THE RAILROAD WEEK IN REVIEW
MAY 16, 2008

"If your business model depends on borrowed money, your existence depends on what the world thinks of you each day." – Warren Buffett in Barron's

It is a truth universally acknowledged that a financially sound company will turn each dollar of retained earnings into a dollar or more of market value. Take a look at the UP's balance sheet for 2007. At the beginning of the year, retained earnings were $11.2 bn; at the end of the year, retained earnings came to $12.7 bn, a 13% increase. Market cap (per-share price times share count) was $24.8 bn at the beginning of the year and $33.7 bn at the end, a 36% increase. However, look at what happens to the dollars: retained earnings increased $1.5 bn while market cap increased $8.9 bn. That is to say, every dollar of new retained earnings became $6.15 in market cap.

Alternatively, look at KCS. During the course of 2007 retained earnings increased by $118 mm and market cap gained $674 mm, which meant that every dollar of new retained earnings was worth $5.70 in market cap gain. At the other end of the scale, NS share price barely budged in 2007, from $50.29 on Jan 1 to $50.85 by New Year's Eve. There was a 4% decrease in diluted shares so the market cap actually *decreased* 3%. Retained earnings were essentially unchanged with a delta of minus $3 mm, hardly a rounding error on the $8.3 bn base. However, what this tells us is that market cap actually decreased $209 for every dollar decrease in retained earnings.

Check out the table following the disclaimer and let me know what you think. I know it's kind of off the usual merch-carloads-for-short-lines theme however the clever short line owner can use this kind of financial information to good advantage. As a rule, a stock's price is a function of the direction of the industry it is in and investors' perception of the company's earnings power. Both NS and UP are in an industry that has been traditionally viewed as cyclical however with more revenue coming from non-cyclical commodities like steam coal and grain, that's less and less the case. Both UP and NS generated about 80% of 2007 revenues in merch carloads and coal yet operating income was up 17% at UP whereas NS ops income rose just a point. Below the line net income dollars at UP gained $249 mm to NS' negative 17 mm.

Since this year's retained earning is essentially last year's plus net income, the greater the yoy gain in net the greater the effect on retained earnings; the better the earnings story the better the investor perception of earnings power. Now recall that the biggest driver of earnings is revenue and go back to the top line where it all begins. UP total revs increased 5% yoy to NS' no change. UP ops expense was up 1.7% to NS' no change. But UP ops income was up 17% to NS' one percent. That's what drives investors' perception of earnings power and it is worth 50% of the stock price delta over time.

The way for short lines to capitalize on this knowledge is to focus business development efforts on high-yield commodity OD pairs. That's doesn't necessarily mean high margin carloads, it means that at the end of the year whatever moved in that lane generated decent revenues at low unit cost. A few carloads of plastics may look good on paper, but whole trainloads of aggregates properly run with good asset utilization can bring home a nice piece of change. I'd also like to see short lines developing intermodal business where carload economics do not work. A handling fee for a container load of paper is worth more than a handling fee for a boxcar that won't move.

At the end of the day, it's all about owner value -- making sure that each dollar of net income is worth more than a dollar or market cap change. Isn't it time you looked at *your* connecting class I's balance sheet and income statement, the better to find the strategic fits? Any questions, see me.

By all accounts, the recently concluded ASLRRA Annual Meeting in San Antonio was the best ever. I was unable to make it due to other commitments however, feedback from those who did go was all quite positive. Tony Hatch writes, "What a show! I had figured that while the sector remains a hotbed of rail entrepreneurialism, with only one publicly traded carrier of size (GWR) and significantly less private equity (PE) hype in the marketplace, I expected a calm, relaxed time with little to learn with broader rail implications. I was wrong.

"The all-time record for any American rail convention of any kind of 1500+ attendee was up about 20% from last year's convention, which came in the middle of the Rail America, FEC, DM&E hoopla, and is yet another sign of the railroad renaissance. STB Commissioner Frank Mulvey was the keynoter, and gave a solid rundown on the STB's busy plate – I took note of the change from looking at the definition of contract vs. tariff to looking at disclosure. On the very day of the AAR's filing on replacement costs, Mulvey disclosed some sympathy "as an economist" with the position [of replacement cost] versus book (CoC) returns. I do, however, remain somewhat concerned about the STB-sponsored Christensen Associates study on 'rail competition' – which Mulvey said could form the basis for other Board actions or even legislation.

