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The Railroad Week in Review 4/28/2001

Scott Flower of Solomon Smith Barney summed up Earnings Week quite nicely in Tuesday's WSJ piece by Dan Machalaba. Said Scott, "The economy is obviously taking its toll on the rail industry. Even so, earnings at CSX and CN held up reasonably well because of strong utility coal at CSX and continuing Canada-US trade flows at Canadian National. At both railroads their operating plans are improving service while decreasing costs."

In the following summaries the focus is, as always at WIR, on what's being done to increase revenues faster than carloads. Bulk commodities like coal and grain are more subject to rail diversion between carriers than from rail to truck, so the best price/service package wins. Long-term legacy contracts, as Matt Rose said in Tuesdays BNSF call, "lock and load" expectations, and these may actually fall behind the curve as new improved offerings come along. Shorter contracts improve marketplace liquidity for both buyer and seller, creating a more fertile environment for price/service enhancements.

As for the merchandise carload business, we see more emphasis on getting back share from the trucks. The rails are finally realizing they can't keep buying business from each other because if they do there will be less and less to buy. They have to go after the trucks by beating them at their own game: providing a service that customers actually want. Read on.

CSX railroad 1Q01 operating income was $182 mm vs. $160 mm, a 14% increase YTY, this in spite of $15 mm more fuel cost and $20 mm more in maintenance. CFO Paul Goodwin said there was more than $40 mm in "operational cost take out." Locomotives, for example. CSXT President Mike Ward said there were 263 fewer units on the active roster than there were a year ago. From that you can take another 100 units stored serviceable and 50 more working off line. At the same time there was a 71% reduction in the number of recrews and a 94% reduction in the hours trains were held for power. Check out www.csx.com for the whole operations story.

Next to bat was Bill Flynn, SVP-Merchandise, who was able to point to a 4% increase in revenue per car in the face of a 4% decrease in carloads. I think what we're seeing at CSXT is a real focus on providing truly competitive products at a fair price. There are two parts to success in any market. Giving customers what they want gets you a seat at the table. The competitive differentiator comes in the ability to charge a premium price for a premium service.

New product revenue growth hit $20 mm YTD with particularly heady results in food, alcohol, MSW, and newsprint. CSXT has, like the western roads, identified corridors by the parallel Interstates to give customers continuity with their truck lanes. Of particular note, CSXT is rolling out the Express Lane service to seven new markets, is combining auto, intermodal and merchandise trains to maximize corridor capacity and has instituted new "Watershed" run-through services with the western roads. What's all this worth? Says Flynn with a grin, "A hundred million a year and up." Better yet, freeing up assets and capacity means much of this is incremental business. And we all know what than can mean to the Bottom Line.

Canadian National freight revenues were up 3% to $C1.40 bn from $C1.37 bn in spite of no change in carload numbers. Operating expenses rose 2.3%, hammered again by diesel fuel (up

31%) and equipment rents (up 9%). Thanks to cost containment most everywhere else, the OR lost a mere 30 basis points, however, to 72.5, and shareholders pocketed a 3% net income gain before one-time items, 7% all in. Cashflow after divs but before financing charges was a respectable $C39 mm. Share buy-backs have been postponed to be prepared for the early cash needs of the WC purchase, which, by the way, should be approved as a “minor” transaction and completed by year-end.

Like CSX, new service offerings and more realistic rates drove the revenue gains, even though automotive was off and coal did not change. Chemicals, metals, and ag products (both STCC 01 and STCC 28) were up moderately while intermodal walked off with the honors with a 13% revenue increase. During the presentation Jim Foote, EVP Sales and Marketing, said auto inventories were returning to normal and higher coal prices and shipments should turn those lines around second half.

More to the point, truck conversion rates are expected to accelerate for two reasons. One, the highwaymen have troubles of their own what with high fuel prices and driver shortages. Two, rail’s inherently lower absolute per-ton prices combined with the growing shipper acceptance of superior rail performance will lead to further growth in both the merchandise carload and intermodal sides of the house.

Burlington Northern Santa Fe posted a 45% drop in first-quarter net income, hurt by higher fuel and energy costs. The result fell well short of analysts' expectations. So says Reuters. What that doesn’t tell you is that freight revenues were essentially *unchanged* YTY. Winter storms, Mississippi floods, and an extra 14 cents per gallon of diesel fuel conspired to push the OR up 400 bp YTY. Still, revenue ton-miles and gross ton-miles both rose 4%, RTMs per employee improved 6%, and the railroad got 2% more GTMs per gallon of fuel.

The thread begun by CSX and CN continues as the thrust is clearly on truck conversion and better revenue yield. Chuck Schultz, EVP and Chief Marketing Officer, charted changes in revenue and carloads by business group. Ag products revenue was up 11% on 9% more cars. Merchandise revenue was off 3% on 6% fewer carloads. Intermodal and auto (“consumer”) revenues were up a percent on flat loadings. Only in coal did revenue lag carloads, thanks largely to legacy contracts running more coal farther out (would you believe *New England?*) in bigger cars.

The key to increased asset utilization, said Carl Ice, Chief Operating Officer, is running to plan (about 90% on time YTD). That drives asset utilization and that in turn dictates how much capex to put in the plant. Better ROA means less capex, meaning the 2001 capital plan is a shade under $1.6 bn, down from $1.8 bn in 2000. And the less money you have to put in the RR to make it work, the more shares you can buy back. Which is precisely what BNSF plans to do.

Norfolk Southern totally blew away the nine-cent street estimate with 16 cents from continuing operations, four times the severely depressed 1Q00 number, both excluding one-time charges. Rail revenues for Q1 hit $1.54 bn, up 2% from $1.52 bn YTY. Even better, rail operating costs got taken down 3%. The combination lowered the OR by nearly four points to 86.7 from 91.4.

