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Shortlines created under BNSF will grow again by another 1,000 miles in the next two quarters with possibly more miles to come. Speaking at the Tuesday's 3Q01 analyst conference Matt Rose said there were three determinants to selecting a branch for spinoff. First, lowering operating expense 20% or more, cutting overall capex exposure, esp with the shortline community's ability to get public branchline infrastructure funding not available to the class 1 community. Second, the shortlines' ability to generate around 7% yoy organic revenue growth vs. the class 1s' more modest 2.5%. Third, the shortlines are simply better at gathering and distribution, which plays to the larger railroads' focus on core growth.

Carl Ice touched on this in his remarks, too (get the PDF presentation at www.bnsf.com). The service design goal (slide 35) is for no more than two connections per carload shipment, setting up train starts so fewer trains can serve more customers all within their trip plan requirements. Shortlines benefit because there is less chance for service degradation at the hands of the local industrial trainmaster.

BNSF results for the quarter held their own with revenues and carloads essentially unchanged yoy. Operating expenses were up 4%, however, pushing the quarter's OR to 78.3 from 75.4 yoy. Earnings per share dipped 9.4% to $0.58 from $0.64 yoy. Still, in his concluding remarks Rose said BNSF will continue to follow the yield-based business model, reducing the expense run-rate, and remaining on track for one $billion in FCF by '05.

Revisiting the UP quarterly results, estimated freight revenue for '01 is up a mere 60 basis points, yet coal revenue is expected to be up a whopping 9.4%. Freight revenue estimates for '02 are up 1.4% over '01, and automotive leads the pack, up 5%. Going into '03 intermodal takes the lead up 7% with automotive and chems at 5%.

Industrial finally makes a showing in '03 at 4%, from minus 50 bp in '01 to a plus 2% in '02. The message for shortlines is to start building the franchise today for an accelerating rate of growth over the two years. UP operating income for the last two years showed a smaller change yoy than for earnings per share. In '03 it reverses again with the Morgan Stanley estimate showing operating earnings up 16.3% and eps up 23.5%. ROE (margin* yield* leverage) hits 10% in '03 as debt/cap finally falls below 40%.

Canadian Pacific freight revenues were flat at $859 mm while operating expense dropped 2% thanks to labor reductions, other cost cutting initiatives and fuel prices. However, higher purchased services expense, which reflects CPR's shift toward contracting out more services, offset some of the expense savings. After split-related charges pro forma earnings (there was no CP Rail trading as such a year ago) rose 43% to $0.86 from $0.60, largely due to lower taxes.

Revenue per RTM was up 2% on higher bulk freight rates and relatively stable revenues despite the soft economy. Met coal was up as was automotive, thanks in part to higher imports through Vancouver. Export grains and paper softened somewhat while revenue from the intermodal and industrial products business groups remained virtually unchanged from 3Q00.

CP continued to expand its scheduled railway operations in the quarter, generating improved asset utilization and reduced train expenses. Fuel consumption improved 2%, average train weights were up 2%, and operating expenses per gross ton-mile were down 1%. The market has sent CP stock up 18% since October 1 and analysts see still further room for growth.

It was encouraging to see that CSX held its own in railroad freight income. Per share earnings jumped 68% yoy on what some would call "easy comps," however the real message is that recovery from the depths of the Conrail absorption is well nigh. With what CFO Paul Goodwin called "sizable cost takeouts" and interest rates down, the stage is set for improving returns. Operating revenues remained at $2 bn yoy, however operating income was up 26% yoy.

CSXT President Mike Ward set the theme for the presentation (see www.csxt.com for PDF slides). Ward said train starts are being consolidated wherever possible without hurting dock-to-dock service. Better service begets better rates that can in turn be used to good effect to offset the present economic weakness. Truck conversions continue at an accelerating rate, running about 350,000 annual highway loads to CSXT rails, worth some $130 mm in new revs.

Shortlines would do well to study Chief Commercial Officer Mike Giftos' "Flat and Favorable" exhibit (slide 21) in concert with the service design graphic (slide 24). Though it is unlikely CSXT will do any spin-offs near term, the opportunities are there for increased feeder line revenue contributions. The outlook for 4Q01 is flat revenues yoy, however with the improvements in cost takeouts and operating efficiency earnings ought to show another nice bump (consensus FY 2001 $1.63 vs $0.93 yoy). Says Ward, "Better service *is* cheaper."

Norfolk Southern was next up, posting earnings of $0.20 a share vs. $0.14 yoy and a Street estimate of $0.20. CEO David Goode hit the theme squarely: creating a "service we can sell." True, the soft economy took NS carloadings down 6.3% however there was a mere 1.3% drop in freight revenues. The big revenue hits were auto (4.3%) and intermodal (4.8%). Coal revs rose 0.8% despite a 5.1% hit in carloads (mainly export). See slides at www.nscop.com.

Broadening the picture somewhat, revenue per carload improved 4.9%, and 5% was shaved off operating expense yoy thus lopping 2.5 points off the OR, to 83.2. COO Steve Tobias rattled off a number of improved yoy metrics – loco utilization 72% vs. 61%, 30% improvement in on-time performance, TYES network 2/3 rolled out, gtm per gallon of fuel up 4%, average dwell 23 hours – you get the picture. As a result, railway operating income was up 16%.

More than 176,000 truckload conversions in metals, paper, and automotive contributed an estimated $55 mm in new money. These two themes – truckload conversions and improved productivity – send a clear message to NS shortline connections. As the Chairman said in the Q&A, "NS is looking for constructive partnerships that protect and enhance the revenue stream." Later on, he told me he is looking for "creativity" in branch line solutions. Recall that carload freight is 40% of total NS revenue, and that branch lines are mainly merchandise.

Next week: CN, KCS results.

Roy Blanchard

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