The Blanchard Company

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The Railroad Week in Review 5/12/2001

RailAmerica (RAIL) posted 1Q01 earnings of 14 cents per share, beating Street Estimates by a healthy six cents but lower that the 17 cents reported in 1Q01 -- excluding acquisition-related and other one-time items -- on 21.4 mm fully diluted shares vs. 16.5 mm diluted shares a year ago. By way of review, RailTex was formally brought into the fold on 2/4/2000 for approximately $128 mm in cash, assumption of $111 mm in debt and issuance of approximately 6.6 mm shares of RAIL common stock. This accounts for most of the increase in shares outstanding YOY.

North American carloads increased 4% to 228,110 including the RTEX acquisition, not bad when you consider YOY car counts are flat to down on the class 1s. Coal traffic increased 28% and bridge traffic increased 12% from the first quarter of 2000. Declines in automobile, lumber products and chemical carloads were pretty much as expected. The OR shed 110 BP to 77.2 as synergies from the RTEX acquisition kicked in and revenues rose 26% to $62 mm. Offshore, currency devaluation hurt the raw numbers, however on a constant currency basis revenues were up 15% on 10% more carloads. That helped the OR dive 5.2 points to 76.5, which goes to show the benefits of privatization.

During the Q&A there was some discussion of the operating cost differences between class 1-operated branchlines and shoreline-operated lines. CEO Gary Marino accurately pointed out that the savings aren't so much in operating costs are they are in overhead expense. As we've said before both the class 1s and shortlines are operating with two-man crews and are maintaining track to the FRA class appropriate to the service. The biggest difference however is the closer attention given even the smallest customers by the local managers. As a result, it's entirely possible shortline growth in carloads interchanged to the class 1s masks some class 1 fall-off in shipments from smaller customers.

Getting back to RAIL, Marino says there remains about $25 mm in "non-core" assets to spin off, mostly individual RRs that don't meet his 35% return target. On the acquisition side, he feels there will be "$billions" in revenue opportunities both here and abroad. Australia is the biggest chunk, with offering memos expected for Nations Rail and Freightcorp coming soonest. As we all know, there will be class 1 divestitures, and to that we can certainly add some extant shortlines as the original owners decide to hang up their spurs. But, says Marino, the opportunity has to be "fantastically accretive."

Finally, even with six-cent surprise Marino maintains the $1 per share estimate for the year is "on track." That being the case, the multiple is 12, about right for a railroad, and so the present $12 stock price may be seen by some as "fair value." Others of us think the growth rate could be closer to 15 percent if the acquisitions work as planned. Do I hear $15 for fair value?

Apropos of stock prices, my friend Drew Robinson of TransMatch (www.transmatch.com) in NYC makes an interesting point regarding how and why stocks move as they do. If you have rail stocks in your portfolio you know the rails have had a good run since mid-October. If on the other hand, you haven't been paying attention, take a look at Drew's Chart 1 on the attachment.

His Chart 2 is an even more useful way to look at stock prices. On many days all the rails went up and on other days all the rails went down. The chart is constructed to show the relative performance of the rails vs. the average stock in the S&P 500 over the preceding month (21 trading days). This takes away the day-to-day noise from the broad market. As you can see, most of the time all the rails move up and down as a group and the market doesn't particularly distinguish between Union Pacific and Norfolk Southern or any other pairing you care to make.

Drew's reasoning is that stock prices move for big reasons like interest rate moves and small ones like earnings surprises and analyst upgrades. But most of the time investors buy or sell individual railroad stocks like CSX and BNI because they want to have more or less exposure to the rails as a group. When CSX's stock price is doing well usually BNI is going up as well.

So what does it all mean? Simply this. The best way to add shareholder value is to improve the economics of the railroad industry as a whole. It means growing market share for the mode, cutting costs across the industry, eliminating barriers to cooperation among carriers and most importantly sharing assets. This isn't Pollyanna-talk, either. In fact most investors really can't distinguish CN from CP or UNP from BNI. But they do notice when the rail industry gets its collective act together as it did in the early 90's. That's when stock prices go up and stay up.

