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The Railroad Week in Review 4/7/2001

As longtime WIR readers know, the purpose of this Letter is to educate, enrich, and perhaps even amuse. We try to look not only at what railroad industry stocks are doing but why they act as they do at any given point in time. The premise is that a better understanding of what's behind the numbers will help shippers, shortlines, and class 1s educate one another as to their goals in life and enrich themselves and the railroad community in the process.

Everybody's worried about whether The Market is going up. But they seem to have forgotten it's possible to make money in a down market as well. Options and shorts are two vehicles which come to mind and which some railroad investors have used to good effect. All it takes is an understanding of the railroad industry and the fundamentals.

We've written before about the PEG ratio: the PE of the next year's earnings divided by the projected growth rate. The PE by definition is supposed to mirror the growth rate, so a PEG of One is Fair Value. Thus the investor should look for stocks with PEG ratios less than One, the ideal being oh-point five or less.

Buying calls in a low-PEG stock allows one to participate in an upturn faster than owning the stock outright thanks to the time value of money and leverage. For example UNP and CNI April and May at-the-money calls are showing some nice gains. A mere $1200 in CNI April 35 calls bought a recent Friday at the open was worth nearly $2000 the next Monday before the close. A similar gain in pure equities would have required an investment of $24,000 if the stock were bought at the strike.

When the outlook is more to the downside the choice can be either to short the stock or to buy puts. Stocks with PEG ratios north of 1.5 are a good place to start. Say XYZ is trading at $25 a share and has forward earnings estimated at a buck a share, up 10% YTY. The PEG is 25/10 or 2.5. With a stock like this, a short sale at the start of a downturn can be quite entertaining, as long as one sets an exit point and doesn't get greedy.

Ditto for puts. At stock at $35 headed for $30 or less can make you a fast five bucks buying near term at-the-money puts and selling when they hit your target as the underlying equity heads south. But attention is required; a good grounding in the basics is essential. If you're interested, check out the Learning Center at the Chicago Board Options Exchange site, www.cboe.com.

The cold fact is that investors like winners. Whether your company is traded on the NYSE or is closely held, attracting capital is always an issue. And, as pointed out last week, capital follows liquidity, and liquidity follows the money.

The Commerce Department on Tuesday reported that factory orders fell for the second straight month. February orders fell 0.4% after a revised 4.3% drop in January. Orders excluding transportation fell 0.3%. Meanwhile, the WSJ said Monday, “A report by the National Association of Purchasing Management showed that manufacturing activity fell in March for the eighth month in a row.” OK, it was a slower rate of decline than we saw in Jan and Feb, and some saw hope in that. But for the small railroads it's not pretty.

It's what Jim Valentine of MSDW calls the "economically sensitive" carloadings -- merchandise, to you and me -- that get hurt as fewer goods making it to the customers' shelves require fewer raw materials in the manufacturers' bins. Happily, neither of the major shortline holding companies -- RailAmerica, Genesee & Wyoming -- are totally beholden to North American freight follies thanks to their presence in South America and Australia.

Other, nonpublic shortlines have a particularly tough go of it. Increasingly tight controls on supply chain management mandate smaller, more frequent shipments keyed to usage and distribution rates. Class 1 railroads are under the gun to improve ROIC, and that means asset management which in turn means better car utlization rates. Thus is the large railroad rewarded by keeping its cars on line, unloading the contents into a distribution facility, and releasing empties quickly. That makes 'em available sooner for reloading at the next location.

The good news is that regional rail operators often have reload sites close in to major distibution centers where the class 1s do not. Then the Unique Selling Point (USP) for the class 1 is, "Get a piece of this market via my reload center or miss out entirely." Just have the empties back within 48 hours of the time they came in.

Speaking of cars, Greenbrier (GBX) announced break-even results for its fiscal second quarter ended February 28, 2001, in line with previously disclosed revised expectations. In addition, subsequent to quarter end, the company announced new orders for 2,700 railcars valued at $110 mm (that's $37K a copy) and the completion of a $50 mm private placement of senior term debt.

Sales for the quarter just ended came in at $157 mm, off 9% YTY while net income a year ago was $4.3 mm or 30 cents per diluted share. For six months, revenues were up 9% YTY to $311 mm and earnings were off a third to 22 cents a share. For 2Q01 GBX North American car build rates were down, there were "timing differences between the actual production and delivery of new railcars," and margins on some car types were below budget. GBX now holds more than 20% of the total market and anticipates FY 2001 earnings of 40 to 60 cents a diluted share. There are 14.1 mm shares outstanding, indicating a year-end share price around seven bucks and a rather generous dividend yield of 5.14%.

Quick Takes: NSC has filed with the SEC to sell up to $1 bn in debt securities, preferred and common stock, depositary shares to use for general corporate purposes, including outstanding debt, acquisitions and working capital… According to the most recent PWX Proxy Statement "An investor group proposes PWX seek an immediate sale of the Company or pursue other options to increase shareholder value." Details at www.pwrr.com Investor Relations… BNI says it may miss 1Q01 estimates of 49 cents a share before charges… WCLX shareholders have OK'd the CNI transaction.

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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.