The Railroad Week in Review
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There were no howls of righteous indignation over my decision to play up core business results and play down below-the-line earnings, and, in point of fact, there was even muted applause. Wrote the CFO at a leading shortline holding company, "The new emphasis on operations is especially meaningful to our railroads. We're now taking a much closer look at our financial and productivity metrics." Gratifying.

Canadian Pacific presents a very concise operating summary and it's a format I'll have to pursue with the others, particularly commodity freight revenue per revenue ton-mile (RTM). In 2Q04 CP averaged C$3.00 per RTM with automotive the leader at C$12.45 per RTM. Intermodal was second, gapping all the way down to C$3.79. The only other above-average performer was the forest products group at C$3.05. CP operating expense per RTM was C$2.45 system-wide. What I'd like to know is ops expense by commodity group before I'm comfortable saying that intermodal is more profitable than, say, industrial products.

For the quarter CP operating income increased 18.6% as sales rose 9.9% to C$1 bn and ops expenditures were held to an 8% gain. Grain/sulfur/ferts, and industrial products all posted double-digit revenue gains though carloads increased even faster, reducing unit yield as average RPU dipped 0.9%. Coal scored best with RPU up 5%. Compensation and equipment rents were the chief culprits on the expense side, both up 13%. Fuel expense was held to a 2% gain yoy helped by a 1% decrease in price per gallon and a 3% improvement in GTMs per gallon.

Below the line we have a classic case of why one can't rely on eps to tell one what's *really* going on. Net income was C$84 mm, up 142% from last year's C$35 mm and eps rose similarly 138% to 53 cents Canadian. But…*excluding* the 2Q03 C$215 mm special charge for asset impairment and labor *and* the foreign exchange effects the 2Q04 net increased 24% to C$104 mm and eps was up 21% to 65 cents from 53 cents Canadian. That's why I stick to the above-the-line results for the real story on how the core business is faring.

The past six months' CP stock price curve is a classic example of support turning into resistance (and back again) and of the relationship between and among price, volume, and over-bought/over-sold indicators. Going back to Feb CP fell through support at the 200-day curve. That line became resistance as it was tested four times through late July and share price was turned back each time. In early April it broke through new support in the form of the 50-day average and kept heading south, albeit on decreasing volume as selling conviction was waning.

By mid-April CP was clearly over-sold at $22. Renewed investor interest (volume) helped turn the corner. There was an over-bought indication in early June and after a slight dip on small volume and it was off to the races again. Just this week CP punched through resistance (the 200-day average) and is over-bought again. I look for it to stabilize at $26 and barring any really bad news pushing up a few more points. The 200-day curve is support again and the cycle repeats.

Genesee & Wyoming rang up an 18% yoy revenue gain from North American operations while holding the ops expense gain to 14% and taking a point off the OR, now 81.7. Excluding the $523,000 GS&A item relating to the 1818 Fund stock offering it would have been 81 even. Six of nine commodity lanes posted double-digit revenue increases with increased RPU in seven of the nine (coal and intermodal excluded).

Fuel expense was up 27% (no surprises there) to 7.6% of revs, up from 7.1% yoy. Compensation rose 14% but actually declined to 33.7% of revenues from 34.8% a year ago. Casualty and insurance expense was up 10% yoy but again came down 40 bp as a pct of revs to a reasonable 4.9%. During the conference call CEO Mort Fuller allowed as how Class I congestion in the PNW presented “difficult operating conditions.” Free Cash Flow (operating cash less capex) for six months was up 18% yoy to $19.5 mm, a highly respectable 26% of revenues.

Australia (ARG) and Bolivia are counted below the line as equity income, adding US$3.5 and US$0.2 mm respectively. ARG’s 2Q04 $US sales were up 36% and ops income improved 23%, the OR added two points to 80, and equity income was up 61% yoy. Net income was up 44% and the net margin gained two points yoy to 14%. Looking ahead, Fuller sees congestion costs in the PNW mitigating, and is in the market, as it were, for new NA properties. Down under, track improvement expense incurred in 2Q won’t be back and operating results will get even better.

Norfolk Southern operating income for 2Q04 increased 43% to $425 mm on record quarterly revenues of $1.8 bn, up 11%, and a 4% ops expense increase. The OR dropped more than five points to 76.6, the best yoy improvement of the Big Six Class I group (see summary chart attached). Merchandise revenues increased 8.6% on 4.6% more loads, led by double-digit increases in met/construction and chemicals. Coal revenues were up 9.0% on 1.6% more volume with export coal up 49% yoy and representing 10% of total coal car count. Intermodal sales jumped 21.3. % on 16.5% more units, reflecting more truckload conversions and strong international shipments.

Diesel fuel expense increased 14% yoy and was the largest line item pct gain. Even at a 77% hedge average ppg was up 7.4% to 86 cents from 80 cents last year. Consumption was up 6.1% on 6.5% more GTMs, so that’s to the good. Had the fuel price remained unchanged the OR would have been 40 BP better, 76.2. Casualties and claims were down 19% on lower personal injury and claims expense. FWIW, this quarter’s OR is NS’ best since the Conrail integration.

Below the line net income grew 55% to $213 mm and eps increased 54.4% to $0.54 on an essentially unchanged share-count. Looking ahead, the tealeaves are lining up to give David Goode his “seven and seven” goal – an OR beginning with a seven and annual revenues in billions beginning with a seven. It’s $3.5 bn for 1H04 and with the railroad spinning like a TOP there’s every reason 2H04 will do as well or better.

From a technical standpoint NS stock is comfortably above both the 50- and 200-day averages and for the last three months at least there have been more up days than down (use a candle-stick chart for best visibility). The 2004 consensus eps is now $2.00 and rising; the 2005 consensus is $2.20 and rising against a nominal 14 PE. But 2004 will be the banner year for NS with estimates up nearly 50% yoy, slowing to 12% in 2005. Like the man says, “Get ‘em while they’re hot.”