The improved revenue picture was driven mainly by utility coal with tonnage up 5% YTY. Higher electricity generating rates and stockpile replenishment reduced the supply of steam coal available for export where tonnage was off by 1%. Elsewhere, intermodal sales were up 12% YTY mainly due to increased domestic container business. General merchandise revenues were off 5%, due in large part to cutbacks in automotive production (carloads off 11%), and that in turn hit metals (off 6%).

Rate increases are clearly holding firm. In four of the five carload groups revenue was down less YTY than units (agriculture being the exception). CEO David Goode summed it up beautifully, saying, "It's about time we got a fair price for the service rendered." Now that reliability and consistency are becoming more the order of the day, he's exactly right. And though NS has said they are not in the business of demarketing any lanes, clearly a railroad has to go where the business is and where it pays.

Earlier NS had said they planned of shed 3,000+ miles of branch lines. In his prepared remarks Goode noted that in Q1 more than 200 miles has been transferred and that another 350 were to go shortly. Operators, he said, are selected on their ability "to operate the branch more efficiently and yet protect the revenue base and reduce NS exposure to future infrastructure investments." [NS looks particularly to those shortline operators with whom there is a track record of successful collaboration. – RHB]

Looking forward, coal revenues will probably continue to lead with intermodal a close second. Merchandise traffic volume is not likely to set a lot of records, though yields are clearly improving as prices and length of haul move up. The productivity metrics showed some striking improvements YTY – GTMs per employee up 6%, RTMs per employee up 7%, RTMs per train-hour up 27% -- and I have every reason to believe the trend will continue. Still, NS has one of the highest ORs in the biz where it used to have one of the lowest. One would like to see the revenue/cost curve continue upward, unit costs continue down. Perhaps MultiModal and the Scheduled Railroad will do the trick.

Union Pacific revenues were up a percent while operating expenses were up two points, leading to a 3% decline in operating income, to $439 mm from $452 mm on revenues of $2.9 billion for both quarters. Net income dropped 2% to $181 mm from $185 mm and diluted earnings per share drifted down two cents or 3% to $0.72 from $0.74 YTY. Given the combination of a killer winter, a soft economy, and continuing extremes in fuel prices, that's not too shabby.

The railroad delivered a one percent revenue increase even though carload volumes drifted down in every commodity but coal, up 12%. Intermodal and ag, however joined coal in providing some black ink to the percent revenue change column, though it has to be said that coal revenues and carloads were both up the same, indicating no real change in rates.

The railroad's results are improving on two fronts: productivity and innovation. Average train speed is up slightly over 4Q00 and the recrew rate is down by about 10%. Failure costs as a percent of revenue are half what they were when the program started in 1998, though UPRR President Ike Evans concedes there is still work to be done with equipment utilization rates (recall that on UP one MPH better average train speed means 250 fewer locos in service).

On the initiatives front UP expects the I-5 corridor to be worth a $billion in new business. The "5-7-9" carload service between the PNW, California and Arizona has already won back business from the highways with improved service reliability. The "Cascade Connection" intermodal service along the same corridor and featuring day-of-the week pricing is proving another winner. Then there's the "Freeport Pipeline" service for chemical customers in the Texas Gulf and reaching northwest and northeast.

Looking into his crystal ball CEO Dick Davidson foresees a continuing soft economy, moderating fuel prices, an OR breaking 80 (for 1Q01 it was 83.8), improved free cash flow generation and better shareholder return. The key, and Ike Evans puts it, lies in "a new paradigm" – identifying what's needed in the market place, figuring out how to make it profitably, and selling it across commodity lines. The view from here is everything is in place to do just that.

Canadian Pacific's results were largely driven by the energy side of the holding company. Railroad revenues were up a percent YTY yet the 6% hike in operating costs pushed operating income and net income down 19% and 20% respectively excluding spinoff-related charges. Here again the saving factor was improved yields as price hikes and mix offset much of the volume loss and the effects of high diesel fuel prices and an unusually harsh winter.

By now the worst of the winter has passed has passed, and CEO Robert Ritchie has announced intentions "to drive down costs for the remainder of the year." MSDW's Jim Valentine says, "It may take some time to drive out the excess costs, yet this will have minimal impact" on the breakup value of the company. CP stock is up nearly 40% YTD, and could well see a near double before year's end assuming the break-up proceeds on schedule. Once free of the holco, the railroad will be able to stand on its own and the stock could be worth nearly what the whole deal was in Jan.

Kansas City Southern brings up the markers in this extra-length Earnings Week review. In a turn-about from pervious reports, higher equity earnings from TFM helped offset some of the many negatives hitting KCS in Q1. Net income from continuing operations came in at of $6.3 mm (a dime a diluted share) vs. $10.4 mm (18 cents per diluted share) YTY. The 39% drop in earnings came about as a result of $4.9 mm lower freight sales (though plastics, petroleum and plastics were up) and a $7 mm jump in operating expenses. The chief culprits were derailments, car hire, and fuel.

For the week, NS walked away with the honors for the biggest stick price jump, 25%, starting with a two point gap-up to $18 from $16 at the open on Thursday and finishing the week above $20. BNSF, CN, and CSX all saw gains in the range of 5% for the week with UP and CP holding their own. Only KCS fell, losing about six bits to $13.25, even after joining everybody else in Thursday's jump.

The view from here is that the rails reporting this week held the line on revenues even as volumes fell, which says that shippers want to business with the rails, and will pay for services rendered as long as services are rendered on a reliable and consistent basis. The rail's inherent rate advantage has for too long been nibbled away by disadvantages in total landed cost thanks mainly to lack of reliability and consistency. It's beginning to look like the rails may once again become the low-cost vendor of choice.

Roy Blanchard

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