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The Railroad Week in Review 1/27/2001

Earnings week got started in earnest with the Canadian Pacific (NYSE: CP) conference call on Monday. CP's a little tough to compare since the railroad (CPR) is one of five separate businesses under the corporate umbrella: PanCanadian Petroleum Ltd., CP Hotels, CP Ships and Fording Coal. Something may have to go, and the first inklings something might be up came last Nov when CP President David O'Brien told a Toronto press gathering, "We're obviously not going to build five global businesses. We don't have the financial capacity to do that nor the intention. But we think that we can build a couple of global businesses."

The hotels are an international business and so are the ships. CP’s 87% stake in PanCanadian (Toronto SE: PCP) brings much to the table. PCP has had a one-year stock price run-up even better than Houston-based Enron (NYSE: ENE) and might even be worth more if spun off. Coal is, well, coal. And that leaves the railroad, about which O’Brien had this to say during Monday’s conference call: “We expect the railway will continue to make progress.” And so it has.

CPR generated $256 of the $607 mm net income for the quarter, up from $121 out of $307 a year ago. PCP accounted for $295 of the net vs $126 in 4Q99. For the full year, CPR accounted for $532 mm of the $1755 corporate net, up from $364 of $886 (before special charges) YTY. PanCanadian did $894 mm of the total, up from $302mm. So CPR is in deed making progress.

Looking at the full year, the railroad’s OR shed 1.3 points to 76.9 on 4% greater freight revenues and in spite of a 10% increase in workload and sharply higher diesel fuel costs. GTMs per employee rose 17%, locomotive productivity was up 15%, and fuel burned per GTM dropped 6%. Looks like the scheduled railroad they talked about in Oct is paying off.

The story at BNSF (NYSE: BNI) is ***cash flow***, and cash gives you choices. For the year BNI banked $431 free cash flow after dividends, up 66% from last year. Prior years’ intensive capital programs allowed BNI to slow the FY 2000 program 22% to $1.4 bn from $1.8 bn YTY. With its stock trading at less than 10X forward earnings, the company clearly felt its own stock was the best possible use of its money. So it bought 64.6 mm shares at an average price of $23.16 during the year, covering more than half the cost with FCF and capex savings.

Out on the railroad, BNI took the same hits as everybody else, with 4Q00 revenues off 2% -- some help in auto and intermodal as coal, merchandise and ag traffic were weak. Operating expenses were essentially unchanged, yet the doubling of fuel costs drove a two-point degradation in OR to 76.7. That earnings per share were only off 6% YTY was helped in large measure by the share buyback program. Looking forward, the return of benefits from BNI’s strong coal franchise (57% share of PRB, low stockpiles, cold weather) and the continuing share buybacks will do much to offset weakness caused by any economic slowdown.

On a final finance note, we like to see FCF margins running about the same as net margins. BNI is approaching that mark hitting 9.2% this year, up 220 BP from last year and within 190 BP of this year’s net margin. It’s going to get better, too. Rose wrapped up the meeting by saying the FCF goals are $500 mm in FY2001 and a cool $1.0 billion by FY 2005. Said he, “We can’t control the stock price, but we can control cash flow.” Say Amen to that.

Mike Haverty's smiling face on the cover of the January issue of *Railway Age* says it all. Nominated by the magazine as "Railroader of the Year," the new boss at Kansas City Southern (NYSE: KSU) is on the way to reaping some nice rewards for his stakeholders. It was nice to have Mike on his own talking railroads without the distractions of a Financial Asset Management business hogging the limelight.

KSU stock dropped to $5 at the split as the FAM types bolted. Never mind many observers (yours truly included) felt KSU was worth something north of a sawbuck. Happily, those who shared Haverty's long term view have been rewarded with a double in less than six months. Note too that net income before extraordinary items increased $250%

Like everybody else, KSU carload revenues got clobbered in 4Q00 with matters made worse by being blind-sided by a major utility customer changing hands and parking several trainsets. It was a dismal quarter with revenues off $17 mm and the net off $7 mm YTY, yet smart expense management kept the wide revenue spread from reaching down into the net. For the year, a 5% shortfall in revenue faced a 5% reduction in operating expense so the net was off a point-plus.

South of the border, TFM turned in a hefty 22% jump in sales and that translated into a 35% hike in operating income, pushing the net up by a factor of ten, to $40 mm from $4 mm YTY. As a result the TFM contribution to KSU net income rose to a plus $1.2 mm from a negative $10.9 mm YTY. The KSU outlook for 2001 is helped by the fact that 1Q01 carloads are up 5% already YTY. Haverty looks to shed $100 mm or so in long term debt, is talking a possible IPO for TFM, and looks to make other arrangements with UP to save some miles in SE Texas. Let's watch.

