THE RAILROAD WEEK IN REVIEW
OCTOBER 24, 2008

"A man I do not trust could not get money from me on all the bonds in Christendom." – J.P. Morgan

***New Yorker* financial columnist** James Surowiecki writes, "In December 1912 J. P. Morgan testified before Congress in the so-called Money Trust hearings. Morgan's point is that systems of credit depend on trust. When trust is present, money flows smoothly from lenders to borrowers... When it's absent, we find ourselves in a world where lenders hoard capital, borrowers are left empty-handed and the economy's gears grind to a halt." (*The New Yorker*, October 20, 2008, page 36)

The *Wall Street Journal* for the same day noted that "Entrepreneurs feel the squeeze as venture capital gets scarce." Though the story was clearly aimed at small start-up enterprises, the shoe fits amazingly well on highly-leveraged short lines with limited working capital. Now add the context of increased federal safety legislation clearly aimed at the Big Roads but which hit the Class Is and IIs simply because they're railroads. The FRA's Grady Cothen told those gathered at last week's Eastern Region ASLRRA meeting, "We feel your pain," but left little hope of Congress doing anything about the situation.

Which started me to thinking, when does the cost of running a smallish short line become too dear? Is there a point where even the staunchest, most talented and dedicated small railroad entrepreneur decides to leave the field? The irony of it all is we have states trying to fund track rehab grants and the federal tax credit program reinvigorated at the same time small businesses are threatened with higher income taxes and the indirect taxes of greater FRA regulation. Could it be that once again the way to make a small fortune in the shortline business is to start with a large one?

On the other hand, "heat and eat" continues to work on the Class Is as coal and agriculture loadings grow along with domestic intermodal while the broader "merchandise carload" category is sucked deeper into the doldrums. The papers are full of stories about marginal trucking companies shutting down or going Chapter 11. Can certain small Class IIIs with slim margins be next?

Short line car-loadings as measured by RMI's RailConnect Index show accelerating negative deltas in just the last three weeks. Year-to-date forest products (both STCC 24 and 26), aggregates and intermodal (see my recent caveat about this line) are the major decliners. Weekly car-counts are trending down in grain (perhaps a function of prices and farmers waiting for a rebound), scrap (a west coast short line participating in the scrap-to-China market says scrap steel prices are way down) and chemicals (an eastern short line owner says plastics for auto parts are taking a haircut).

As for the Class Is' third quarter results, four of the five Class Is reporting to date have posted single digit declines in total revenue units (CN was up a point) while reporting smallish gains in revenue-ton-miles (again, CN excepted on a two-point dip). In other words, the Class Is are hauling more tons in fewer cars, which is not good for the myriad short lines that depend on the single-carload segment. Adding to that misery, quarterly merchandise carloads were off from two to six percent across all five Class Is reporting to date.

UBS Rail Analyst Rick Paterson writes, "We think the pullback due to the credit crisis and accelerating EPS growth on falling fuel prices is creating a compelling opportunity and we have six of the seven rail stocks rated Buy. While cheap stocks are hardly unique in the current market, the dichotomy between accelerating EPS growth and falling valuation is becoming extreme and we think a rally is a question of 'when', not 'if.' In terms of exactly when, it's anybody's guess. There's still a perception (wrong in our view) that the rails are a derivative of the unwinding commodities trade."

To which William Greene of Morgan Stanley adds, "After the past month's sell-off, rails are trading at recessionary multiples and offer compelling long-term upside potential, in our view. Investors should take comfort in the rails' ability to continue raising rates and driving productivity. We expect to see strong pricing performance from all of the rails this quarter."

And that's exactly what's going on. I've sequenced these Class I reports in order of this week's calls. Reviewing the presentations and listening to the conference calls for the nuances (did they "mail it in" or was there passion in the presentation?) is highly recommended. Onward.

Canadian National kicked off Earnings Week delivering what JP Morgan's Tom Wadewitz called "meaningful upside 3Q results driven by stronger than forecast yield growth and solid cost control." Tom continues, "For the first time in many quarters CN did not need to fight the headwind from a year-over-year increase in the Canadian dollar. Without the foreign exchange headwind, CN's reported year-over-year yield growth of ten-point-two percent was much more robust. Core pricing remained very solid in the four to five percent range."

Total revenue increased 12% of which about two-thirds came from higher fuel recover thanks in part to lower fuel costs in the quarter and the lag between fuel cost and fuel surcharge collections (This was a recurring theme among all class Is and something allowance-based short lines ought to watch very carefully). Five of seven commodity groups increased revenue led by metals/minerals (29%), coal (41%, though on a very small base) and intermodal (24%). Operating expenses including fuel gained 13% and operating income was up but 10% as the OR actually added 60 basis points to 62.6.

