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The Railroad Week in Review 8/9/2002

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AAR carload reports for Week 30 (ending July 27) show merchandise (all but coal and intermodal) continues the steady upward slope begun a year ago. Chems, metals and automotive all increased by about 5% yoy while and forest prods are off. Our *Quarterly Review* shows the three leaders in chems to be CN, GNWR and KCS, all up double-digits.

The logical segue from this is that commodity carload patterns leave no doubt as to where the class 1 strengths and weaknesses lie. Shortlines and shippers both are class 1 customers so they can see where their particular commodity mixed fit the given class 1's pattern. Moreover, shortlines have an additional ace-in-the-hole: a network of resources.

One example of what can be done is the sand/rock combo set by NS and two shortlines, the Reading Blue Mountain & Northern in Pennsylvania and the Winchester & Western in New Jersey. Both small railroads have been recognized for *Railway Age* marketing awards, having been nominated Paul Heymann, the NS product manager. The full story is available at www.railwayage.com/breakingnews.

Moreover, national account customers of class 1 roads are in a position to move a lot of goods on shortlines – assuming they know where the shortline is and what it offers. Paul Heymann is a good example of a class 1 sales rep promoting shortline destinations. And so, if you're a large paper, lumber, chemical or coil steel shipper, for example, you may have customers served directly by shortlines or close to a shortline transload. If you're a shortline, there are rewards for expanding your national account list of prospects.

BNSF's Matt Rose gave a presentation at Thursday's Fort Worth Club Business Forum luncheon. The theme of his remarks went to business ethics and I thought it instructive he began by quoting Wharton's Jeremy Siegel on "core earnings." (see WIR 8/2/2002). Matt's premise is that in every company "there is a business culture-- a set of values that will guide and direct the company officers and the board of directors as they deal with the multitude of decisions."

Regarding the current furor over accounting standards, Matt says that even as GAAP and the FASB set the generally accepted standards of financial behavior "the issue of morality is interpreted differently by different people." Matt makes the point that the chief question is whether the financial reports comply with the spirit as well and the letter of the law.

Driving through central Pennsylvania the other day I saw a church in the middle of a parched field of corn with the message, "Pray for rain" out front. Hasn't rained anything worth noting since June. I can only imagine what's going on in the granger states where, according to Friday's WSJ, the winter wheat crop forecast from the Dept of Agriculture is the smallest in 30 years.

Meanwhile, in Colorado it's gotten so dry that UP is providing free transportation of hay donated by producers in central Wisconsin. So far 15 carloads have made the 1,400-mile trek to Alamosa where it will be transloaded to trucks for delivery to ranchers in the Durango area. Where is the D&RGW narrow gauge when we need it? According to my June 1953 OG it's 199.8 miles.

Pioneer Rail reported 2Q02 results this week with sales up 4% to \$3.8 mm and expenses decreased 15% thanks to lower personnel and lease costs. The 16-railroad holding company increased YTD sales 4% to 7.5 mm while operating expenses decreased 12% yoy. But the trouble with these very small companies is they rarely tell you what the operating expenses actually were or what the operating income was.

For example, in 1Q01 there was an asset sale of \$1.055 mm and net income of \$1.074 mm. Does that mean net income was \$19,000 before the sale? If so, how did they get to \$760,000 net income for YTD 2002? I've been asked a number of times why I don't follow these small operations. The paucity of financial reporting is a very big reason.

One of the favorite hedge strategies in a sideways market is to play longs and shorts against each other. For example, shorting TRN against CP mid-May through July 8 was quite entertaining, up 10% vs down 8%. An interesting play this week would have been long NS and short RRA. As of 2PM Friday NS was up 12% while RRA was down 8%.

What's particularly enjoyable is that railroads are essentially misunderstood and under-appreciated by your average market player. However, when you know there's a glut of leased equipment out there and you can read between the lines of the railroads' carload figures very often you can find a satisfying play. The S&P rail index is up more than 5% while the broader S&P 500 is down more than 20% and some names – BNSF, CSX, GNWR, UP in particular – are above their 200-day averages on the uptick. Could it be there's a shift toward the boring cyclicals and away from the go-go equities of the bubble just burst? If so, railroad stocks ought to lead.

The *Quarterly Review* I've mentioned in previous WIR notes is now available. Unlike investors' reports from the various Wall Street sources, the focus here is on the carload business. In particular shippers and shortline operators will find this an invaluable source of strategic planning information for business development, operations planning, and financial guidance.

The second half of 2002 presents a unique opportunity to capture new and additional carload business. Knowing which lines of business leverage best against your connecting class 1 railroads' strengths will help you pick your best opportunities. This 22-page report details second quarter 2002 and year-to-date carload revenues, commodity car counts, average revenue per car and year-over-year changes for the six big class 1 roads, two small class 1 roads, and the two largest shortline holding companies.

In addition, you can see the breakouts between merchandise carloads on the one hand and coal and intermodal on the other. And there is a summary income statement for each of the ten railroads as well as a summary sheet comparing all ten railroads at a glance. In short, this *Quarterly Review* is the only single-source report of its kind available anyplace. For more information please go to www.rblanchard.com.

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Roy Blanchard provides railroad financial and operating performance measurements for shortlines and shippers. Disclosure: Blanchard may from time to time hold long, short, or debt positions in the companies mentioned here. A list of such holdings is available on request.