The common thread of the Earnings Week reports is one of increasing shareholder value by getting actual performance closer to what freight buyers expect of their vendors. As good as the formal presentations were, and as encouraged as I have been from private meetings with senior railroad officials, I have to say there are still pockets where pricing and performance have yet to catch up with each other.

The transportation manager of a large chemical company writes, "We have just received a rail contract renewal offer and even though the rates were higher they were below the truck equivalent. However, when you take into account the higher [per-move] leased car cost brought about by a five-day jump in round-trip transit times, the new rate level is virtually the same as what the truckers are quoting. From my point of view, I can go with the truck and not make any new investment in equipment. Additionally, I can either redeploy the private cars handling this movement into a more efficient lane or simply return them to the lessor and realize a nice savings in fleet rental costs."

And speaking of the carload volume/revenue issue, a former Conrail senior manager notes, "In my experience, there has never been a quarter where volume dropped that revenue per car didn't go up. That is because when volume drops, you are stuck with the higher paying captive freight that has no place to go. The more competitive customers leave first when trucking capacity is freed up. When the economy tightens up and the lowering paying guys return, revenue per car invariably goes back down. You always lose the lighter loading, shorter stuff to trucks first in an economic downturn and get it back when people run out of trucks. You need to separate the rate effects from the mix effects to find out what is really going on with carload yield."

Roy Blanchard

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.

Chart 1

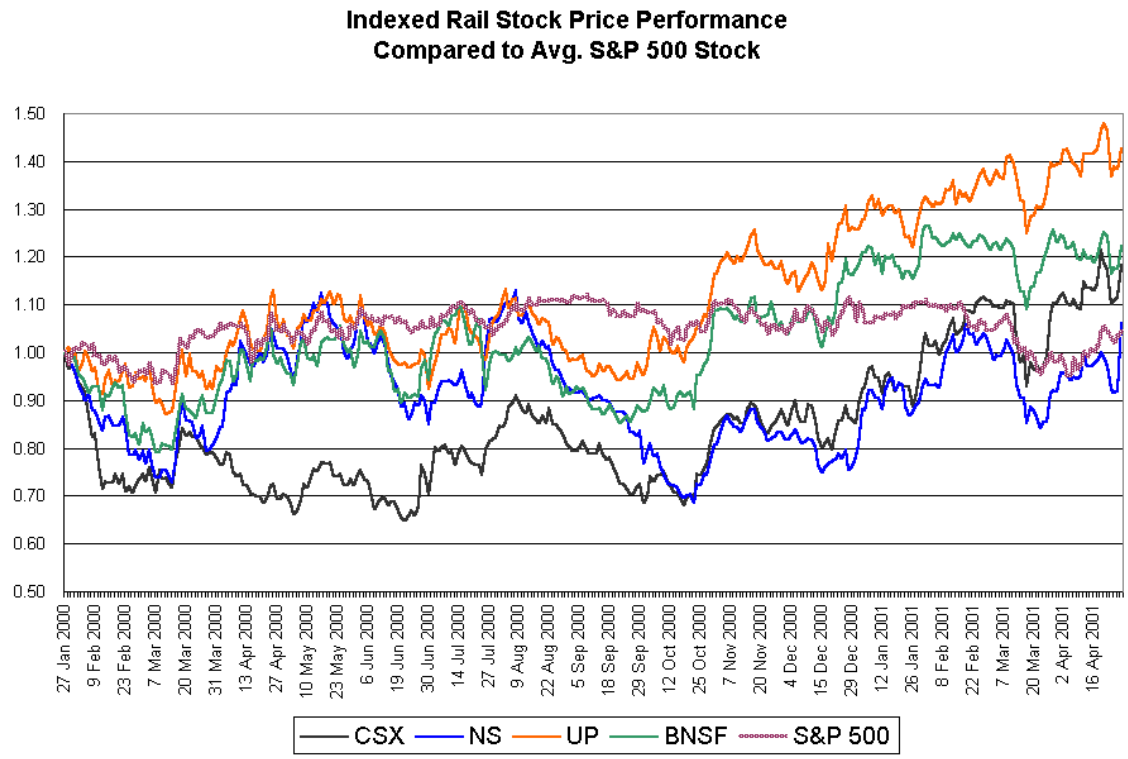

Chart 2