The Railroad Week in Review
October 24, 2003
www.rblanchard.com
(215) 985-1110

I've been asking around about what readers find most and least helpful about WIR. On the most side, it's who's doing what to develop new carload business and how well they're doing. The flip side is that stock reporting, net income and earnings per share are less so. And so it is that starting this week we'll look more closely at operating income and the metrics associated thereto. What happens "below the line" between operating income and net income is more germane to portfolio management than it is to finding the clues as what drives operating income. What do *you* think?

Canadian National started the week out with a bang, announcing at 0730 Monday its agreement to buy the railroads, switch carrier, and the ore boat fleet from Great Lakes Transportation (GLT) for US$380 mm. CN anticipates closing the deal in mid-2004 in what ought to be a "minor transaction" to the STB. Industry watchers figure the results will be almost immediately accretive to earnings and free cash flow.

The railroads are the Bessemer & Lake Erie and the Duluth Missabe & Iron Range; the Pittsburgh & Conneaut Dock Company works the docks at Conneaut. CN is no stranger to the northern reaches, already operating over 17 miles of the DMIR between Nopeming Jct. MN and Itasca WI these 20 years. By adding the other 64 miles of essentially parallel track west of Nopeming Jct. CN saves itself considerable cash and operating headaches. In Pennsylvania CN gains direct access to the BLE's ore network, though BLE itself remains an island railroad to the rest of CN. How this will affect regional carriers like the Wheeling & Lake Erie or GWR's Buffalo & Pittsburgh remains to be seen.

Also this week CN reported 3Q03 results. Operating income was C$454 mm, down 6% yoy more on exchange rates than constant dollars and the OR was unchanged at 67.9, still the best of show. During the conference call CEO Hunter Harrison noted that reported sales fell 6% though adjusted for yoy changes in exchange rates it was more like a point. Re the Great Lakes transaction Harrison said pinch points around Duluth are eliminated and 64 miles of parallel main save him the expense of double-tracking the original CN (ex-DWP) main.

Chief Commercial Officer Jim Foote said CN was able to recover 60% of the coal and auto yoy revenue shortfalls (33 and 21% respectively) mainly on price with some mix. Grain was up 18%, the first double-digit gain in some time while ferts were flat. Intermodal was up on 5% growth in overseas traffic through Vancouver offset by a two-point decline in domestic boxes. Model year changeovers and plant closings contributed to the 12% YTD decline in auto revs, but it'll be made up on 2004.

CN retains leadership in percent total revenue from the merchandise carload side of the house at 73%. Moreover, intermodal pricing is aggressive enough to capture 68% of the average merchandise revenue per car (carload equivalent revenue equals intermodal revenue divided by intermodal units over 1.7). One reason is that CN put intermodal on the same operating discipline as carload on the Canadian lines and will start in the US in 2004. Results are that terminal costs and dwells are down to new levels leading to a potential 25% improvement in profit levels. CN is moving toward more to door-to-door products with its retail trucking fleet. Says Foote, "We're in business to move boxes, not store 'em. If we have to store them we'll charge what the traffic will bear."

BNSF has a pretty good 3Q03 earnings story especially for the carload business. Operating income was up 2.6% on 3.6% more revenues and 4% added expense with fuel the chief culprit. Fuel cost net of hedge was $0.864 a gallon, up 17%. That on top of 3% more GTMs pushed fuel expense up 21% yoy. Had fuel remained at $0.739 a gallon the OR would have been a very respectable 80.8.

Ag and industrial products revenues increased 8.5% and 5.7% respectively. Ag gains were propelled by export wheat and bulk foods; building products and chems drove the industrial products increases, lending further strength to the thesis that as consumer manufacturing moves offshore carload gains will be in food, forest and chemical. The big revenue swings were double-digit gains in consumer perishables, international and truckload. Average revenue per merchandise carload was up 3.3% in spite of the 2.9% decline in auto RPU.

The operating story was one of give and take – gains in GTMs and unit miles, dips in loco and car velocity. As a result system dock-dock on-time performance came down a few points, though the dips came where the traffic base is most concentrated. But then, that's where the industry has to go – pushing the maximum number of RTMs over the smallest number of track miles. CEO Matt Rose said there are still too many miles of railroad and so it is BNSF will shortline another 3,000 miles in oh-four through a mix of sales and lease transactions.

Rose also said the BNSF focus is highway conversion. That's where the growth lies, and key corridor capacity constraints don't help. Letting UPS go was a conscious decision based on the UPS service design impact on the rest of the system. Capacity freed with the loss of some coal business has been quickly filled with higher yield carload and consumer business. Coal was down 1.8 points to 21.3% of total revenue and intermodal took up 2/3 of the slack; carload the other third. What's more, coal averages $985 a car to carload's $1,619 and intermodal's $1,293 carload equivalent based on 1.7 boxes per platform.

