THE RAILROAD WEEK IN REVIEW
OCTOBER 31, 2008

"Presidential elections in bear markets invariably foreshadow further declines." -- Barron's, October 27, 2008

The signs are everywhere that people are still spending like there's no tomorrow. The October 18 Providence & Worcester excursion sold out 275 seats at nearly $100 a head. The Eastern Region ASLRRA meeting sold out its 200-room block at the Williamsburg Lodge for $160 a night plus tax for two nights -- make it $1,000 a person for room, registration and transportation just for showing up. The Philadelphia Zoo was mobbed with moppets on Sunday for the annual Halloween celebration on Sunday -- $20 a head just to get through the gate-- and there were lots of very creative costumes on kids and grownups that did not come cheap.

But surely the piper must be paid. The jobless rate is now north of six percent and still going. Credit card issuers like American Express warn of further pullbacks in consumer spending. Highly-leveraged companies have been among the worst performers in the Dow of late and making matters worse bank loans to those companies are not helping the bankers' solvency.

So even though the class Is reported solid third-quarter earnings, it was mostly on domestic intermodal, agriculture (ethanol included) and energy-related commodity groups. The single-carload sector lags and with it the shortline group. (You can see it in the attached Week 41 RailConnect Index -- in making my calls around the industry I find the "heat and eat" gang doing quite well, thank you, while the single-carload guys are suffering.)

A friend well-wired with the corporate credit side of investing and who knows the shortline business first-hand writes, "I assume there will be some abandonments or perhaps curtailments as operators run out of cash and credit. The question for many of these roads is who goes first: the customers or the operators. With state budgets constrained, things will only get tougher. Even if everyone stays in business, track and plant infrastructure is going to suffer.

"This is the beginning of the death spiral we have expected for a while. Some of the majors may need to take back leased-out segments. When you get to know the smaller short line operators it becomes obvious they are not living high and handsome. There isn't a lot more to cut. Last guy out please align and lock the switches and cover the stacks." That said, the level of shortline attendance at the annual ASLRRA meeting in Vegas come April will be telling.

Canadian Pacific rounded out the Big Six third-quarter earnings season Tuesday reporting revenues up by seven percent (all year-over-year changes are foreign-exchange adjusted) to C$1.3 billion thanks in part to a double-digit gain in the Industrial and Consumer Products group (including among others chemicals, aggregates, metals/minerals and non-coal energy-related commodities such as we see supporting the Alberta oil sands development activity). During the call Marketing SVP Marcella Szel noted that the energy-related commodities had done particularly well, though metals shipments may be down slightly in the fourth quarter.

Aggressive market-based pricing propelled revenue-per-unit upwards by eleven percent including fuel surcharges. Responding to a question after the prepared remarks, Szel confirmed that prices excluding fuel surcharges will continue their six-percent run rate in the fourth quarter. Thus if sales increased seven percent in the quarter, some C$76 million, one-seventh or C$10 million went to the fuel surcharge column. Revenue units declined across the board except for industrial and consumer

products, up eight percent.

Operating expense rose seven percent with fuel the big hammer (ex-fuel, ops expense was up one percent). Operating income dropped six percent and the operating ratio deteriorated to 76.0, down 310 basis points. But CP has to get credit for taking out cost by running a sharper railroad. Even though fuel expense increased by nearly half and price-per-gallon leapt 59 percent, fuel burn decreased seven percent as gross-ton-miles dropped only four percent; gross-ton-miles per gallon increased three percent.

Below the line net income dropped 21% to C$173 million from C$219 million and eps fell to C$1.11 from C$1.41 a year ago. To be sure, that looks pretty grim on the surface. However, if you back out the effects of foreign exchange net income was off only four percent and eps came down two percent. Earnings before taxes and interest was actually up a percent which tells me that -- all considered -- the Green Team isn't doing too bad.

As for the DM&E, equity income net of tax was C$17 million against zippo last year and by this time next year revenue and expense will be bundled with CP's numbers. During the Q&A Fred Green allowed as how DM&E had outperformed in its expected earning-per-share contribution, has not lost any demand momentum and that the "conservative values" going in are paying off, especially in ethanol. He looks for double-digit operating income and ebitda growth and "has "no apprehensions" going forward.

Kansas City Southern stock performance Wednesday exemplifies "buy on the rumor, sell on the news perfectly." The rumor (Street estimate) was sixty cents a share for the quarter; KCS had the noive to report fifty-two cents (the news) so immediately KCS gapped down three to around twenty-three smackers per ticket.

As it turns out, the lower number is a GAAP number that includes a seven-cent charge for the hurricane-related revenue loss and expense increase plus another nickel for foreign exchange. Absent these two the core railroad delivered sixty-four cents a share, a respectable 33 percent increase year-over-year. Happily, KCS rode Tuesday's hockey-stick Dow gain to close essentially unchanged on the day.

