The Blanchard Company
www.rblanchard.com

The Railroad Week in Review 7/28/2001

Lagniappe [American French, from American Spanish la napa -- the lagniappe, First appeared 1849]: something given or obtained gratuitously or by way of good measure.

As a railroad investor, shipper advocate and shortline consultant, I find the income statement noise between gross operating income and net income most distracting. One's focus ought to be on what management is doing to build a better product and how well customers are responding to that better product. Everything else is GAAP window dressing.

The so-called extraordinary charges *below the line*, to use a bridge payer's term, only serve to cloud the picture of how the railroad works. The good news this week is that once you strip away the *lagniappes* it's a pretty decent picture of smart managing in a challenging environment.

At CSX the story is heavily weighted toward rate increases and truck conversion. I thought Chief Commercial Officer Mike Giftos' remarks about the metals business were particularly telling -- they've called on customer CFOs to talk about cost benefits in terms of corporate profits. Says Giftos, "You find out an awful lot about what's available to you" with such meetings and it pays off in business you never even knew existed.

Recognizing the benefits of increased prices requires delivering a superior product. The theme of CSXT President Mike Ward's remarks was "cheaper is better." A remarkable slide (which you can see in the financial area at www.csx.com) shows $65 mm of the $96 mm operating expense reduction came from just four metrics: cars on line, personal injuries, crew costs, and number of locos deployed. Moreover, said Ward, working smarter lets CSXT do things like the recent maintenance blitz on the Jacksonville-New Orleans main.

That being said, corporate earnings came in at 51 cents a share, up from 26 cents a share yoy on revenues of $2,057 mm, up from 23 cents on $2,071 mm sales in 2Q00. (Back out the real estate and other lagniappes and 2Q01 gets closer to 40 cents.) Of this, "surface transportation" generated $1.8 bn each year, however the OR dropped to 86.8 from 91.4 yoy. Railroad and intermodal operating income rose 53% to $242 mm from $158 mm a year ago. Separately, the rail OR dropped to 85.9 from 91.1 and intermodal shed 160 basis pts to 91.7.

Pricing and improved service played a major role as revenues in most commodity groups were off less than carloads in percentage terms. Only intermodal saw revenue percentage drops greater than the decrease in units. Truck conversion was a major contributor in metals, food and consumer. Finally, we're seeing "trucks off the highway." Let us rejoice.

Lagniappes nibbled at the heels of NS as 2Q01 net income dipped to $107 mm on $1.6 bn sales vs. $115 mm on $1.6 bn sales yoy causing a two-cent decrease in eps to 28 cents. Strip out the 2Q00 proceeds from some non-operating asset sales and you get 26 cents, hardly the 8% yoy decline trumpeted by the press. Operating income remained essentially the same, $282 mm vs $278 mm yoy, and the OR shed 20 BP to 82.3 from 2Q00, its best since Split Date. The big savings were in comp and benefits while Conrail SAA costs were down slightly more than 10%.

Yields improved as revenue per car rose 4%, offsetting the 3% yoy decrease in carloadings and producing the same total revenue on fewer revenue loads. Of course, this is not entirely bad. Fewer cars for the same money mean less congestion in yards and a more fluid railroad. Cars on line remain comfortably under 200,000 thus continuing a downward trend started two years ago. Average train speed started the year at 21 MPH and continues to climb and system average yard dwell time is finally under 24 hours. Doing more with less has led to $40 mm cash savings mainly from reduced fleet ownership and reduced car hire.

One place it all comes together is in loco utilization and availability. The former is pushing 70% whereas NS thought 60 was doing good a year ago. As a result, NS can do the same work with 10% fewer locos in service. That's 318 locos, if you happen to be counting, and at $1 mm-plus a copy that's no rounding error.

Lastly, the MultiModal management program embarked on late last year has morphed into "TOP" – the Thoroughbred Operating Plan." So far, it's produced operating patterns to lop 200 miles off the heavy Linwood (NC) – Elkhart (IN) route, eliminate the Knoxville block on the Linwood-New Orleans route, and brought Enola (Harrisburg, PA) back to life, relieving some of the pressure on the Allentown (PA) class yard. Faster, better, cheaper. I like it.

BNSF quarterly revenues were $2.71 bn vs $2.61 bn for 2Q00, but significantly greater expenses in all categories took operating income down 11% to $428 mm from $483 mm. Fuel was up 12% even after hedge, flooding pushed up purchased services and car hire 10% and 8% respectively. That's the bad news. The good news is RTMs were up slightly on flat loadings and RPC, RTMs per employee went up a tad and better prices have held their own.

Service is the reason. Intermodal loads were off 2.5% yet revenues were up 0.8%. Revenues for other consumer business rose 7.7% on 2.4% more loads. The industrial group took a 1.7% hit in carloads yet shed but 1.2% in revenues. The picture is less rosy with respect to freight revenue per ton-mile and coal is the culprit. Coal represents a quarter of all ton-miles yet thanks to legacy contracts and mix RTMs were up 5.2% and revenue per thousand RTMs fell 3.6%.

Operationally, IMHO these guys are way ahead of the curve in terms of service delivery and asset management. Even with the spring floods system on-time performance remains in the high 80s, a slight drop yoy. COO Carl Ice showed how most of the metrics are improving, and the cost increases seem to me more an aberration than a trend.

During the Q&A somebody asked about the prospects of any further line sales. BNSF is taking a cautious and realistic approach, looking at each branch in terms of capex exposure and revenue potential. My hope is that BNSF will look closely at how much revenue is possible because, as Chief Commercial Officer Chuck Schultz says in the BNSF company magazine, "Take ownership of everything you do because that's when opportunity happens."

Have a safe week. I'll do CN and KCS 2Q01 results next week once I get some Qs answered.

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.