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The Railroad Week in Review 8/25/2001

Short positions mid-month support our previous observations about which rail stocks are overpriced and which may be bargains. To review, some investors borrow stocks to sell when they think the market has inflated prices beyond reason and then buy them back when prices retreat from the lofty levels. The "short interest" is stated as the number of days trading at the average daily volume to trade out all short shares. The higher the number the more shares short.

Most rails hover in the one to four days short interest range; FLA and CNI come in at 6.6 days and 9.4 days respectively. The big changes in shares short were KSU with a 60% decrease and CP with a 68% increase. The swing in the east is interesting – CSX up 50% and NSC down 30%. Rival shortline operators GNWR and RAIL were down 32% and up 28% respectively in absolute number of shares short.

Want more proof the rail car leasing business is not enjoying the best of times? The GATX (NYSE: GMT) 10-Q says it outright: "Increased railroad and shipper efficiency are expected to continue affecting car demand and lease rates." The press release accompanying the earnings announcement carries s similar sentiment, "The problem of excess railcar inventories has been compounded by a slowing economy. Our customers, especially those in the chemical industry, are experiencing their own difficulties and demand for railcars has declined accordingly."

Now the icing on the cake. Drew Robertson, a good friend in NYC who follows these things intently, writes, "Car builds will reach 38,000 this year even though new car orders are the lowest since…perhaps ever. Certainly the early 1980s. It's hard to tell from the RPI quarterly data which only go back to 1987. The trouble is that there aren't any logical buyers of large quantities of new cars (except perhaps TTX)."

Stock price movement among rail industry suppliers has taken an interesting tack. Car builder Trinity Industries (NYSE: TRN) is up about 15% in the month whereas last month technical indicators pointed to a short. The recent announcement to acquire privately-held Thrall Car in a cash and stock deal worth about $350 mm, however the state of the new car market probably won't make much difference in the bottom line just yet.

Track and car component vendor ABC-NACO (Nasdaq: ABCR) is beginning to turn positive, closing the week up 15 cents from its low of 35 cents. The 10-Q for the period ending 6/30/2001 outlines steps being taken to cut costs and reduce exposure to the soft market for its products. Among them, mothballing the wheel plant, selling the Flow and Specialty Products Div, and accepting the resignation of the CEO. The company lost $21 mm in 2Q01 vs a $3 mm profit yoy, though the '01 numbers include a $9 mm restructuring charge.

Meanwhile rail construction company RailWorks (Nasdaq: RWKS) has taken a nasty spill, dropping as low as 15 cents from a buck-seventy-five two weeks ago. WIR warned of trouble brewing in this camp (7/7/2001) over too narrow and too cyclical a business portfolio. According to the 10-Q issued Monday RWKS may not be able to make its $10 mm October interest payment on the notes due 10/15/2001 and is in default on certain paper. This situation, says RWKS, "could aversely affect its ability to continue as a going concern." The situation is obviously a result of the 2Q01 loss of $38 mm ($2.48 a share) vs a $5 mm profit ($0.15 a share) a year ago. Both the CEO and the COO have left the company.

The other shoe has dropped on the other side of the world as the Australian federal, New South Wales and Victorian governments now say it's time to move on the sale of National Rail Corp. and FreightCorp. They're looking for a singe purchaser and want to have the deal done by Dec. That's a tall order as the two businesses together could fetch up to A$2 bn. Complicating matters, National Rail Corp. is 70%-owned by the federal government, with 20% owned by New South Wales. Victoria owns the remaining 10% of the business and FreightCorp is owned by the New South Wales government. The usual suspects, including GNWR, are circling.

In an audacious move on the Texas Gulf Coast BNSF and a consortium of chemical manufacturers want to put up $80 mm for 13 miles of brand new railroad into the Houston Chemical Alley stronghold UP got in the SP deal. These are no small potatoes operators, either, including the likes of Atofina Petrochemicals, Lyondell Chemical Co., and Basell USA. Construction is slated to start in 1Q03 assuming the STB says OK and first cars will roll by 2Q04.

According to Danny Machalaba in the WSJ, the BNSF partners maintain that "It costs us twice as much to ship our products out of the Bayport district as compared to some of our other facilities that have rail competition. [With this connection] we can get our transportation costs down." Needless to say, UP is not amused and has promised to "compete vigorously" with BNSF.

There are those who say earnings are earnings and attempting to zero in on core or operating results distort the picture. The question is one of what is a legitimate "extraordinary" expense. Then in Thursday's WSJ came a story about how Waste Management called truck painting and consulting fees "unusual" expenses. That was the last straw for me.

WIR has always used the Operating Ratio – expenses as a percent of revenue – as a guide to railroad performance, however we have always insisted that operating expenses be called exactly that. We also cast a leery eye on the tendency of some operators to capitalize operating expense such as locomotive overhaul or routine tie replacement.

The lesson for owners, operators, and investors is to know your economics and what constitutes operating revenue and expense. Revenue derived from asset sales has nothing to do with how one runs a railroad and so must be excluded when totting up operating revenue. Railroad retirement expense on the other hand is driven entirely by operating wages and so is an operating expense. So is painting locomotives. Class dismissed.

Roy Blanchard

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