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The Railroad Week in Review 11/10/2001

Ike Prillaman, Vice Chair and Chief Commercial Officer for NS, writes, "Amid a global war on terrorism and continuing economic softness, there are encouraging prospects in our carload business mix including metals, chemicals, paper and agriculture. Late last year, we began a redesign of our merchandise service network. A cross-functional team worked to develop our Thoroughbred Operating Plan (TOP) that we've now implemented on two-thirds of our merchandise network. We now have a single comprehensive plan that allows all of us to work much more closely to provide the reliable and dependable service our customers must have, and what we must offer and deliver in order to grow our business." (www.nscorp.com/newsbreak)

Elsewhere in "Newsbreak," NS reports "TOP is the combined effort of Marketing, Transportation Planning, Car Distribution, Strategic Planning and field operations employees working with MultiModal Applied Systems (www.multimodalinc.com). The premise is that reducing the number of times a car is handled and the distance it travels will reduce both costs and variability, with improved shipment velocity. These added efficiencies, coupled with consistency, will help boost customer confidence and drive new business. Full implementation expected in 1Q02.

RailAmerica (RAIL) will buy three more shortlines, this time from ParkSierra Corp. for $48 mm in cash and RAIL stock. ParkSierra expects $9 mm on earnings before taxes and depreciation on revs of $24 mm for 2001, yielding a price-sales ratio of 2.0 and price/EBITDA of 5.3. RAIL itself at the close of 2000 sold for 0.66 times sales and 2.43 time EBITDA. The ParkSierra buy plus the previously announced StatesRail deal will add roughly 2,400 miles and 240,000 annual carloads to the RAIL portfolio.

Commenting on the anticipated merger benefits, COO Gary Spiegel noted that since the RailTex acquisition the safety records of the combined properties improved to two reportable accidents per 200,000 hours worked from five beforehand. Spiegel also said during the conference call that the expected $10 mm in savings from the RTEX buy came in closer to $14 mm and we should see the pattern repeat on these two buys. CEO Gary Marino said same-store carloadings were up 5% yoy and he expected this to continue.

The RAIL portfolio including StatesRail and Park Sierra will run a million carloads a year on 8600 route miles of track, 116 carloads per mile, improving my previous count by six cars. This ought to improve, however, as RAIL sheds the poorer performers (under 100 cars per mile per year) and adds stronger lines from similar transactions and the inevitable class 1 rationalizations. With the debt/equity ratio now down to about 2.0, and the focus on better-yielding properties that complement the portfolio, this latest combo could be good for the shortline biz.

Shortlines on my e-mail advisory list have been most helpful and encouraging in my proxy project. I am building a list of NYSE companies that are leaders in the commodity groups most apt to be found on feeder line railroads – grain and grain products, chemicals from petroleum to plastic, building and forest products, packaged foods (STCC 20 mostly), manufactured goods. The idea is that following stock performance and news on these firms may be a better proxy for where shortlines are headed than any macro industry or rail industry news.

Two proxies made the Zack's Number One list on Thursday: Procter & Gamble (PG) and ConAgra (CAG). Zack's thinks PG will outrun previous growth rates on consumers' renewed preference for "basic goods." CAG gets a nod for the same reason, with Zacks citing "new steps to improve sales." Meanwhile processed food maker Heinz (HNZ) shed $3 (7%) on Friday after reporting expected 3Q earnings below 2Q results. Ketchups, sauces, soups and desserts "remain sound." Steel maker Nucor (NUE) was up 6% for the week on no news.

Providence & Worcester (PWX) earned a dime a share in 3Q01 vs. 11 cents a year ago. As reported last week, non-railroad revenues have a significant on earnings, and I prefer to back them out to get at railroad performance. Freight revenues dipped 2.3%, operating income fell 9.5%, and the OR picked up 70 BP to 90.2. For the trailing 12 months, operating income rose 28.3% while eps fell 53.8% largely due to property sales in 2000 not repeated in 2001.

The press release accompanying the latest report says, "The decrease in conventional carloadings is attributable to delays or losses of freight resulting from the terrorist acts of September 11, 2001. During October the Company's conventional freight carloadings returned to their pre September 11, 2001 levels. The decrease in container freight traffic results from the loss of a customer and weaker economic conditions." So far, PWX has not responded to repeated requests for more details on the operating picture. Let's see what Q4 brings.

Chatting with one of my chums at BNSF the other day we touched on the subject of how different reporters write up earnings week. A classic hit my desk this week, comparing 3Q results for CSX and NS. First, this: "CSX said third-quarter operating earnings rose 69% on cost cuts and higher prices." Hard on its heels came this news: "Railway operator Norfolk Southern said its third-quarter net income fell 20%, hurt by lower freight demand in the slowing economy."

Comparing results as above is to err on several counts. The first talks about CSX operating earnings and the second about NS net income – not the same thing. Moreover, what the article calls CSXT "operating earnings" is really "net income before discontinued operations" and is compared with NS net income before adjustments for one-time nonrecurring items. If you go to the CSX "Flash" you'll see earnings before discontinued operations $100 mm in 3Q01 vs $59 mm in 3Q00, up 69% and that's what the writer picked up. Add back the net from operations discontinued in 3Q00 and the net becomes $427 mm, a decrease of 75% yoy.

As for NS, reported earnings were $79 mm in 3Q01 vs $99 mm in 3Q00, off 20%. Fair enough. Now back out the 3Q00 $45 mm net after tax benefit from timber sales and net income from continuing operations becomes $54 mm, putting NS net from continuing operations *up* 46%. Note too that CSX includes app $250 mm non-RR revs, yielding in the range of $30 mm operating income each year. The lesson here is that you really have to run your own numbers.

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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.