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**The Railroad Week in Review**
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**W**ar news glommed the front page this week as investors and pundits scrambled to figure out what it all means. One thing it means is increased attention to what's going on around you and trying to stay ahead of what the Army euphemistically calls "the bad guys." Several games are afoot. According to the AAR the freight railroads have established a progressive series of counter-terrorism measures based on the level of threat against the industry.

With the start of military action against Iraq, the industry has taken additional security steps including real-time monitoring and additional surveillance of designated trains, increased security at certain rail yards, increased inspection of priority track, tunnels and bridges, and working with customers to tighten control of supply chain logistics. Rich Timmons, President of the ASLRRA, and a former military man, recently told the TEA-21 subcommittee the shortlines "carry the same security requirements and demands that the Class I railroads shoulder each day." And the local law enforcement agencies are glad to help, if you let them know what to look for.

**G**enesee & Wyoming (GWR) acquired the Utah Railway in 3Q02, not 2Q02 as reported here last week, so, in the words of one reader, "Q4 will be the first apple." Elsewhere, I was comparing GWR's 2002 Australian results with those of RRA. How could one emerge relatively unscathed while the other one gets clobbered? A look at the map shows that Victoria (RRA's venue) is 2,000 miles from Western Australia (GWR territory).

A second factor has to do with commodity mix. GWR's Australian Rail Group is blessed with ample quantities of iron ore, alumina, and bauxite, in addition to grain. Conversely RRA's Freight Australia generated half its 2002 revenue from the ag side and they have said they're looking to expand the commodity base in 2003.

**S**martmoney.com ran an on-line piece called "Stocks for the Foxhole" on March 19, selecting CSX as one of its eight picks. Selection was on the basis of low beta (less than 1 means less volatile than the market as a whole), positive margins, debt-to-capital less than oh-point-five, a strong revenue stream and a market cap north of a $billion. CSX made the grade and if you have WIR's Quarterly Review turn to page 5 and follow along.

The article cites STB performance measures on train speed (up 24%), yard dwell time (30% improved), and much better on-time arrivals and departures. Turning to page 17 in the WIR Quarterly, we get full-year freight revenues up 2% on flat carloads, railroad operating income up 10%, and a 120 basis point OR reduction to 86.1. First Call says 2004 estimates have CSX up 21% vs. 14% for the S&P and a 2003 PEG ratio of 1.04 vs. 1.44 for the index. Concludes smartmoney.com, "Add to that a beta of 0.5, and cautious investors may wish to hop aboard."

**R**ailAmerica's slides for the Deutche Bank presentation are up for your viewing pleasure at www.railamerica.com and are worth while for three reasons. First, you can see RRA's strategy and the numbers that drive it all in one place. Second, the slides provide some insights as to the state of the shortline industry as a whole. Third, the presentation gives us greater transparency as to what drives the results.

With respect to the first, the 50% debt/equity target is laudable and within the “sweet spot” mentioned before. I’m more comfortable with net proceeds from Ferronor in the $30-40 mm range, meaning anther $60-70 mm has to come from asset sales. The trains.com letter reports that the Nova Scotia line may be truncated by 100 miles and Vancouver Island’s E&N will go to a local consortium. There are more than a dozen relatively light-density shortlines that seem to me sale candidates though it remains to be seen what sort of sales multiples they will bring.

As to shortlines, start with slide 11 and see where RRA thinks the growth will be. Note the “other shortline” target in terms of financial parameters. This seems an apt measurement set for any shortline operator – the operating ratio, the ratio of free cash flow to revenues and earnings before taxes and depreciation. RRA has found that economies of scale may be had, too, per slides 13 and 18. This supports my thesis that the trend is toward fewer independent names as the big get bigger. But the best part is the 5-6% carload growth because it comes largely from closeness to the customer, and if RRA can do it then so can other shortlines.

**F**red Smith of Fed Ex said 15 years ago that “information about a shipment is as important as the shipment itself.” Yet here today on the cusp of the 21st century much of the rail industry still uses the same manual reporting processes in vogue at the turn of the last century. A car moves, somebody writes it down, and somebody else reports to the next party up the line. All we’ve done is substitute the internet and Train II for the telegraph.

Until the event record triggers the next event it might as well not even exist. The challenge is to post the event report at the same time as the event is complete, to get the updates into the transaction system immediately, and make the event record available to every constituent – customer, railroad operating manager, and railroad commodity manager – simultaneously. Keypads in the cab aren’t reliable – all they do is transfer the clerical activity to the field and are even more prone to keyboard errors. Any ideas?

**L**ast week I asked if there were any readers to take the other side of my idea that most line sales will be from shortline to shortline. Nobody did, however long-time reader offered these thoughts: “There is a downside that occurs when one shortline sells its franchise to another shortline for a premium. Good for the seller--it walks away with lots of cash and no cares regarding the future of the franchise it just sold. Bad for the connecting Class I, left having to find a way to salvage its business with a now, highly-leveraged shortline.

“So what happens? At the first sign of financial troubles, the leveraged new shortline knocks on the Class I's door, asking for higher divisions to survive. That same Class I probably sold or leased the line far below market value to keep the original shortline's debt low in order to not upset the cost structure to assure that traffic continues to move by rail. The high-dollar sale undermines that effort.

“Lesson here: Anybody contemplating purchase of a property from an existing shortline must first determine the existing divisions from the connecting Class I and bid accordingly--the divisions today are the divisions tomorrow. Class I's should not be burdened with financing (through higher divisions) the premium paid by the acquiring shortline and, yes, the seller's bank account.” That’s good advice and *caveat emptor*.

***Roy Blanchard writes and consults on railroad commercial, financial and operating best practices for shortlines and shippers. Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned here. A list of such holdings is available on request.***