Responsiveness is what Canadian National (NYSE: CNI) is all about. Marketing SVP Jim Foote says they intend to grow market share through superior services, even if the economy has seen better days. How? By offering more supply chain management value than the other guy. As we've noted before, quality products earn quality prices and in a high fixed cost business a high top line feeds a healthy bottom line.

That's one reason Jim Valentine of Morgan Stanley Dean Witter says, "If you are going to own a railroad make it CNI." That CNI's promised rate hikes have not only held but also increased loadings is proof that running a scheduled railroad means running a responsive railroad. Shippers benefit with services they can depend on and shareholders benefit with net margins consistently in the high teens.

For the year, it only took 4% more revenue to produce 12% more operating income and a whopping 25% increase in the net. Cost control, productivity gains, and pricing to value added are essential. For the year GTMs per available horsepower let CNI shrink its fleet by 650 units and still have enough power to handle moderate annual traffic increases for some time. Car miles per day went up 11% in 2000 and the target for 2001 is 20%, further improving asset turns.

These results prove once again that Running to Plan is not an option, it's a necessity. Asset utilization and market share gains combined with incessant attention to detail is how you get increasing earnings in a not-so-hot market.

Recovery is the theme CSX (NYSE: CSX) brought to NY this week. To be sure, it's still a work in progress however the improvements since mid-2000 are worthy of note. In his opening remarks CEO John Snow said he was encouraged by customers' response to improved service levels. He sees 2001 as a “generally good” year after two modest quarters. Hardly a recession says Snow, though 50 more basis points from Greenspan and Co. would be welcome.

That the 4Q00 traffic downturn delivered a short sharp shock to results is undeniable. The announced 26-cent eps missed the consensus by a dime and has caused some observers to cut 2001 estimates to the $1.50 range from their previous $2.00 consensus, at that down 13 cents over the past 90 days. The presentation slides (www.csx.com) show the effects of the Conrail merger and the shedding of ships still linger. Once those anomalies are gone let the recovery begin.

CSXT President Mike Ward and his team have a clear vision of where they want to be and a plan for getting there. It may take a couple of years, but my sense is they’re heading in the right direction. Anecdotal evidence from the field seems to say not everybody has gotten the message but that will change. Operating income rose 30% in Q3 and Q4, significant because as CFO Paul Goodwin noted, Q4 generally equals Q2 and here was a nice bump despite the economy. Of particular significance in Q4 was the nearly 1% revenue increase given a 2% drop in loadings – credit strong utility coal and price increases that stuck.

The plan for 2001 calls for continued productivity improvements (cost per crew start down 10%, a 5% improvement in power utilization, 6% better car cycle time), service innovations (Express Lane produce with UNP up 57% thanks in part to 94% on-time performance), and pricing to value. If I were to sum up the change at CSX in one word, it would be accountability. “If you own the process,” says Ward, “you’re accountable.” And that’s the right message, because recovery always starts out where the wheel meets the rail.

Retrenchment is unfortunately the continuing thread at Norfolk Southern (NYSE: NSC). Recall last month NSC warned 4Q00 eps would be about half last year’s 20 cents, and right they were: 11 cents before the “workforce reduction” charge. So far this month NSC has cut the annual dividend by 70% to 24 cents a year from 80 cents, announced another 6% headcount cut, and will dispose of another 15% of its route miles.

That being said, it is reasonable to expect that the operating improvements envisioned by Operating Vice Chair Steve Tobias will dovetail with the commercial initiatives of Ike Prilliman, Vice Chair Marketing to realize the tremendous potential of the new NS franchise. In his presentation, the latter correctly noted that intermodal has the potential to gain share in a down market, even as did CN’s Jim Foote. The reason is that individual boxes are often more suited to tighter inventory control than freight cars carrying four times as much.

Peering into the future, utility coal will be up for the same reasons as noted above, though met coal may drop as steel production is cut. Intermodal looks good, though automotive, metals and chemicals will be down for sure. Agriculture will be flat and forest products a mixed bag between housing starts and paper overcapacity. The good news in all of this – yes, Virginia, there is a bright spot – is that moving more goods with fewer assets improves yields. Fewer short trains, less yarding, mixing intermodal and carload for bigger trains and running everything to plan will do the trick, provided it’s monitored, measured, and managed.

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