Rail Renaissance: Capital & Capacity

Anthony B. Hatch – abh consulting
155 W68th Street NYC 10023 (212) 595-0457
ABH18@mindspring.com::

US Chamber of Commerce
Western/Northwestern Regional
San Francisco
November 8, 2007
Railroads at historic tipping point

- Capacity issues across all modes
- Volume increasing – *right?*
- Share increasing
- Rates increasing
- Services levels (yes) increasing
- Returns increasing
- **But pushback (shipper/regulator/union) also increasing!**
- A *secular*, not a cyclical story – *right?*
- Capacity and infrastructure – and competitor - issues remain
- *Fully reflected in the market? Or is this just another cyclical slowdown?*
Railroad Performance

Class I Railroads

Index 1981 = 100

Productivity
Volume
Revenue
Price

Source: Railroad Facts, AAR
Street influence on RRs – and Why that affects ALL stakeholders

- Battle for cash
- Management’s reactions to pressures
- Investors, competitors, regulators, politicians, labor – oh, yes, and customers
- Short term decisions/long term consequences
- Which “bucket” will they place their chips?
Show Me the Money

- Share Price is *the* Indicator – over time!
- Cash (Flow) is King
- High ROIC = High Stock Price
- And Vice Versa
- Key is the phrase “through a cycle”
- Old Model: Disinvestment
- New Model: TBD (But CP gives us a clue)
Spending $: Mgmt.’s #1 Decision

- Capex for Maintenance – “base”
- Capex for Capacity, Service & Growth
- Dividends
- Share Buybacks
- M&A – Strategic
- M&A – Non-strategic (conglomeracy)

How management allocates indicates confidence & direction and impacts all stakeholders
Virtuous Circle 2004-06 –and beyond?

- Better returns (half *finally* earn returns equal to the cost of capital)
- Better stock prices
- Better revenue prospects – up double digit ’04-06
- Equals more investment – capex up sharply
- Equals more capacity, better service
- …equals better returns and growth….
Sources of capital

- FCF – booming at most carriers (capex vs. ROIC)
- Governments – states, PAs, Feds
- Governments – Canada as contrast
- Traditional Street sources & Banks
- Institutional investors
- Hedge funds
- Private Equity/Infrastructure Funds (still?)
New Sources of Capital – Threat or Opportunity?

- Fortress-RailAmerica/FEC (etc)
- Infrastructure Funds (Toll Roads)
- Hedge Funds & “Activists” (TCI)
- Share repos – UNP, BNSF, etc - especially CSX
- C-1 Buyouts (DM&E)
Threats to the Renaissance

- Cyclical vs. secular argument
- New Congress – impacting labor & shippers
- Rereg – the MAD answer
- Execution: service
- Execution: merger
- Hedge funds (BNSF, UP & especially CSX example)
- Liquidity?
Railroad Stock Prices
January 2001 – Mid-Year 2007

Index Jan 2001 = 100

Sources: MSN and CSI, Inc.
S&P 500 and Railroads
Monthly Data January 1980 – April 2007

Index Jan. 1980 = 100

Sources: MSN and CSI, Inc.
Even With Booming Traffic, Rail Earnings Are Substandard
Median Return on Equity in 2005 (S&P 500 companies)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Return on Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil &amp; Gas</td>
<td>28.4%</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>24.9%</td>
</tr>
<tr>
<td>Chemicals</td>
<td>18.7%</td>
</tr>
<tr>
<td>Autos &amp; Parts</td>
<td>16.9%</td>
</tr>
<tr>
<td>All Industries</td>
<td>16.1%</td>
</tr>
<tr>
<td>Railroads*</td>
<td>12.3%</td>
</tr>
<tr>
<td>Electric Utilities</td>
<td>11.3%</td>
</tr>
<tr>
<td>Forest Products</td>
<td>10.3%</td>
</tr>
</tbody>
</table>

*BNSF, CSX, NS, and UP
Source: Business Week
Yet Rail Earnings Are Still Below Average

