The Railroad Week in Review
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We've commented before on the spread between operating earnings and net earnings, suggesting the narrower the spread the better off the core business. Now, in the context of the 2Q03 pre-announcements, comes a Charles Schwab comment on same: "Finally, earnings quality has improved, as illustrated by a *narrowing gap between reported earnings*, which include impairment charges and writedowns, *and operating earnings,* which generally exclude such items (emphasis added).

This is important for two reasons as we approach Earnings Week. First, because the smaller the spread the better the earnings from the core business; second, because below-the-line items can cloud the outlook. For example, Morgan Stanley's Jim Valentine writes, "The fluctuating peso exchange rate and the rate of inflation in Mexico has a large impact on equity earnings [below the line] where KCS currently recognizes the impact of its investment in TFM. We are anticipating 2Q EPS of $0.22, but would not be surprised to see the ultimate figure swing either way by a dime."

I'm also concerned about low price, low volume stocks where a relatively small up-tick in trading volume can move the price up or down several points. Take shortline operator Providence & Worcester (PWX). On Thursday 16,000 shares changed hands moving the price up 4.2% to $7.95. In contrast, RailAmerica (RRA), was down 4.8% to $8.20, but it took 101,500 shares to do it. There are some who say less than 200,000 shares daily average volume makes for added volatility and potential manipulation. Seems reasonable.

Contrary to popular opinion, shortlines are winning spots at the intermodal table. Representatives of the three biggest New England shortlines, Vermont Railway (VTR), St. Lawrence & Atlantic (SLR, a unit of GWR), and newly-minted Montreal Maine & Atlantic (MMA) have each told me of new opportunities in *trailer* service, the very units the class 1s seem to shun.

Perhaps Eric Moffett, Vermont Railway's intermodal VP, says it best. Truckers in domestic lanes want 53-foot trailers, not the 45s most railroads were marketing. They don't want containers because the chassis tare takes away as much as 4,000-lb. load capacity. Worse, there's the added delivery time if there is no chassis for the inbound. And if you're a domestic hauler already on thin margins (as are most) you really can't afford either.

The intermodal growth we see in the weekly AAR traffic reports is largely international. BNSF's Matt Rose, in his June 11 Merrill Lynch Global Transportation Conference remarks, cites IANA data showing total North American intermodal volume 1996-2002 increased at a compound annual growth rate (CAGR, or Kay-gar) of 3.5%. Within that international traffic increased 5.7% and domestic a paltry 1.7%, less than the annual growth rate of the economy (Slides at www.bnsf.com).

On his own road, the spread is even more striking: 5.9% overall, international 10.1%, domestic 2.9%, roughly the same as the GNP. But that could change. BNSF sees a $7 billion opportunity in the domestic side, of which about a third is short haul. In the east, CP's Expressway service, FEC's Hurricane Service, and VTR's New England Service (now including a link with MMA's Presque Isle terminal) are all short haul trailer-based growth opportunities.

Now, shortlines, let's take that the next step. Say to your connecting class 1, "Twice a week I'll give you 50 platforms and 50 trailers (or 50 boxcars) to deliver to the Fallen Flag & Eastern at the other end of your railroad. Twice a week the FF&E will give you the same for you to bring to me. Hook and haul at each end, FAK. What am I bid?" I find the question intriguing on the eve of Earnings Week as we keep hearing senior management say they want new revenues and trucks off the highway tops of the list. Here's 200 trucks a week, 10,400 trucks a year. For $500 a box that's $5.2 mm in new revenue. If just ten shortline pairs stepped to the plate…

Another attraction of the all-trailer business is its simplicity. All you need is a few acres, a Packer, and a bobtail. States have been known to pitch in with CMAQ funding to assist in the acquisition of same. Moffett tells me in the container business there are several sizes of boxes, each with their own chassis requirements. Do all that and you'd run out of room in a hurry.

Charles Hunter, General Manager of the SLR, took me on a tour of their ramp in Auburn Maine two weeks ago. Yes, there is some international business from Zim and APL, but the push is for trailers because that's what the paper makers want. And if you're in northern Maine that's what you get. It was easy to see that his trailers depart almost as soon as they are grounded and the lag time between arrival at the gate and departure on the train is minimal. That's ideal, it seems to me.

If you need further proof times are tough out there on the open road, this week's announcement that Yellow Freight (YELL) will acquire arch-competitor Roadway (ROAD) ought to suffice. Recall it wasn't that long ago that CF closed its doors forever. The slack was taken up so fast by everybody else's excess capacity the loss was hardly noticed.

The half-stock half-cash transaction is valued at roughly $1.1 bn including the assumption of $140 mm in ROAD debt. The deal is expected to close by the end of 2003 with the necessary regulatory approvals taking six months of that. Plans are to operate the two brands separately, with both pursuing their current strategies without change. That means that cost savings will come from combining back-office tasks, rather than any operations.

Help wanted, Part II. To put a finer point on it, we're looking for origin shortlines serving the so-called "bread-basket" regions of North America that package the consumable goods lining grocery store shelves. We're also looking for destination shortlines serving distribution centers in major consumer markets, chiefly in eastern seaboard states.

The responses to date have been encouraging. Every one has presented an outstanding list of the benefits they bring to the process, nailing each requirement exactly. Class 1 response has been encouraging as well since any long-distance move between shortlines requires a class 1 in the middle. And in case you missed it last week, here it is again:

Help Wanted: Shortlines for grocery products (STCC 20) distribution network. Need direct access to at least two class 1s with daily interchanges. Must be able to switch on-line food-grade distribution center (temperature control a plus) twice a day. Active, measurable ISAs with class 1s and real time event reporting to Train II required. Able to handle 286 and high-cube cars. Minimum FRA class 2 track. To be considered must be willing to share financials and five-year safety record. Million-dollar revenue potential.