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The Railroad Week in Review 6/22/2002

Rail traffic for Week 23 ending 6/8 was up 2% yoy, and no real surprises there. The surprise is the extent to which Union Pacific exceeded the averages for all five measurement periods this year (see chart at end). This bodes well for UP's shortline community, in particular the holding companies like RailAmerica where 28% of revenues comes from UP connections.

To be sure, shortlines are mostly merchandise carload operations with little play in the intermodal or coal trades. However, the carload side of the house typically enjoys higher margins than the other two, and with the shortlines growing carload traffic twice as fast as the class 1s, everybody makes out.

On the equity side, rail stocks this week again bested the DJIA. While the index was off 2% NS again took the class 1 brass ring, up 6% vs. 2% apiece for BN, UP and CSX. The Canadians remained in the plus 2% range as well as did KCS. GNWR rang up a 10% gain while RRA slipped below its Monday price, down 5% for the week.

Looking ahead Goldman Sachs sees slow growth in the 2% range for the balance of 2002 and 3% or a little better in 2003. If the class 1s can grow at the GNP rate and still take some points of the OR, then there is some additional price appreciation possible, though the elevated PEs of some players would appear to have the gains priced in already. However, if shortline companies like GNWR and RRA can grow at twice the class 1 rate AND take out costs, then that side could prove rather entertaining in 2003.

On a related note, Goldman Sachs initiated rail industry coverage on Wednesday by putting BNSF on its "Recommended List." UP and CN were listed as "marker outperformers" while CSX and NS are expected to be "market performers." The accompanying research note said Goldman views the rails as reasonably priced and with earnings momentum that should produce low double-digit returns going forward. Boring isn't bad in this market.

Railway suppliers Trinity, Greenbrier and Wabco stayed ahead of the index, though Trinity did best of all with a 6% gain vs. a percent or two for the others. GATX shed two percentage points, however, on no particular news. Still, the car business remains a shadow of its former self. Railway Age reports 1Q02 deliveries down 65% to 3,855 yoy, new orders off 69% to 2,637, and the back shriveled 68% to 6,443 from 19,991. Maybe that's why TRN shorts are up 37% in June.

Grain receivers in the Southeast are taking bigger trains. High-horsepower, high-adhesion locomotives have ratcheted up optimal train size to 75 cars from 50 cars. All of which is fine for the large receiver equipped to take the big trains. Smaller facilities can be accommodated as well, but that takes a bit more creativity.

These feed grain receivers need not face the same fate as the non-shuttle train grain elevators in the west. Density is one reason. There are, for example, several places in the Carolinas where there are multiple receivers along a single stretch of track or on a shortline. Individual trains can alternate trips between receivers or run directly to shortline yards with the class 1 power and crews in place. CSXT has its Express Load/Unload program that pays the customer to release the train in 24 hours and will keep the power on the train to do it. That solves the problem of limited track space.

At both CSXT and NS the grain groups has teamed up with their bulk transfer group to offer truck transloads to reach sites the big trains can't. These are mostly small operations that are either not-rail served or are single-car receivers along congested lines such as Amtrak's Phila-Harrisburg route. Suffice to say the economic advantages of bigger trains plus scheduled operations will offer lower transit costs to more customers, not fewer.

Railroad bonds are back in favor according to a Dow Jones news item. BNSF, for example, was in the market Tuesday with a $300 mm offering 113 basis points over Treasurys, though spreads were as wide as 180 BP eight months ago. The article says rail bonds always trade tight relative to ratings and the market uncertainty has made the sector even richer.

The rails have a couple things going for them in the credit market. One, rails are seen as strategic assets and while there's no government guarantee they always get a lot of support. Two, the Big Four in the USA don't have a lot of rail competition except from each other. Ergo much of the volatility is removed from the revenue stream.

Consequently rail pricing power remains pretty much intact. Moreover, industrial production is showing signs of resurgence (see chems -- leading indicator? in WIR 6/15/2002) and that means more goods to move. As one fixed income investor put it, "Investors believe stability is worth paying for."

David Gunn's promise to shut down Amtrak July 1 got stronger when Jim Lehrer interviewed him on PBS June 13. Asked whether he was serious, Gunn replied, "If we can't get $200 mm to cover operating expenses July-September we're going to close down." The problem is that Congress mandated where Amtrak had to run while at the same time mandating self-sufficiency without the market to support the fare box.

He makes some of good points: One, USAirways wants a $billion grant to keep flying yet there are alternative carriers every place it goes. Why should they be kept in business any more than Amtrak, with its dominant share of the NY-Washington shuttle trade? Two, why should folks along the NEC support a four-lane Interstate in the middle of North Dakota? "There's not a rail passenger system in the world that doesn't require government subsidy for some either capital or operating or both."

"The passenger movement or transportation market in the United States is [already] thoroughly subsidized, whether it's highway airlines or [commuter] rail." To get the full flavor, go to http://www.pbs.org/newshour/bb/transportation/jan-june02/gunn_6-13.html# and dial up the video while you're at it. Two weeks to go and I still don't know whether my granddaughter will be able to come up from Georgia on the *Crescent*.

Roy Blanchard

Roy Blanchard provides railroad financial and operating performance measures for shortlines and shippers. 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.

AAR Carloads thru June 8, 2002

UP vs 7 class 1s plus WC

Percent Change	% of Traff	Q1	Q2TD	YTD	4 Weeks	Week 23
Total Commodity	78.3	-3.2	-2.2	-2.7	-1.7	-1.1
UP	79.2	0.6	1.0	0.8	-0.2	2.4
UP Advantage	*0.9*	*3.8*	*3.2*	*3.5*	*1.5*	*3.5*
Grain	5.2	-4.7	0.2	-2.8	4.3	8.9
UP	5.2	2.2	2.3	2.3	7.5	13.9
UP Advantage	*0.0*	*6.9*	*2.1*	*5.1*	*3.2*	*5.0*
Chemicals	7.2	-2.6	5.5	0.9	8.2	8.6
UP	10.4	-0.5	3.2	1.1	4.1	9.9
UP Advantage	*3.2*	*2.1*	*-2.3*	*0.2*	*-4.1*	*1.3*
Coal	32.8	-4.6	-6.7	-5.5	-6.6	-6.8
UP	28.3	1.9	-2.5	0.0	-5.9	-2.0
UP Advantage	*-4.5*	*6.5*	*4.2*	*5.5*	*0.7*	*4.8*
Intermodal	21.7	-0.3	8.7	3.6	8.9	8.6
UP	20.8	-1.0	10.7	4.0	11.8	12.8
UP Advantage	*-0.9*	*-0.7*	*2.0*	*0.4*	*2.9*	*4.2*
Total Volume	100	-2.2	1.5	-0.6	1.9	2.3
UP	100	0.1	4.3	1.9	3.8	6.0
UP Advantage	*0.0*	*2.3*	*2.8*	*2.5*	*1.9*	*3.7*

Carload Conclusions:

UP's commodity traffic base is 90 basis points higher than average and dominates gains in every period

UP grain growth withstood the 1Q02 slide and takes honors in Week 23

UP chemicals weakened in Q2 while the others did not. How odd.

UP total volume change has been positive in every period avoiding any Q1 weakness