The Blanchard Company

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The cover letter for WIR these last two weeks charged the readership to write in about rail service successes and failures. Perhaps the most intriguing observation comes from fellow pundit Larry Kaufman: "At a recent speaking engagement I sensed a real disconnect between those 'captives' who really buy freight transportation and their trade association executives and hired gun lobbyists. The latter are very zealous on behalf of their clients, as they should be, while the former are much more pragmatic about the real-world market in which they operate. If the carriers only would learn to talk directly with their customers, I suspect there would be much less emotion in the competitive access debate."

Excellent point. It's not all that difficult for railroads to get their arms around what their customers' thoughts are. All they have to do is ask, and I'm sure the better sales reps do. Trouble is, the sales rep in the field can't do much to change the product offering if the leadership isn't listening. Every quarter the class 1s talk about the effect of the economy on revenues, and every quarter shippers write WIR about easily solvable service problems: cars stuck in yards, irregular transit times, high demurrage charges driven by irregular transit times, etc. Rates rarely. Makes one wonder how much revenue declines can be attributed to "the economy."

Case in point: a chemical shipper writes, "Railroads should tailor a customer's service measurements and goals to what the customer wants. Sounds simple, huh? Yet it rarely happens. Too often, railroads determine on their own what the goals and measurements will be for a particular customer. The customer usually finds out after the fact, when the railroad comes in to tell him that his traffic has been running 98% on time. Wonderful news, but if I needed 10 day transit and the carrier is providing 15 as their goal, that 98% on time translates into 100% late as far as I am concerned."

Here's the challenge. Let shippers and railroad sales reps benchmark (1) ease of doing business, (2) delivered cost, (3) consistency and (4) unit volume against what it was a year ago. The shipper data will tell the railroads what the trade associations are hollering about, and the sales reps input will validate or refute shipper stories. Then finally investors can drill down into quarterly revenue changes to see what's really caused by "the economy."

Stocks this week got knocked down again, and the rails got caught in the downdraft. It seemed half the world was on vacation Mon and Tues, and the other half was out to lunch on Fri. EMC's pre-announcement of lowered earnings triggered a sell-off in tech (IBM off 6 just because, e.g.). It seemed at the end of the week that the bulls were away and there was nobody to buy what the bears were selling. As usual, the malaise spread lemming-like and no good deed went unpunished.

Except possibly for the rails. CP and CN were the winners, up 3% and 5% respectively, while the US majors essentially ended the week where they started. Among the smaller class 1s and shortlines, only GNWR saw any increase, up 5% on no particular news. Rail industry investors long July calls may want to pay close attention early this week, however.

Just out-of-the-money July calls bought a month ago have lost value, and some, like of UNP 60s, about disappeared from the scene. I think the ticket may be to look at the underlying stock price in relation to the moving averages and the direction of the averages. Most appear to be trading at pr slightly below the moving average now on a flattening curve. Only CN continues to trade at or slightly above a still-rising curve.

Still, the outlook for 3Q and 4Q isn't all that great for the rails, with coal remaining the hero du jour. Interestingly food is the only other positive YTD while even intermodal is flat to down. Economically sensitive automotive and chemical traffic through June are off 9.6% and 5.2% respectively. Total YOY carloadings remain in positive territory on CP and CN alone. No wonder slightly OTM calls for 3Q and 4Q are unexciting. There may be some action in Jan, so it looks like traders still expect a slow second half. Railroad marketeers would be well-served by focusing on market niches; operating types would be well-served by listening to what the reps are telling them.

Speaking of market niches, beware the customer portfolio to skewed to one or two lines of business. Take Providence & Worcester (AMEX: PWX). The positive $14,000 net income of 1Q00 turned into a $191,000 loss in 1Q01. Carload revenues were off 7% and 75% of the decrease in volume was construction aggregate traffic. PWX said bad weather was the culprit. However, given the state of the economy in the PWX service area, 2Q01 results will be telling. Indications of an expanded and less cyclical customer portfolio would be welcome.

Among vendors, there has been little joy in stock price appreciation. Particularly hard hit was Railworks (Nasdaq: RWKS). A reversal in quarterly estimates sent it down 14% to $1.50 a share on Friday. It appears this relatively new (1998) aggregation of rail engineering support companies had back in mid-May suggested 2Q01 earnings of 20 cents a share. Last Friday's press release put estimates in the range of a dime profit to a dime loss. Turns out the sale of a construction business, poor results in its wood tie business, and liquidity problems slowing some projects combined to trigger the shortfall.

For the record, RWKS is a $600 mm (sales) company that has fallen just short of break-even in two of its first three years in business. The company carries more than $350 mm in debt against $85 mm in shareholders' equity. Just last week RWKS filed an 8-K to report a $111 mm bump in its revolving credit agreement. That in turn depends on a minimum EBITDA of $15 mm in 2Q01. The press release says it will be close.

RailAmerica (Nasdaq: RAIL) completed an additional $8.4 million in locomotive sale/leaseback transactions, continuing RAIL's long-term plan to reduce debt through asset rationalizations, sale/leasebacks and equity infusions. Including these transactions, projected 2001 lease payments are now only 3.2 % of projected 2001 revenue, vs. an industry average of 3.9%. RAIL says that by the end of 2001 it expects a debt-to-equity ratio of less than 2:1, a considerable reduction from its earlier 3: 1 ratio.

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