The Railroad Week in Review 11/3/2001

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Kansas City Southern (KSU) closed out 3Q01 with $9.0 mm net income, 15 cents a share, from continuing operations vs. $2.6 mm or a nickel a share in '00. This tripling of net income was driven almost entirely by improved domestic operating income, up 10.3% to $16 mm, and Grupo TFM, $7.5 mm vs. 2.6 mm yoy. KCS Railroad revenues were essentially flat, 144 mm, with some strength in coal offsetting weaknesses in chems, ag, and intermodal. Operating expenses for the quarter were unchanged at $129 mm yoy.

Looking ahead, KCS President Mike Haverty says Q4 revs will be about the same as Q3. Costs may decline somewhat and the railroad can hold back capital improvements until the economy improves because it has been investing heavily over the last few years. KSU shares are up nearly 50% in the past 12 months vs a 20% decline in the S&P in the same period.

Investors will note, however, that after the initial run-up to $16 from $9 in the first six months following the split, KSU has been mired in a trading range drifting slowly down from its highs. There my be some upside left, however, as options players focus on the Dec 15 and 20 calls with the underlying at $12.50.

Canadian National wrapped up another stellar quarter, pushing net income up 11% to $250 mm or $1.21 per share, $1.27 after a tax credit. Operating income rose 6% to $430 mm as the OR shed another 1.9 points to a highly respectable 67.5, lowest in the biz by a bunch. Revs for the Q were flat at $1.3 bn on a 4% drop in carloadings and a 9% improvement in revenue per carload. Double-digit gains in earnings in this environment are an admirable feat for anybody, much less a railroad.

During the quarter CN experienced lower revenues in grain, fertilizers, and automotive. Partially offsetting these decreases were higher revenues for metals and minerals driven by strong Canadian aluminum exports to the United States and market share gains in steel, ores and concentrates; increased forest products revenues as a result of higher lumber shipments, and the impact of the weaker Canadian dollar. Four of seven business units posted revenue gains in the third quarter: metals and minerals 16%, forest products 3%, intermodal and coal 1% each. Petroleum and chemicals revenues were flat, while revenues were off 8% in automotive and 4% in grain and fertilizers.

CN continues to lead the major rails in Wall St recommendations. Says Morgan Stanley's Jim Valentine, "They followed through on a promise to walk away from low-margin business during the quarter and watched carload volumes fall 4.3%, but saw margins expand by 190 bps." The earnings picture for the quarter shows what ALL the rails are doing to improve returns. Tony Hatch writes, "Overall, cost cutting rules the day, along with yield improvement and tight capital budgets, as rails turned in a solid, solid set of performances in difficult circumstances."

BNSF shortlines should be well pleased with the story they heard at this week's annual gathering in Fort Worth. Against the backdrop of BNSF 3Q earnings somewhat below expectations, the group was treated to an impressive display of initiatives, chiefly in service design and making it easier to do business with BNSF and its shortline connections. With respect to the first, the

Transportation Service Planning (TSP) process mandates complete, timely, and accurate car management data flow between large and small rails. VP Service Design Rollin Breedenberg outlined a menu of options to make shortlines part of the TSP and carload trip plans, but they all require an accurate and measurable Interline Service Agreement (ISA) going in.

My correspondence over the past year with shortlines all over the map says that getting ISAs in place has been like pulling teeth, with nobody taking any real accountability. The time has come for shortlines to step up to the plate and make themselves part of the TSP. Only then can shortlines participate in the coming revolution in rate-making and web-based rail transportation management. See BNSF's "Virtual Customer Consultant" (www.bnsf.com/vicc) and the public pricing page, www.railprices.com.

Some have written and said that public pricing works to the disadvantage of the big shipper moving on contract rates. Not necessarily so. The real push here is to capture the potential rail user that has been intimidated by the rail pricing process. Remember that the BNSF byword in its growth strategy is "Ease of doing business." Bookmark these pages, run some sample OD pairs for your customers and commodities, and see how it works. The view from here is these two sites alone ought to create significant new revenue opportunities at relatively little incremental cost.

Shortline holding company Genesee & Wyoming (GNWR) reported 3Q01 results this week. Net income was $4.5 mm, $5.4 mm excluding the results of the "Speedlink" logistics subsidiary, which ceased operations on September 30. So in terms of "continuing operations" we're looking at a 31% bump in per share earnings yoy, 63 cents over 48 cents. North American (US, Canada, Mex.) rail revs increased 3.6% to $42 mm yoy.

Operating income dipped 9% to $5.1 mm from $5.6 mm as the OR picked up 160 BP to 87.9. Absent the Speedlink effect, the OR would be 84.8. In Australia, 3Q revs from the Australian Railroad Group (ARG) hit US$46.7 mm with operating income of US$13.1 mm. The operating ratio was 71.9%. Net income at ARG was US$5.4 mm of which 50%, or US$2.7 million, was reflected as equity income to GNWR. Equity income from GNWR's 22.6% indirect ownership of a Bolivian railroad, Empresa Ferroviaria Oriental, S.A., was $0.2 mm for the quarter.

Coal revs in Illinois and New York-Pennsylvania offset the downturn in paper, lower cement and petroleum traffic in the PNW and Mexico. Strong grain shipments in South Australia and good iron ore shipments in Western Australia were in line with expectations. ARG has renegotiated a long-term contract with ALCOA and management expects the 2001-02 grain harvest in Western Australia will be slightly better than last year's harvest.

Providence & Worcester (PWX) has hit the technicals screen as a short candidate. Every trading day since 10/19 has been down on higher than usual volume and wider than usual price swings. By way of review, 2Q01 eps was 7 cents vs 23 cents yoy on revenues of $5.9 mm vs. $7.3 mm, $1.3 mm of which was "other income" from easement sales in 6/00. Rail revenues declined 5% to $5.7 mm from $6 mm yoy. The rail operating ratio is in the 90s, not good for an outfit this size. What do they do when they run out of property to sell?

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.