### Fortune 500 Return on Equity: Selected Industries, 2006

<table>
<thead>
<tr>
<th>Industry</th>
<th>ROE %</th>
<th>Industry</th>
<th>ROE %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil &amp; Gas Equip., Services</td>
<td>31.8%</td>
<td>Fortune 500 Median</td>
<td>15.4%</td>
</tr>
<tr>
<td>Petroleum Refining</td>
<td>30.7%</td>
<td>Food &amp; Drug Stores</td>
<td>15.4%</td>
</tr>
<tr>
<td>Metals</td>
<td>30.3%</td>
<td><strong>Railroads</strong></td>
<td><strong>15.0%</strong></td>
</tr>
<tr>
<td>Household &amp; Personal Prod.</td>
<td>24.6%</td>
<td>Energy</td>
<td>14.9%</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>24.2%</td>
<td>Food &amp; Grocery Wholesalers</td>
<td>14.8%</td>
</tr>
<tr>
<td>Industrial &amp; Farm Equip.</td>
<td>22.6%</td>
<td>Engineering, Construction</td>
<td>13.8%</td>
</tr>
<tr>
<td>Mining, Crude-Oil Prod.</td>
<td>21.8%</td>
<td>Motor Vehicles &amp; Parts</td>
<td>12.6%</td>
</tr>
<tr>
<td>Aerospace and Defense</td>
<td>21.5%</td>
<td>Pipelines</td>
<td>12.6%</td>
</tr>
<tr>
<td>Chemicals</td>
<td>20.9%</td>
<td>Utilities: Gas &amp; Electric</td>
<td>10.6%</td>
</tr>
<tr>
<td>Food Consumer Products</td>
<td>20.5%</td>
<td>Packaging, Containers</td>
<td>9.6%</td>
</tr>
<tr>
<td>Computers, Office Equip.</td>
<td>18.5%</td>
<td>Telecommunications</td>
<td>6.4%</td>
</tr>
<tr>
<td>Beverages</td>
<td>18.0%</td>
<td>Food Production</td>
<td>-3.1%</td>
</tr>
</tbody>
</table>

Source: *Fortune* (April 30, 2007)
RR CoC vs. ROIC - stocks have done well but... they still trade at a discount to all stocks

Source: Surface Transportation Board
Railroads and the Economy

Class I Railroads

Index 1980 = 100

Sources: Federal Reserve System and AAR
Railroads and the Economy

Class I Railroads

Index 1980 = 100

Sources: Federal Reserve System and AAR
Railroads and the Economy

U.S. Railroads

Index 1980 = 100

- Industrial Production
- Rail Intermodal

Sources: Federal Reserve System and AAR
Serious U.S. Transportation and Congestion Problems

- High Cost of Highway Maintenance and Construction
- Interdependence of Modes
- $67 billion per Year Drag on Economy
- Demand for Freight Transportation to Double by 2020
- Significant long term trucking issues
"Today, too much of our country is living in the slow lane. All the rewards that once came from transportation — the freedom, opportunity, and independence — are being strangled by gridlock."

-U.S. DOT Secretary Mary Peters
Sound Policy Demands That RR’s Be a Major Part of the Solution

- Cost effectiveness
- Fuel efficiency
- Congestion and highway costs
- Environment
- Safety

“If improvements are not made in the freight-rail system, the nation’s freight transportation system will weaken and shippers, highway users, and communities will pay the social, economic, and environmental costs.”

– AASHTO
An Upward Trend in Rail Traffic

Excludes U.S. operations of Canadian railroads. Source: AAR Weekly Railroad Traffic
Railroad Intermodal Revenue Growth Over 5% - Long Live the New King!

Source: Carload Waybill Statistics (includes non-Class I railroads)
Intermodal Growth Drivers
Domestic *and* International

- Globalization
- Trade
- Railroad Cost Advantages
- Share Recovery From Highway
- Truckload Issues
Future Demand for Freight Transportation Will Continue to Grow

Billions of Tons of Freight Transported in the U.S.