Florida East Coast Industries CEO Robert Anestis opened Wednesday's call by saying that the five 2002-2003 financial goals set for the company have largely been achieved with room to spare. On the rail side said Anestis, "This was the eighth consecutive quarterly gain in FEC freight revenues." He then commented specifically on "operating profit *before depreciation"* (emphasis added). Taking the railroad income statement apart, it appears depreciation in 3Q02 was $4.5 mm; this year it was $4.9 mm, though depreciation as a percentage of operating expense actually dropped to 14% from 15% yoy.

Railway revenues increased 12% to $44.7 mm yoy, however actual freight sales increased but 5%, the difference being $2.6 mm in drayage being taken in-house. Operating expenses went up 13% to $34 mm, though 25% of the dollar increase yoy was depreciation. The 76.1 OR was 60 BP higher yoy. Commodity carload revenues were up 6.6% on 6.9% more units leaving carload RPU essentially flat yoy. The FEC is unique in that crushed stone and intermodal make up 75% of the revenue stream. On another property, this might be a negative, but here both are essentially unit train operations. And with the longest haul less than 400 miles, one train is all it takes.

Union Pacific (the railroad) chalked up a 4% yoy quarterly revenue gain to $3 bn thanks to merchandise carload gains of 10% and 7% respectively in ag and industrial products, both posting percentage revenue gains double the carload gains, pushing up ARC accordingly. Chems and intermodal each rang up 3% unit losses but held the line on revenue. Of the six commodity groups only auto came in with a lower ARC, down 2%. CFO Jim Young (slide 9,

www.up.com/investors) showed that of the $39 RPU increase only ten bucks was fuel, the rest was price and mix.

This is good news to shortlines and shippers alike. The former for obvious reasons since many are paid on a percentage allowance basis. Shippers may grumble about higher rates but as the service quality and their customer satisfaction improves then their total shelf-to-shelf transportation bill ought to go down. CEO Dick Davidson in his opening remarks conceded that recent service was less than it ought to have been and as a result quarterly revenues were softer than what best practices would indicate, and that "customer satisfaction grows as errors are reduced."

Out on the railroad Express Lane sales went up another 10% (UP will buy another $50 mm of new reefers in 2004); wheat, ethanol, lumber, plastics (even with the high feed-stock cost) and scrap showed gains. In point of fact 15 of 16 industrial products groups increased sales. And auto parts, up 13%, is the saving grace there, also good news for shortlines -- like Pennsylvania's North Shore Group, supplying auto carpet to a GM plant served by UP.

The expense line was another story, up 6% yoy on double-digit increases for fuel and purchased services, pushing ops income down 4% and the OR up 170 BP to 80.0. Had fuel prices remained the same as last year the OR would have been closer to 77.3, right in line with what we've seen elsewhere: high yoy fuel costs add 2+ points to the OR. Looking ahead Davidson said new T&E hires and buying 46 new AC units for $80 mm cash in early 2004 will help. Asked if new business would increase congestion, Davidson never missed a beat saying, "UP's been working for years on removing bottlenecks to improve capacity {see Nebraska triple track, double track in Iowa, double-track to the PRB – RHB]. The railroad is more fluid than ever."

CSX brought up the markers on this first week of railroad earnings reports. CEO Mike Ward made no bones about the fact that operational performance took away from what was a pretty decent showing in revenue gains. Operating income was down 6% excluding a one-time claims charge on 2% more revenue ($1.8 bn) and 3% more expense excluding the claims charge. Fuel was the big hit, up 21% yoy; no surprises there.

Five of the eight merchandise carload categories posted RPU increases with revenue gains across the board. Chief Marketing Officer Mike Giftos said during the call that this was the sixth consecutive quarter of revenue increases. Coal RPU was up on down volumes, with mix contributing on short-haul wins in export coal out of Baltimore and New Orleans. Auto volumes came down a bit too and again RPU held, up 2% yoy. Intermodal revenue was flat with loads down slightly on tough comps as there was no preshipping in 3Q03 vs. 3Q02 West Coast port strike. Still, said Giftos, "Intermodal is an big driver of revenue growth."

Regarding ops, Ward waded right in saying, "We never got out of the tactical mode the hard winter forced upon us. To break the mold we benchmarked CN and NS and found clear roles and responsibilities spelled out in operations. The results thus far are encouraging but it will take time." The three parts to Ward's plan are first to improve service, second to sustain that improvement through increased accountability and third to drill down into root cause analysis. This, IMHO, is the only way to go and is an excellent lesson in making things work better. Shippers, shortlines, shareholders and the transportation community at large will all benefit.

The Railroad Week in Review, © 2003 Roy Blanchard, is a publication of the Blanchard Company. 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.