Revenue units grew a meager one percent, mostly on coal and intermodal while merchandise carloads dropped four percent. Pricing gains pushed system revenue per revenue unit up ten percent; the average merchandise carload garnered a similar increase. Net income rose 14% to $C552 mm and earnings-per share went up 21% thanks to CN's aggressive (one billion dollars Canadian this quarter) share buy-back program that shrank the diluted share count by five percent.

Norfolk Southern was next up, presenting a strong quarter in which Norfolk finally got an OR beginning with a six. It's not hard to see how they did it. Freight revenues increased 23% on essentially unchanged revenue-unit count (off aught-point-seven percent) and a 2.4% gain in revenue-ton miles. The caveat to short lines is merchandise carloads slid more than five percent as both forest products STCCs and chemicals came down even though agricultural products including ethanol and DDGs partly offset.

Once again NS proved that running a faster, safer railroad costs less, holding the total operating expense gain to less than 20% (less fuel it was ten percent), leveraging ops income up by nearly a third. Net income grew by 35% to $520 million; eps gained 41% to a buck-thirty-seven and the operating ratio came down two points, marking the first quarter to break seventy.

Asked about the sustainability of pricing gains in the face of shrinking volumes, CEO Wick Moorman said (a) domestic intermodal continues to grow as major trucking companies put their boxes on flat cars to owner expense and (b) beneficial owners adapt supply chains to rail to save freight expense without harming supply chains (Ed Wolfe's "Friday Freight" says rail intermodal rates tend to be between 10%-30% cheaper than truckload on comparable lanes longer than 700 miles and buyers are capitalizing on that.) And – contrary to what others have told me -- Moorman says the WTI price of oil has little to do with modal selection going forward. Once the economies of intermodal are worked into inventory management, there's no going back.

Thursday brought a double-header with Union Pacific in the morning and BNSF after the market closed. UP first. Freight revenues went up by more than 16% on gains of more than 25% in coal and ag ("heat and eat," again) supported by double-digit revenue gains in chemicals and industrial products. Merchandise carload revenues overall increased 14% and intermodal came in at plus nine percent. The bad news is that revenue units dropped five percent system-wide with only coal and ag remaining in the positive column, up three and five percent respectively. But even then revenue-ton-miles stayed positive, but just barely at one percent.

Operating expense, alas, was up 14%, two points behind the revenue gain, allowing a 20% ops income gain but the OR remains stubbornly in the mid 70s, along with BNSF and CSX. Still, ops expense before fuel was up just 4% and UP has done much to conserve fuel. The burn dropped 10% even as gross-ton-miles dropped not quite three percent. Below the line, net income was up 32% to $703 million and eps went up 38% on four percent fewer shares outstanding.

Morgan Stanley's William Green nailed it in his note: "UP's impressive third quarter surpassed our bullish expectations. Management is comfortable with 35-45% EPS growth in 4Q08 on a five percent carload decline. Seventy percent of rail pricing is locked-in for 2009, virtually eliminating any chance of material price erosion next year. With such strong fundamentals, Union Pacific is no longer a deep cyclical. We think patient investors will be rewarded for owning UP here and we would buy the stock now." (Somebody must be listening. UP gapped down to $53 at Friday's open and closed the day just north of $58.)

BNSF batted cleanup for the week, bringing in a 21% quarterly revenue gain with double-digit hikes across all commodity groups except auto with its paltry plus six percent. Total revenue units declined only a point and a half; auto was the biggest loser (down 18%) while none of the other commodity groups was off more than four percent. As at the other Class Is, revenue-ton-miles showed a slight gain as bigger, faster trains with bigger, heavier cars meant moving more tonnage with a smaller number of revenue units.

Unfortunately, the operating expense increase matched the revenue increase – 21% -- so the operating ratio remained stuck at 75.4 – not a bad number in days past but when its peers Norfolk Southern and Canadian National are in the sixties and look like they'll stay there, BNSF has some work to do. Even without the 59% hike in fuel expense, ops expense was up eight percent. Below the line, net income grew 31% and eps went up 35% as share-count dropped three percent.

Let me turn once again to Tom Wadewitz to sum up the picture at BNSF. He writes, "Earnings growth at BNSF clearly was not very sensitive to volumes. With roughly 65% of their contract pricing already in place for 2009, we believe that BNSF has good visibility to 2009 pricing; it's likely to follow a pace similar to the six percent level that BNSF has realized over the past several years. While portions of the BNSF book of business are economically sensitive, large exposure to the coal and agriculture segments should provide stability even amid a sustained soft economy."

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