2002

2035p

p – U.S. DOT projection
Intermodal’s Enduring Questions

- Lots of moving parts
- The improved ROIC of RR Intermodal ’03-’06 is the essence of the *Railroad Renaissance*
- Long term volume growth rate of 5-7%
- Long term pricing growth rate 3-4%
- True International drives the train
- Will “True” Domestic join the party?
Truckload Issues

- TL surplus – “perfect (ugh) storm” in the short term
- Driver shortages – permanent?
- Tight capacity – a secular issue
- Q4/Q1 capacity and rates a temporary/cyclical issue (isn’t it??)
- Transload increase to absorb some capacity?
- Stubbornly high fuel prices – growing price gap to intermodal
- Insurance costs
- Traffic congestion
- Net: better switch than fight?
Coal and Ag – Bulk Comeback

- New growth mode?
- Emissions and environmental issues
- Oil prices and coal
- Politics and coal; and grain/reg
- Ethanol
- Exports
- Feed
Tight Capacity on Parts of the Rail Network

Millions of Class I Ton-Miles Per Mile of Road Owned

Source: AAR
What Are Railroads Doing to Increase Capacity?

- New operating plans
- Cooperative alliances
- Working with customers
- Technology
- Massive equipment and infrastructure investment
- Additional employees
Rail Employment is Up for the First Time in Decades

Total Class I Employment: Jan. 2001-Aug. 2007

Source: Surface Transportation Board
Railroad Capital Expenditures
Class I Railroads

Source: Railroad Facts, AAR
Capital Expenditures 2006
Class I Railroads

$6.4 billion for Roadway & Structures and Equipment

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOFC/COFC Terminals</td>
<td>2%</td>
</tr>
<tr>
<td>Public Improvements-Const.</td>
<td>2%</td>
</tr>
<tr>
<td>Computer Systems &amp; WP</td>
<td>2%</td>
</tr>
<tr>
<td>Freight Cars</td>
<td>3%</td>
</tr>
<tr>
<td>Grading</td>
<td>3%</td>
</tr>
<tr>
<td>Bridges, Trestles &amp; Culverts</td>
<td>6%</td>
</tr>
<tr>
<td>Signals and interlockers</td>
<td>8%</td>
</tr>
<tr>
<td>Locos</td>
<td>9%</td>
</tr>
<tr>
<td>Ballast</td>
<td>10%</td>
</tr>
<tr>
<td>Ties</td>
<td>18%</td>
</tr>
<tr>
<td>Rail &amp; Track Material</td>
<td>26%</td>
</tr>
<tr>
<td>All Other</td>
<td>11%</td>
</tr>
</tbody>
</table>

Source: AAR and R-1 annual reports

Excludes new operating leases.
Plan to Spend Record Amount in 2007

Class I RR Capital Commitments
($ Billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital Commitments</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$5.7</td>
</tr>
<tr>
<td>2003</td>
<td>$5.9</td>
</tr>
<tr>
<td>2004</td>
<td>$6.2</td>
</tr>
<tr>
<td>2005</td>
<td>$6.4</td>
</tr>
<tr>
<td>2006</td>
<td>$8.5</td>
</tr>
<tr>
<td>2007e</td>
<td>$9.2</td>
</tr>
</tbody>
</table>

e - AAR estimate   Source: AAR
RRs and Investment

- Is growth affordable? Capex up 10% in ’07?
- One rail cuts, 2 increase capex during ’07
- **What will 2008 look like?** (long term growth v short term weakness)
- Is additional capacity necessary? Desirable?
- Can the intermodal model extend to carload?
- Wall Street’s constrictive role (“fighting the last war”) – is it changing?
- *Is this disconnect between the Renaissance and the Street the opportunity of a lifetime?*
Focus on Primary Rail Corridors
Current Train Volumes Compared to Current Train Capacity

- Below capacity
- Near capacity
- At capacity
- Above capacity
% Growth in Trains Per Day From 2005 to 2035 by Primary Rail Corridor
Future Corridor Volumes Compared to Current Corridor Capacity

2035 without improvements

- **Below capacity**
- **Near capacity**
- **At capacity**
- **Above capacity**

**Future Level of Service**
- E
- A; B; C
- F
- D
Future Train Volumes Compared to Future Train Capacity

2035 with improvements

- Below capacity
- Near capacity
- At capacity
- Above capacity
Class I Railroad Capital Spending vs. Net Income

(Current Dollars)

Source: Association of American Railroads
Tax Incentives to Leverage Capacity Expansion

- 25% tax credit for projects that expand rail capacity
- Expense other infrastructure capital expenditures
- Leverage private investment
Public-Private Partnerships Can Also Help

- Best used for projects whose main purpose is to meet public needs.
- RRs pay for their benefits and public pays for public benefits.