Kansas City Southern for the first time has provided commodity revenue and carload data with its press release, making not only yoy comps a snap but also facilitating comps with other railroads. Moreover, the slide set accompanying the presentation does a nice job of drilling down to how the core rail business works and changes over time. Highly recommended.

KCS Railway 2Q04 operating income increased 22% yoy on 5.7% more revenue while double-digit decreases in car hire, depreciation and materials held the ops expense increase to 3.3% thus taking two points off the OR , 84.9. Corporate operating income increased by $5 mm or 37% to $19.5 mm. That plus the $4 mm swing in TFM equity earnings from a negative $2.3 mm to a positive $2.9 mm helped propel the net to shareholders 18-fold to $9.2 mm from a $500,000 loss yoy. Net to common after preferred nearly quadrupled to $7 mm from a $1.8 mm loss a year ago. Diluted eps was up by a factor of *five* to 11 cents from a negative three.

Out on the railroad the 19% increase in the price of a gallon of fuel cost about $2 mm in hard cash and 1.5 points on the OR. Moreover, the fuel use increase (6%) was about equal to the gain in total revenue units (also 6%). KCS leads the rest of the Class Is in average train speed by about 25 to 23 MPH. Yard dwell times are running about 25 hours to the rest of the class Is 30-plus. And KCS cars-on-line at the end of 2Q04 were actually down 7.4% vs. a 4.8% increase elsewhere. But then the Class I average revenue increase was closer to 10% than KCS' 6%. How much of the KCS cars-on-line decrease was due to a slower rate of yoy revenue change?

Still, 20 commodity groups out of 45 showed double-digit revenue increases yoy and chems, ag and intermodal all posted double-digit volume gains. The Mexico business is really starting to pay off. Total cross-border carloads increased 17% while sector revenues were up at double that rate. Intermodal traffic to Mexico is up 16% yoy while 92% of ag & minerals export business was to Mexico.

For the balance of the year KCS expects four of five commodity groups to outperform 2H03 with only coal ranked a more modest "compare favorably." The rolling five-week KCS cumulative net revenue figure is right at $55 mm, up 15% yoy and up 20% since 2002, so the rate of increase is accelerating. Can you say "turned the corner?" Nice job.

Barron's On-Line on Wednesday suggested that the recent run-up in rails tocks may be nearing an end. The writer argues that "rail companies should be barreling down the track as the economy improves but some of their stocks remain derailed by congestion." The kudos are given where deserved – NS, BNSF, e.g.) but are overshadowed by the relatively poor showings of CSX and UP, for example, saying "higher costs [fuel, comp & benefits among others] and weaker economic growth may lessen these stocks' gains in the next year." The basic thread is the big gains have already been made and it's probably too late to climb on board now.

Maybe. NS Sep 30 calls are less than 50 cents while the 25s are running in the $2.50 range. Ditto Jan: the 30 and 25 calls are 60 cents and $2.90 bid respectively, implying an expected stock price around $28. NS traded in a $26-$27 range most of the week. Over at BNSF, the week's range was $35-$36 while Jan 35 calls are showing $2.35 bid and the Jan 40s less than a buck.

Meanwhile UP spent the week in its $56 funk but the outlook may be slightly better according to the options crowd. Jan 55s are $6.00 bid with Jan 60s $1.10 bid, implying a stock price just north of $60 and a possible 10% gain in five months. CSX, trading around $31.50, with Jan 30s $2.80 bid and the 35s just 65 cents bid, may not have much upside left.

Big Six Class I Commodity Carload Comps

Quarter ending 6/30/2004

Revenue and income in $millions

Metric	BNSF	CN	CP	CSX	NS	UP
Railroad revs (1)	$ 2,685	$ 1,665	$ 1,005	$ 1,995	$ 1,813	$ 3,029
YOY Pct. Change	17.0%	13.8%	9.9%	5.7%	11.0%	4.7%
Carload revs (2)	$ 1,203	$ 1,230	$ 566	$ 1,227	$ 1,025	$ 1,760
Pct carload	44.8%	73.9%	56.3%	61.5%	56.5%	58.1%
Pct Intermodal	32.8%	17.2%	27.0%	16.2%	20.1%	18.0%
Pct Coal	20.6%	4.8%	14.0%	21.4%	23.4%	19.7%
Mdse Carloads (000)	623	735	298	910	740	1,057
Rev/CL x coal, IM	$ 1,726	$ 1,673	$ 1,901	$ 1,348	$ 1,385	$ 1,665
Rev/IM CL equiv	$ 1,341	$ 1,553	$ 1,491	$ 932	$ 874	$ 1,201
IMCLE/avg CL rev (3)	78%	93%	78%	69%	63%	72%
RR Operating Income	$ 508	$ 575	$ 221	$ 295	$ 425	$ 359
YOY Pct. Change	23.3%	31.6%	18.6%	13.9%	42.6%	-38.4%
RR Operating Ratio	80.7%	65.5%	78.0%	85.2%	76.6%	88.1%
YOY Point change	(1.06)	(4.66)	(1.61)	(1.06)	(5.19)	8.29
GTM/gallon diesel fuel	749	849	834	777	766	753
Fuel/gallon (US$)	$ 0.97	$ 0.96	$ 1.15	$ 1.00	$ 0.86	$ 1.16
YOY Pct. Change	7.6%	-5.6%	-1.3%	6.5%	7.4%	31.7%

(1) CN, CP in $Canadian

(2) Excludes coal, intermodal

(3) Intermodal carload equivalent revenue as percentage of average carload RPU

Source: Individual railroad reports