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The Railroad Week in Review 7/5/2002

Union Pacific turned 140 years old on Monday, celebrating by finishing Week 25 (6/25) with traffic volume up 7% vs. 2.8% for North America as a whole. UP's beginnings are documented in Stephen Ambrose's *Nothing Like It in the World*, a must for any student of the railway scene. What was particularly fascinating for me was to have the present-day track charts at hand as I followed the Ambrose narrative across Nebraska and into Wyoming. Get the book; there will be a quiz if I see you in Omaha next month.

Elsewhere, UP confirmed that the 12% yoy intermodal traffic surge is due in part to container pre-shipping on fears of a dock-workers strike in the West. Contracts have been extended on a day-to-day basis. Some 10,000 workers in one union have a monopoly on labor supply across 29 ports. It seems the main issue is computer technology.

BNSF scored some nice yoy gains for Week 25 with chems up 7.2% and intermodal up 8.6%, bringing the railroad's YTD traffic growth record to within one percentage point of 2001. Grain and coal continue to lag YTD however the 4-week trend flags a potential bottom. Rail analyst Jim Valentine feels the turn is enough to boost the current quarter's estimate by five cents. The view from here is that the BNSF carload franchise, combined with some very astute service design, has reached and passed an inflection point. Given the current manufacturing trends and consumer spending patterns – Worldcom et al not withstanding – another nickel a share this quarter for BNSF seems reasonable enough.

Meanwhile Goldman Sachs initiated coverage of the rail industry by adding BNSF to its Recommended List, tagging CN Market Outperformer, and awarding the whole group a Modestly Overweight position. Their rationale is the present momentum combined with reasonable valuations should produce low double-digit returns with below-market risk. Long-term Free Cash Flow (see below) is called "a key metric for the mature industry" and both BNSF and CN are expected to perform well here.

Earnings Week begins with the UP conference call July 18. Norfolk and BNSF will be in NYC on successive days the next week. As of Friday estimates for the Big Six class 1s are mostly up, though BNSF and CP are expected to be off 4% and 3% respectively. Analysts expect CSX and NS to be up 14% and 7% respectively, due in part to easy comps from last year's continuing Conrail hangover. Look for UP to increase eps by 11% and CN by 9%, both on carload momentum established in 1H02. Watch the websites for conference call details.

Cash flow details are going to be especially important in this wary environment. A fixed income analyst I know called the other day and we got chatting about Ebitda and the link to free cash flow (FCF). As noted here before, depreciation lets you write off what's worn out so you can replace it. Railroads are a wasting asset whether you're making any money or not, and if there's insufficient depreciation to support capex you go to the bank. Interest must be paid, and that cuts into operating cash flow. Ideally, FCF as a percentage of revenue should be equal to or greater than the net margin. BNSF, for one, is getting close (see chart).

Canadian Pacific and Norfolk Southern are doing some track swapping in Penna and the state is ponying up to absorb some of the cost. The deal is this: CP gives NS rights over its ex-PRR line from Sunbury to Scranton and over the old D&H to Mechanicsville. This gives NS a competitive route to New England and boosts traffic density on CP lines, a desirable end in itself.

It's a single track railroad out there, so NS and Penn DOT will plunk down $2 mm to build a run-around at Clarks Summit PA. The new agreement succeeds a previous haulage agreement and puts more freight on the Sunbury line, where NS and CP spent $12 mm four years ago, and where there is now capacity to spare.

RailAmerica (RRA) carloadings for May and through Week 22 were announced two weeks ago but due to space limitations we did not pick them up. Let me rectify that omission now. North American May carloads rose 23% yoy thanks to the StatesRail and Park Sierra acquisitions some months ago. The YTD increase was 22%. On a "same railroad" basis loadings were off 2% for the month and YTD. Nationally, class 1 carloads through May were off 1%, though if you strip out gains from intermodal the commodity decline approached 3%.

RRA's May was particularly strong in metals, minerals and paper with double digit increases. Recall also that GNWR was strong in forest products (WIR 6/15/2002). Through May class 1 wood and paper carloads were off 6%. Why the spread? IMHO it has to do with service. The whole forest products business is fragmented with many origins and many destinations, driving up both fixed and variable costs. Revenues aren't all that hot, either.

Thus it's not surprising that many of the first lines to be spun off by the class 1s were heavily into wood chips, pulp, paper, dimensional lumber and sheet products. Yet one of the secrets of success in the forest products commodity group is equipment velocity. A shortline will drill a customer a couple of times a day if need be to keep the loads and empties from piling up on industry tracks.

Class 1s will tell you car cost is a major consideration in pricing forest products rates and yet very often they are their own worst enemies in this regard. We see cars released loaded on consecutive days only to be placed at the destination on the same day in greater quantities than the customer can handle demurrage-free. We see new business turned down due to equipment shortage while the very cars needed at A are languishing empty at B. Shortlines, at least, can time pull and place to match supply chain requirements and fill in class 1s' car shorts. That keeps the customer happy and gives the class 1 the long haul with fewer O-D pairs to worry about.

CSX has sent notices to the newspapers in all the states it services with the headline, "Residents of [State] Urged top Stay Off Railroad Tracks!" The sorry fact of the matter is that last year nationwide nearly a thousand souls were killed or injured while wrongly on railroad property. And to drive the fact home, the notice gives the grizzly facts by state: "In Alabama last year 12 people were killed and three were injured while trespassing on railroad property." Moreover, "An automobile being hit by a train is proportional to a soda can being hit by an auto and a 55-MPH train will take the length of 18 football fields to stop." I hope the shortlines will pick up these releases and spread them around *their* service areas.

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Roy Blanchard provides railroad financial and operating performance measurements 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.

Big Six Class 1 Railroad Free Cash Flow (operating cash flow less capital expenditures)

Railroad	**BNSF**	**CN**	**CP**	**CSXT**	**NS**	**UP**
Ticker	BNI	CNI	CP	CSX	NSC	UNP
Year ending	**12/31/01**	**12/31/01**	**12/31/01**	**12/31/01**	**12/31/01**	**12/31/01**
Net margin	8.04%	18.40%	11.08%	4.07%	6.08%	9.30%
Cash Flow						
Ops cash flow	$ 2,197.00	$ 1,621.00	$ 759.00	$ 827.00	$ 654.00	$ 1,992.00
Capex	$ (1,549.00)	$ (1,058.00)	$ (566.00)	$ (930.00)	$ (746.00)	$ (1,736.00)
FCF before divs	$ 648.00	$ 563.00	$ 193.00	$ (103.00)	$ (92.00)	$ 256.00
FCF Margin*	7.13%	9.96%	5.22%	-1.43%	-1.49%	2.46%

*Free Cash Flow as a percent of revenue; CSX and UP are corporate cash flow numbers.
Source: Railroad Financial Statements