railcar industry as healthy for all participants, and thus anticipate that the possibility of a GBX/ARII deal could create near-term support for several of the rail equipment stocks." Could be the other car builders are riding this wave, too. See below.

Bulls and Bears. *Goldman* is "adding KCS shares to the Americas Buy List, as we believe the company will grow volumes in 2008 driven by capacity expansion at the Port of Lázaro Cárdenas (Mexico), but partially offset by a US hard-landing scenario. In a potentially softening economy, KCS could see demand decline and its stock multiple compress. But we believe a more likely scenario is that the stock trades up 25+% to our price target on the back of port volume growth and multiple-expansion due to relative out-performance." And fastmoney.com's Guy Adami says the early recovery names are still working and advises investors to take a look at railroad play KCS.

Zacks has cut CSX to Sell from Hold due to valuation. "CSX is the most dear rail stock we cover as measured on a PEG basis, which is not supported by its fundamental outlook. We believe the share price is being driven up by unfounded speculation regarding a potential recapitalization or buyout, as proposed by several hedge funds that have ownership interests in CSX. The company posted fourth quarter EPS of $0.85, up 50% year over year as revenues and expenses were better than expected, partly due to one-time items. Revenues benefited from strong unit pricing gains that rose 11%, partly offset by a 3% decline in volume as most business lines fell."

All the rail car suppliers (ARII, GBX, RAIL and TRN) plus GMT and WAB are sporting Point & Figure charts with "buy signals" based on price trends. P&F charts are particularly helpful in picking out the direction of trading and eliminating short-term price movements that can make traditional price-time charts look noisy (see www.stockpicker.com for an excellent P&F chart tutorial). The rails themselves are enjoying a nice run from their recent lows (GWR and CNI also have buy signals on their P&F charts). The combination would seem to point to economic recovery with the rails as a leading indicator.

RailAmerica's Puget Sound & Pacific (PSAP) has taken a grown up non-punitive approach to the hated topic of demurrage. PSAP has announced its intention to cancel its 6001 demurrage tariff effective March 1 and replace it with a new RA 1000 tariff with the traditional railroad tariff language plus a new "extended use option" for those times customers need to hang onto cars without the stiff demurrage penalties. A small "daily usage fee" schedule will prevail instead, allowing customers to budget for extra car time. No more demurrage debit/credit days.

One would wish more short lines would take this approach and would stop trying to use demurrage as an offset to car hire. Car hire expense is a measure of how well you turn cars; demurrage is an above-the line other operating income item. Ideally, there should be no demurrage as cars are delivered, loaded/unloaded on schedule, and pulled. Any questions? Drop me a note.

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