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The Railroad Week in Review 1/5/2002
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Our good friends at the Surface Transportation Board have under review “an unprecedented number” of new rail line proposals, this in a day when the class 1s aren’t saying much about further shortline sales. Has the irrational exuberance of line rationalizations ended? Anyway, here’s the short form:

BNSF wants to build 7.8 miles to provide alternative rail service to the Union Carbide complex in Seadrift, Texas; CN (IC) proposes to build 3.2 miles in Baton Rouge for alternative service to the Exxon-Mile chemical plant; in partnership with San Jacinto Rail Ltd. BNSF has proposed a new 12.8 mile line to provide alternative rail service to the Bayport chemical complex near Houston.

NS wants to build 4.75 miles to provide alternative service to the Keystone Electrical Generating Station in Shelocata, PA. CSXT has a proposal to build 1.8 miles in Walbridge, OH to connect the former Conrail Stanley Yard Eastern Running Track to a CSX main line; Midwestern Generation has pitched a plan to build a 4,000 foot connection to its facility in Joliet. The Alamo North Texas Railroad proposes a from-scratch 2-mile track to reach limestone quarries.

In Utah, a group of six local government agencies proposes to build 43 miles of railroad between Salina and Levan for local service. Also the Great Salt Lake and Southern Railroad wants to build a 32-mile line in Tooele County, Utah ancillary to the creation (subject to approval by the Nuclear Regulatory Commission) of an interim storage facility for spent nuclear fuel. (Bet the NIMBY’s love that.)

And the Pemiscot County (Missouri) Port Authority plans to construct a 5-mile line to connect with the BNSF line at Hayti, Missouri. And last, but by no means least, there’s the DM&E’s scheme to build some 280 miles of new railroad and rehabilitate 600 miles of its existing line to provide new rail access to the low-sulfur coal reserves in the Powder River Basin.

The STB notes that Congress intended to facilitate rail construction in amending section 10901 of ICCTA by placing the emphasis on whether the project is inconsistent with public convenience and necessity. To give full effect to congressional intent, the Board has stated that rail constructions are to be given the benefit of the doubt, and that there is now a presumption that rail construction projects will be approved. There will of course be an Environmental Review Process as well, so we’re not holding our breaths.

Meanwhile, a promising note was sounded in upstate NY and nearby Penna this week. The recently formed Western New York & Pennsylvania Railroad (WNYP) agreed to acquire the former Erie main between Corry and Meadville in Pennsylvania. The agreement between the Northwest Pennsylvania Rail Authority and WNYP calls for transfer of the line in exchange for \$1 and cancellation of \$1.9 million in debt owed by the Authority to a company that WNYP acquired in 2001.

Reopening the line segment will make it possible to re-establish through freight service between connections with Norfolk Southern at Meadville and Hornell. Resumption of through freight

service between Meadville and Hornell will substantially improve the reliability of rail service to local industry, cut transit times, and improve the railroad's efficiency once the entire railroad is rehabilitated to a 40 MPH track condition. Moreover, the line is the shortest and most direct route between Norfolk Southern's Conway Yard near Pittsburgh and New York's Southern Tier.

In the present environment of shortline combinations and spin-offs, it's important to consider the organizational impacts and options. Tuesday's WSJ notes (Page B-2) that "roll-ups" (small players rolled up in larger players) occur regularly in "highly fragmented" industries. The shoe fits the shortlines well, and there are parallels.

The article suggests all-cash deals are better because if the larger company hits hard times, there go the fortunes of the selling entrepreneurs. Non-compete agreements are to be avoided or be kept as short as possible. After all, the selling business was in business because it was in the blood of its founders. But do you really have to sell? The independent can often compete against the conglomerate simply by remaining quick on its feet, moving into and out of products and service offerings more easily than the larger firm because there's less overhead and inertia.

More important, acquisitions typically require additional debt. Even if the acquirer keeps the price-sales and price-EBITDA multiples under control, a business downturn can do a real number on interest coverage. Used to be free cash flow wanted to remain six times interest, though 3X is now acceptable. The wrap? Seller beware; you may not get what you asked for.

Morgan Stanley's latest "Freight Pulse Survey" pulls no punches when it comes to shipper views of pricing and service, and the rails fair poorly. The good news is that the report addresses specific service price issues the rails could fix if they wanted to. Each of the seven NA class 1s was ranked on five service points. They were overall satisfaction, delivery when expected, cycle time, ease of doing business, and price/value.

CN won in every category. UP and CP both got two second places and BNSF one. Still, half the respondents see no change in rail use and 20% see less rail, up from 10% in the May survey. Two of the biggest reasons cited were lack of predictability and too hard to work with. Regarding intermodal, the report says, "until railroads can make significant improvements to service we do not believe intermodal will be a viable alternative to most shippers." That being said, there are many positive implications for the carload business on both shortlines and class 1s. But they will take a major cultural shift, and we'll get into that in this space next week.

Also this week Morgan Stanley downgraded all the rails to neutral where it had rated several to outperform the broader market. Forward earnings estimates appear already baked into the stock prices, leaving little room on the upside. The average 2002 estimate PE is 16 against a more usual 15 or less. Trouble is, NS and CSX are now so richly priced (19X 2002E) they push up the average while BNSF and CP remain at the low end (13X 2002E).

Roy Blanchard

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