The Railroad Week in Review
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Kansas City Southern posted a 3% revenue decline, a 2% expense increase and a 44% decline in operating income for its KCSR unit, $7 mm vs. $13 mm yoy. Equity earnings in TFM rose 40% to $7 mm thanks in part to KCS' increased TFM ownership, 46.6% vs. 36.9%. There was no offset to last year's $4 mm gain on the purchase of the Mexican government interest in Mexirail. True, there was a $9 mm credit due to the cumulative effects of the accounting change, but we continue to omit that line for our purposes. Earnings per share dropped 52% to eight cents.

Paper and chems revs were up, but so was demurrage. That's a definite negative. It's an indication that supply chain schedules involving the railroad are broken, else cars would be loaded and unloaded as offered. Demurrage is accidental income and ought not to be a line item – or worse – used to offset car hire. A scheduled railroad and dock-to-dock transit time commitments eliminate demurrage for two reasons. First, empties not supplied as ordered can't be CP'd and charged to the customer. Second, loads that miss their trip plan commitments and get CP'd must be charged to the railroad, not the customer.

Elsewhere, KCS won the necessary consents from its Bank Group to combine itself, Tex-Mex, and TFM into a new entity, NAFTA Rail. The terms are for KCS to buy Grupo TMM's 38.8% interest in the TFM railroad for stock and cash. The stock portion will be 18 mm shares worth $212 mm at $11.77 a share (KCS closed Friday at $11.00). Cash comes in the form of $200 mm down plus as much as $180 mm if the Mexican VAT issue is solved to everybody's satisfaction. Tex-Mex comes wholly under KCS control for a pittance, $32 mm. The entire transaction is expected to be accretive early on.

Then there's the matter of the October put option owned by the Mexican government for its 23.9% interest in TFM worth about $500 mm. Odds are that option is unlikely to be exercised before the VAT thing is resolved. Anyway, this combination gives KCS 76.1% interest in TFM assuming the regulators in both countries pass. The NAFTA Rail system will deliver a single-line haul between KC and Springfield, Illinois (Omaha if you count trackage rights) in the North and Veracruz, Mexico City and Lazero Cardenas in the South. The "NAFTA Rail Transaction Discussion" tab at www.kcsi.com is a worthwhile read for the details.

In a meeting with investors in NY this week CEO Mike Haverty said dividends are not in the cards and that capex has to come first. Recall that in January KCS said capex will remain "in the range of" 12-15% of revenue. For 2002 capex was $81 mm on revenues of 583 mm, 13.8%. Free cash flow after asset sales was $61 mm on $92 mm cash from operating activities. KCS also paid down $75 mm in debt, lowering the debt/cap ratio to a respectable 44%.

CSX freight revenues increased 5% to $1.8 bn in 1Q03 however operating expensed crept up 7% causing ops income to drop 13% to $177 mm and the OR to bump up 1.9 points to 90.8. Fuel and weather-related expenses added $25 mm or nearly a quarter of the yoy expense increase. Fuel increased by $54 mm of which $13 mm was billed back to customers as fuel surcharges. Price was the main culprit, averaging $1.05 per gal vs. $0.71 yoy. GTMs rose 1% but fuel consumption per mm GTM was down 2%.

Freight rate increases appear to be sticking. Revenue per unit (RPU) was up 2% and volume increased 3%. Merchandise carload revenue was up 6% on 3% more carloads. Metals and emerging markets were the bright spots, though the latter included $17 mm in non-recurring military shipments related to Iraq. Looking ahead, Chief Comm'l Officer Mike Giftos thinks metals, forest/industrial products and emerging markets will lead along with coal and intermodal.

One key metric exclusive to CSX is "Industrial Switching Excellence" for switching operations -- the percentage of cars that were switched at industry or interchange according to plan. To my mind, nobody else does this as such, even though trip plan compliance embraces local train performance. For the quarter the score was 88%, down from 89% yoy however "local originations" (percent of local trains departing the origin station on time) improved four points to 76% yoy. The complete set of service performance measures is available for downloading as a PDF file at www.csx.com.