"Norfolk Southern announced (perhaps a bit earlier than they might have wanted) a fascinating new freight "Corridor": the Empire State Initiative, where they will work with shortlines to make a solid run at traffic moving at very short hauls (less than 500mi, often well less). In the pilot program in New York NS is looking to add perhaps 30K carloads of profitable business, so it's a small start but like Heartland and Crescent, one with big potential system (and eventually) network) wide.

"During the annual marketing summit all of the major rails were represented, mostly by their Chief Marketing Officers, who noted how well price and franchise diversity were working in their favor, and the other notable difference between the old rail model and today's. Whereas the old rail would hunker down in a recession and cut capex, the new rails don't do that (see industry's flat capex YOY for '08 in the face of a recession).

"There were some clouds, however. Though most of the [Associate Member] suppliers were reporting excellent business, some of those depending on dwindling state [rehab] funds (especially, I note, in Florida, perhaps key to their disappointing CSX decision) were struggling a bit. And for the first time I heard some – just some – carriers use the number 2010 in talking about full economic recovery. Oh, and two major rail fleets were for sale, which was a bit of a jolt to the conventioneers. The rails will do fine in the meantime, and there is hope that the new '08 model autos and the stimulus and the return of a peak season and the easy comparisons would all add up to recovery sometime sooner than that." Thanks, Tony.

Morgan Stanley's Bill Greene writes, "US grain volume and yield growth should slow in 2H/08 and 2009. Surging grain volumes and pricing, along with coal, have helped boost rail revenue at a time when general carload volumes are struggling. If the USDA forecasts prove correct, overall grain volumes are unlikely to continue growing at their rapid pace, but should still be up.

"The USDA issued its initial forecast for the 2008/09 crop year and, while the crop is expected to be large in historical terms, production growth should be flat overall due tough comparisons and a 7% decrease in corn production. On the positive side, wheat production (which faces less barge competition) should increase 16%, and soybean production is forecast to grow 20%.

"On the other hand, it's hard to be optimistic about grain yields in 2H/08 with high -margin export moves expected to fall." UP and BNSF and surely CP and CN have the greatest exposure, with CP perhaps the most. In the lower 48, Greene sees BNSF "most at risk given its large (and very profitable) export wheat franchise. Canadian wheat production (+25%) and exports (+17%) should be stronger, which helps support our view that CN volumes could surprise in 2H08 and 2009." He cites increased global supply as a reason for a drop in export demand with "wheat, corn and soybean exports are forecast to fall 24%, 16%, and 4%, respectively."

Greene concludes, "The latest crop forecast won't have much effect until 2H/08 and 1H/09 when railroads lap tougher comparisons. Until then, grain volumes and rates should remain strong. Keep in mind that the final numbers can vary drastically from the initial forecasts, particularly export demand, given weather and changes in global supply and demand. For 2007/08, the final US production numbers changed 5-6% by commodity vs. the initial forecast while export numbers were off by as much as 30%. We'd also note that our commodity team feels the USDA forecast for ethanol use may be high, and poor crop conditions may lead to lower wheat yields."

Handling lines (short lines that are paid flat per-car fees) may get hurt worse than ISS roads that at least can share in the recent rate increases. The light-density lines stretching hundreds of miles across Nebraska and Kansas will take significant hits. At least two lines out there have changed hands in the not too distant past and one must wonder who's next.

GWR revenue units for April 2008 increased 2.3% yoy ex-Mexico. Minerals and stone, farm and food and coal were the double-digit winners thanks largely to the Australian ops. Pulp and paper was actually up 8% though lumber continued its swoon, down 17%. Intermodal, though only two- tenths of one percent of the total, is mainly paper out of Maine, off a third yoy. However, the numbers GWR presents are, unlike the rest of the industry, actual platforms, not containers. Therefore, last year's 180 units might be only 180 trailers one to a platform and this year's 125 units could be 250 containers double-stacked on 125 platforms. I'm sure the good folks at Maine DOT would like to know.

GWR's press releases are, thankfully, detailed and give good color as to what's behind the numbers. The Maryland Midland Railway, which GWR started operating January 1, 2008, picked up another 1400 loads and the M&B gained 3100 loads. Same railroad biz was up 3200 loads (5%), mostly coal, coke and ores. Oregon lost 1400 STCC 24 and 26 loads. Farm & Food was up 1400 units in Australia. Through April GWR loads are off 6%, indicating the acquisitions are offsets to losses elsewhere.