Listening to the call, I was struck by all the presenters' upbeat tone of voice. CEO Michael Haverty almost shrugged off the Street's "miss" in his opening remarks, noting how quickly KCS recovered from the two hurricanes even as "customers' difficulties lagged" the KCS recovery. Chief Operating Office Dave Starling pointed out the half-point OR reduction even with a 35 percent fuel expense increase (though fuel burn was down six percent). More to the point, sequential OR improvement has taken this metric from 84.2 in the first quarter of 2006 to today's 77.4 -- roughly seven points in nine quarters.

Every commodity group but automotive posted double-digit revenue gains with fuel surcharge assessments contributing about sixty cents of every dollar (about in line with what we're seeing elsewhere). Total revenue units drifted south nine-tenths of a percentage point however system revenue-per-unit gained eleven percent.

Operating income increased thirteen percent to $111 million, however below the line it gets very noisy. In addition to the usual entries for other income, taxes and interest, there are credits and debits for equity earnings, debt retirement, minority interests, foreign exchange and preferred dividends. In short, these items mask what KCS is capable of doing and working back to the core railroad performance is a challenge, to say the least.

Take fuel, for example. The Mexican government subsidizes fuel expense to the extent that calculated price-per-gallon is about a buck lower than the other class Is are reporting. And during the call EVP Sales & Marketing Pat Ottensmeyer said that the revenue and expense lines would look a lot different were it not for this spread. [I've been working with my buddies at USRaildesktop.com to split out Mexico and the US fuel use and expense using KCS' own numbers plus STB fuel data. After sanity-checking my findings with KCS I'll be back with the details.]

All in, double-digit revenue gains and small single-digit volume losses everywhere but auto, the accelerating rate of integration of the US and Mexican operations plus the process improvements in the operating department give eloquent testimony to this team's vision. Once we're out of these economic doldrums it ought to be off to the races for KCS.

Credit Suisse has just rolled out a new "Framework for Transport Investing" and it was introduced in a webcast by Research Analyst Chris Ceraso this month. The webcast highlights some of the key metrics they've developed and is worth a look. (If you're interested I can e-mail it to you.) The study covers rail, truckload, LTL, airfreight and logistics providers, however here we will focus on the rails -- no surprises there.

The "toolkit" looks at relative stock price performance during recessions, recoveries, freight expansions and contractions plus secular trends, leverage and valuation of the various names.
The freight cycle model calls for year-over-year declines in freight volumes for the next five quarters, making it six in a row if you count third quarter 2008. Key variables in the model are business and residential fixed investment, personal consumption, industrial production, real export of goods and real interest rates. The conclusion is freight tonnage will be down around three percent through the end of 2009. Through this week Ceraso reports further service and volume deterioration, a worrying trend since ag gains have helped mask losses in other carload groups.

One of the most striking bits of thinking in this Framework concerns railroad pricing. The thesis is that traffic density (measured in ton-miles per route-mile) has decreased the available route-miles for new freight. This measure has tripled since 1980 however C-S predicts a reversal starting in the first quarter of 2009 as shrinking volumes lessen the pressure on available track space for the ton-miles.

To put this in perspective, second quarter 2008 (I don't have good third-quarter 2008 data yet) ton-miles per route-mile ranged from 8.7 million gross-ton-miles per route-mile at BNSF down to 4.3 million per mile at Canadian National. I am hearing of instances where shippers are getting some reductions in the ask prices for certain moves as capacity frees up, further supporting the Credit-Suisse thesis that decreases in density make for less pricing leverage. The question now becomes one of whether moves that certain roads were driving away last summer for lack of equipment and track-space will suddenly become attractive once again. It also begs the question of how willing shippers will be to tossed back and forth.

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RailConnect Index of Short Line Traffic

Traffic Type: All

For the week ending: 10/11/2008

Week Number: 41

Carloads Handled	Current Week			Year-To-Date		
	2008	2007	% Change	2008	2007	% Change
Coal	16,968	15,819	7.26%	629,083	613,072	2.61%
Grain	14,640	15,538	-5.78%	606,506	581,563	4.29%
Farm & Food (Exc. Grain)	5,468	5,048	8.32%	216,901	203,242	6.72%
Ores	2,361	2,975	-20.64%	124,966	109,395	14.23%
Stone, Clay, Aggregates	12,398	13,115	-5.47%	462,744	469,708	-1.48%
Lumber & Forest products	5,256	5,496	-4.37%	209,660	250,006	-16.14%
Paper products	7,407	7,584	-2.33%	317,224	342,170	-7.29%
Waste & Scrap materials	5,649	6,596	-14.36%	273,743	259,039	5.68%
Chemicals	17,000	16,734	1.59%	703,977	689,929	2.04%
Petroleum & Coke	5,661	5,733	-1.26%	242,837	229,285	5.91%
Metals & Products	9,547	10,340	-7.67%	487,179	451,410	7.92%
Motor vehicles & equip.	1,966	2,272	-13.47%	80,624	79,705	1.15%
Intermodal	11,905	14,524	-18.03%	516,346	608,884	-15.20%
All Other	2,901	3,041	-4.60%	126,385	129,006	-2.03%
Total	**119,127**	**124,815**	**-4.56%**	**4,998,175**	**5,016,414**	**-0.36%**