The snowy and late winter added 2,000 train starts and 1,400 relief crews. Material costs went up due to more of everything from switch heater gas to derailments to snow removal. Still, CSX is on track to deliver $300 mm in free cash flow in '03 and the budgeted $1 bn in capex remains. The view from here is that CSX mirrors the industry trend of using resources more effectively to generate more revenue.

Since we're at the end of Earnings Week, it might be instructive to look at some earnings trends. Our commentary thus far has emphasized operating results yet yoy earnings change is what measures management effectiveness and directly affects the ability to raise new money. Chart 1 looks at yoy stock prices, quarterly earnings, annual estimates; Chart 2, relative PE ratios.

Several conclusions arise. Stock prices and quarterly earnings both fell but which fell faster varies among railroads. The 2003 estimated stock price appreciation potential is single digits or less. And if the stock-price multiple (PE ratio) is supposed to equal annual growth rate, then everybody is overvalued even now. There are those who suggest a price-earnings-growth ration north of 150 is a short sign. But with the 1Q03 results we see expenses pretty much under control and most new revenue ought to fall to the net line. Keep share counts the same, or better yet decrease 'em, and earnings can grow into these PEs.

On a related note, *Barrons OnLine* for April 29 suggests that the present trading range is likely to persist. "Trading is dominated primarily by Wall Street trading desks and shorter term institutional traders who are buying and selling the various indices based upon their respective support and resistance levels." The writer holds there is no real catalyst to break the market out of its sideways drift. Until there is, "investors will have to continue to be patient and work within those ranges."

That's what makes covered calls so attractive. But the stock today at a reasonable price and sell a call either ATM or slightly OTM a few months out. As long as the stock remains in a range, you can keep the same strike, rolling the expiration date out and pocketing the premiums, lowering your cost basis over time.

Chart 1. Class 1 Railroad Stock Price Change vs. Earnings Change

	Prices			eps		
Tick	**2003**	**2002**	**Change**	**2003**	**2002**	**change**
BNI	$ 24.90	$ 30.25	-17.7%	$ 0.40	$ 0.45	-11.1%
CNI*	$ 42.80	$ 49.97	-14.3%	$ 0.69	$ 0.77	-9.6%
CP*	$ 21.09	$ 21.78	-3.2%	$ 0.43	$ 0.57	-25.6%
CSX	$ 28.52	$ 38.30	-25.5%	$ 0.20	$ 0.32	-37.5%
KSU	$ 11.23	$ 15.99	-29.8%	$ 0.08	$ 0.19	-57.9%
NSC	$ 18.56	$ 24.26	-23.5%	$ 0.22	$ 0.22	0.0%
UNP	$ 55.00	$ 61.58	-10.7%	$ 0.60	$ 0.86	-30.2%
INDU	7,992	10,404	-23.2%			

Chart 2. Price-Earnings Growth Ratios

	Est eps			PE	
Tick	**2002A**	**2003E**	**Change**	**2003**	**PEG**
BNI	$ 2.00	$ 2.17	8.5%	11.5	135
CNI*	$ 3.33	$ 3.50	5.1%	12.2	240
CP*	$ 1.63	$ 1.65	1.2%	12.8	1042
CSX	$ 2.16	$ 2.22	2.8%	12.8	462
GWR	$ 1.53	$ 1.62	5.9%	9.6	163
KSU	$ 0.96	$ 0.85	-11.5%	13.2	-115
NSC	$ 1.18	$ 1.30	10.2%	14.3	140
RRA	$ 0.75	$ 0.78	4.0%	7.8	196
UNP	$ 4.30	$ 4.33	0.7%	12.7	1821

*$US @ $C1.50 = $US1.00