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# The Railroad Week in Review 1/20/2001

Union Pacific (NYSE: UNP) started off Earning Week with a very positive story, given the direction the economy appears to be heading in 2001 (see Analyst Meeting material at www.up.com). Yes, earnings were right in line with estimates -- off 35% on a per share basis. However, drilling down into the numbers one has to come to the conclusion UNP is setting itself for a reasonably good year regardless.

Revenues for the quarter and year were up 3% and 6% respectively. Operating expenses including a workforce reduction charge in 2000 were up 10% and 6% for the quarter and year, driving the 4Q00 net down 35% though the full year net rose 4% thanks to lower interest expense and adjustments for discontinued operations. Still diluted pro forma eps dropped to $0.90 from $0.95 YTY, 5%.

It was 4Q00 that did the most damage. CEO Dick Davidson had attended the recent Business Conference held by President-Elect Bush and told the analysts Thursday that the Conference consensus was that the economy needed three things to right itself. In no particular order, said Davidson, they are (1) a balanced energy plan, (2) reduction in interest rates, and (3) lower taxes. All three would benefit UNP in particular.

Carload levels for plastics and steel can be taken as Leading Indicators of the economy's direction. Go to slides #21-24 (numbers are at the end of the URL) and see the drastic changes Oct-Dec. Happily coal is holding up (slide 32, see also WIR 12/30/2000) thanks to colder than anticipated weather and dwindling stockpiles. But coal alone does not a railroad make and estimates for 1Q01 are in the 80-cent range.

Now, as for what happens next, both Davidson and UPRR President Ike Evans expressed confidence that UNP revenues will again grow at a rate of GNP-plus. And the view from here is they have the tools in place to do it. UPRR clearly has the most extensive railroad franchise in the west and has the most balanced commodity mix of any railroad, so the tools are there.

System velocity is up 31% since the dark days of 1998 while recrews, yard dwell time, and car cycle times are all comfortably down. Prior years' capex investments are paying off as shown by the Triple Track (slide 29). UNP has identified new business opportunities (slides 36-43) conservatively worth another $600 mm in revenues, of which Evans says maybe $200 mm is already in-house.

Last week I wrote, "The rails are scrambling to increase revenues and lower costs," and suggested what shortlines could bring to the table using Norfolk Southern (NYSE: NSC) as an example. Feedback from last week's commentary indicates that there is a wide range of carload contributions among shortlines, and that this has certain implications it has for the shortline community. We'll stay with the NS example, though what follows applies to all the class 1s.

The 229 shortlines listed on the NS map run the gamut from the Alton & Southern to the Pickens. According to published sources, the lot of 'em carry something like 6 million carloads a year for all interchange partners as well as for their own accounts. Fully 74% of that 6 million carloads involve only the top 20 carriers on that list. The top 80 carriers ranked by annual carloads handle

95% of the total. Granted, there is some double-counting as most of these cars go on a class 1 someplace and some may also wind up on another shortline. Now, for the sake or argument and presenting some orders of magnitude, say that the shortlines in the NS universe contribute to NS revenues in the same proportions as they do the total car count. Some lines interchange virtually all their cars with NS, some just a few. But it's a start and something the class 1s – and shortlines – may want to examine more closely.

My premise last week was that shortlines handle roughly ten percent of all class 1 revenues. NS will do about $6 billion in sales this year so if my premise holds its shortlines should handle traffic worth $600 mm to NS. Applying the larger universe percentages to NS revenues, 50% of NS shortline connections will handle 97% of NS shortline revenues. And therein lies the rub: 50% of NS shortlines could be handling just 3% of shortline revenues.*

If we were to say that the NS shortline universe is a good cross-section of the North American shortline universe, the implication is that a large percentage of shortlines could very well account for a very small percentage of class 1 revenues. This will not do.

Back in the days when money was cheap, inventories could pile up and nobody would care. Besides, the Interstate highway system was in its infancy and the rails were the dominant intercity freight carriers. There were a couple hundred class 1 carriers and shortlines were mom-and-pop affairs happily trundling a handful of cars a week over a few miles of 70-pound rail laid in the sand. But that was then.

Fast forward to 2001. We've got a dozen class 1 or near class 1 systems and regionals as big as some former class 1s. Trucks and the time-value of money have put a premium on smart supply chain management. To stay in the game the rails must run faster, cheaper, and smarter. Mergers and branchline spin-offs have been a major result.

Today's shortlines absolutely must position themselves with their class 1 connections to maximize contribution and minimize total cost. This does not mean reduced handling charges, but it does mean working smarter and bringing more to the table. For example, several nearly contiguous shortlines under common ownership could combine interchange in one place. Or several shortlines in one geographic area could take turns with each making interchange for all at one spot convenient to the class 1. Either way, add value by avoiding the end-of-the-branch syndrome.

So if you're one of the 50% of shortlines contributing 3% of revenues, it becomes a matter of survival to make the jump to the other 50% of shortlines contributing 97% of the revenue.

Roy Blanchard

* Sanity Check: The bottom 114 NS shortlines ranked by annual carloads do an estimated 157,000 cars a year. If all their business went to NS (most have only one interchange –NS) and all of it were "merchandise" (not coal, intermodal, automotive) that would represent $189 mm in NS revenues (3Q00 average NS revenue per mdse car was $1213). As it works out, $190 mm is 3.2% of the FY 2000 revenue stream of $6 billion.