“Relatively small public investments in the nation’s freight railroads can be leveraged into relatively large benefits for the nation’s highway infrastructure, highway users, and freight shippers.” – AASHTO
Q307 as a guideline for ’08?

- Trucking earnings universally poor
- Rails – almost universally solid (rates trumping volumes)
- Autos, housing, debt and consumers trouble
- Are rails in some ways more cyclical?
- Very little visibility into ’08 economy
- Very little visibility into ’08 capex budgets
Railroad Return on Equity
Class I Railroads

n.m. - not meaningful (negative value)  Source: Railroad Facts, AAR
Major Sources of Railroad Revenue
Class I Railroads, 2005 Gross Freight Revenue in billions

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Revenue (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intermodal*</td>
<td>$10.1</td>
</tr>
<tr>
<td>Coal</td>
<td>$9.4</td>
</tr>
<tr>
<td>Chemicals</td>
<td>$5.4</td>
</tr>
<tr>
<td>Transportation equipment</td>
<td>$4.0</td>
</tr>
<tr>
<td>Farm products</td>
<td>$3.6</td>
</tr>
<tr>
<td>Food</td>
<td>$3.3</td>
</tr>
<tr>
<td>Lumber &amp; wood</td>
<td>$2.3</td>
</tr>
<tr>
<td>Pulp &amp; paper</td>
<td>$2.0</td>
</tr>
<tr>
<td>Primary metal products</td>
<td>$1.7</td>
</tr>
<tr>
<td>Stone, clay &amp; glass products</td>
<td>$1.5</td>
</tr>
<tr>
<td>Nonmetallic minerals</td>
<td>$1.3</td>
</tr>
</tbody>
</table>

Source: AAR  *Estimated. Some intermodal revenue is also included in individual commodities.
Railroad Rates - the old story
Class I Railroads, Revenue Per Ton-Mile

Cents

Constant $: Down 54% since 1980

Current $: Down 1% since 1980

Source: Railroad Facts, AAR
Pricing - the new paradigm

- Rates up 3% in ’04 – post-Staggers best
- *Up 11% in ’05 (Secular rate of 2-3%?) – up 4%+ YTD ‘07*
- Fuel surcharges similar to TL
- Yet Price Gap to the highway *widening, even in ’05-’07 YTD*
- Capacity (still) short across all freight modes, despite temporary surpluses
- Rails moving toward tariff and spot markets

Conclusion: **Best Ever Rate Environment**

“The new Golden era” – cost of capital *within sight*; not there yet
Railroad Employee Productivity
Class I Railroads, Ton-Miles Per Freight Service Employee

Source: Railroad Facts, AAR
Rail Service Cycles

- Is the recent improvement in the metrics sustainable? Systemic?
- Is it a product of huge capex injection and IT?
- Or, is it merely a product of lower volumes/less stress on the network...
Rail Regulatory Risk

- CTA reform not a major issue; Canadian shipper/provincial/carrier cooperation at all time levels
- STB reviewing a number of issues, with some expected minor shipper “wins”, as rates improve after years of subsidy
- F/S covers 15-20% of revenues (less than 10% of CP)
- Small shipper, cost of capital, other STB issues under review also to have minimal EPS impact; BUT:
  - Labor a wild card
  - Potential new Revenue Adequacy rules not (at all) linked to reality
  - Haz-Mat/Security an emerging problem
  - AAR best lobby in DC – re-reg chances virtually zero, but too much time will be spent on DEFENSE
- ITC chances reduced
ABH Consulting
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