Canadian Pacific held its "Connections 2008" short line conference in Minneapolis this week. There were nearly 100 short liners representing most of CP's 70 US and 30 Canadian class II and II connections as well as about 40 CP staffers including its COO, Kathryn McQuade. There was more material than I can give justice to this week haven just gotten back from it late Friday. However Scott Sutherland, GM for Product Design and Interline Services (and our host for the proceedings) is sending me the presentation PDFs which I will delve into next week.

For the nonce, suffice to say the theme was one of innovation, customer supply chain management, and what CP and short lines can do to get everybody on the same page. There was a minimum of presenting from the 30,000-foot level and a strong focus on diversity, disciplined yield management, sorting out the strong accounts from the chaff, and making markets at the tactical level.

The stakes are high. CP short lines touched some 273,000 revenue units worth C$630 mm, with 88% of that in the critical forest products, gain and industrial products commodity groups. I was especially delighted to see the customer behavior theme that has arisen on recent earnings calls alive and well here. Not only from the CP presentations but also from the pair of short line briefings – Larry Wood of the Dakota, Missouri Valley & Western; Mario Brault of GWR's Canada Group. It's a story worth repeating, so watch this space in WIR for May 23.

Norfolk Southern and Pan Am Rail have agreed to create the "Patriot Corridor," essentially a Yankee Meridian Speedway, between Mechanicville NY and Ayer Mass. The vehicle is a joint venture that establishes a new railroad company to be called "Pan Am Southern" with NS and PAR each taking a 50% interest. The similarity with the Meridian Speedway JV comes from PAR contributing the railroad (as did KCS in the Speedway) and NS putting up $140 mm in cash and other assets (as it did with KCS).

Of this amount, NS will, over three years, put up nearly $90 mm for track and signal upgrades plus yard improvements and a new intermodal terminal on the west end. PAR contributes the 155-mile ex-B&M main west of Ayer plus 281 miles of ex-NH and ex-B&M secondary and branch lines in Conn, Mass, NH, NY and VT (didn't the VTR-PAR Hoosick Connection timing work out nicely). Investments in the Patriot Corridor are expected to improve track quality and customer service, boost train speed and reliability, and increase capacity on the route.

Naturally, the STB will have to bless the arrangement, though on the surface of it I don't think there will be any trouble here. The parties seem to be contributing approximately equally and PAR will get to run its railroad pretty much as it always has. Recall the STB objections to the NS-Watco deal in Mich dealt mainly with what each party was putting up and the amount of Control NS would retain in the joint venture.

Recall also that Conn DOT has asked why it too could not be part of the nascent NS Crescent Corridor (WIR 5/9/2008). Getting from Springfield to New Haven may require some horse-trading between and among PAR, NS, RailAmerica's CSO and Amtrak, but it's certainly doable. A nice carrot would be putting the Vermonter back on the River Line between Springfield and East Northfield. Moreover, this may afford RailAmerica to link up its CSO and NECR, avoiding the CSX jog between Palmer and Springfield. Keep a close eye on the NS website for further details.

Summer hasn't even begun and already we're making plans for the fall. Once again, September is RailTrends month in NYC, and this year it'll be at the newly refurbished Affinity Manhattan on Seventh Ave across from Penn Sta and a few blocks from some of the best undiscovered restaurants in NY. The theme this year is "Financing Capacity and Growth in the Railway Industry," certainly appropriate given the level of interest in railroad capacity to meet shippers' increasingly sophisticated supply chain requirements. Last year everybody who was anybody was there and the rooms were packed. The show opens Sep 30 and runs through Oct 1, to my mind one of the pleasantest times of the year to be in NYC. More anon.

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Financial Measures	BNSF	CN	CP	CSX	NS	UP	KSU	GWR
Retained Earnings	$ 11,152	$ 5,925	$ 3,083	$ 8,565	$ 8,280	$ 12,667	$ 1,169	$ 407
YOY Change	$ 1,413	$ 516	$ 9	$ 1,138	$ (3)	$ 1,452	$ 118	$ 55
Mkt Cap	$ 29,871	$ 23,840	$ 10,058	$ 19,715	$ 20,228	$ 33,716	$ 3,351	$ 1,027
YOY Change	$ 2,576	$ 850	$ 1,680	$ 3,673	$ (627)	$ 8,926	$ 674	$ 11
MC/RE	$ 1.82	$ 1.65	$ 186.63	$ 3.23	$ (209.04)	$ 6.15	$ 5.71	$ 0.19

Source: Company financials

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