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The Railroad Week in Review 2/10/2001

The class 1 roads pretty much across the board saw 4Q00 earnings off about 5% YTY, the only exception being CP which was helped by the holding company's energy interests. Jim Valentine of Morgan Stanley Dean Witter writes that he's positive toward rails regardless, though his optimism would be tempered by any drawn-out downturn in the economy.

For my own part -- and remarks by Ike Prilliman and Jim Foote, chief commercial officers for NS and CN respectively bear this out – the sense is that intermodal will see the least drop as smaller shipments key nicely to smaller inventories. The merchandise carload trade later this year and into 2002 will gain share in those lanes where scheduled service lets supply chain managers combine lower cost rail service with the dependability and consistency of the individual truckload.

A recent ten-day road trip tells me that although senior managers tell the analysts what's being done to improve dependability and consistency, those changes are yet to be embraced in the field. We see unit trains of feed grains sitting for a day or more at remote interchanges for want of proper communication between parties. A major petrochemical company tells of simultaneous rate increases and service degradation. We see local terminal supervisors annulling crew-starts adding days to transit times and putting business at risk. Until local area managers have a stake in the commercial success of their respective operations, it will continue to be business as usual. And that's not good enough.

Carloadings YTD are available at www.transmatch.com and are en excellent tool to gauge performance, productivity, and profitability. The attached chart shows the 13-week rolling averages YTY percent change in total carloadings. Similar graphs are available by commodity (intermodal shows no dip below the line, for example) and by railroad.

There have been two recent developments of note on the railroad logistics services scene. Norfolk Southern has launched MODALGISTICS, "a new supply chain services group designed to provide customers with a broad selection of modal and distribution services." As we've mentioned before, you can't just sell the railcar, you have to sell a logistical service. NS is well positioned to do this with its Triple Crown product and one of the strongest industrial development teams in the business.

John Kraemer, Director of shortline Marketing for NS, says, "We are currently discussing the potential benefits that Short Line Railroads can offer for the MODALGISTICS initiative. We already have significant volumes of rail traffic moving in conjunction with shortlines offering warehousing and distribution capabilities. These will be highlighted as offering the greatest support for future MOADALGISTICS initiatives."

What's more, Senior VP for Strategic Planning Jim McClellan tells me, "As you know, my message to SLs is increasingly 'get into transloads.' The goal is to utilize transload and one of the real growth opportunities for shortlines is to think of their gathering and distribution functions in broader terms than just a railcar. This is a real opportunity for short lines." Enough said.

BNSF has closed down its promising FreightWise e-freight marketplace due to weak shipper adoption. According to www.upside.com "FreightWise, launched last year, was supposed to bring Internet efficiency to the $541 billion U.S. freight transportation market. The marketplace allowed shippers to source and ink freight contracts with rail and trucking carriers. Formed originally as a wholly owned subsidiary of Burlington Northern, the company was later spun out into a separate company with additional investment from **General Electric** and **Canadian National** railroad. Unfortunately, shippers weren't interested."

Perhaps what happened here was that the FreightWise auction-based site was ahead of its time, especially given the economic picture and its increased emphasis on inventory management and tighter expense control. The new NS service supports that emphasis; once shippers are comfortable with the outsourcing the support process, they'll look more favorably on using the spot market to match near-term transport needs with sharper inventory control.

Investment value is a focus of Week in Review because it is an excellent measure of management effectiveness and the ability to grow the business and shareholder value going forward. Shortlines are of particular interest because they fall into the attractive small-cap range. One helpful test is intrinsic value, essentially the net present value of forward earnings less long term debt. Three non-class 1 railroad companies score particularly well by this metric.

The work is done for you by the "stock evaluator" at www.quicken.com. Assume a 15% discount rate and the long-term growth rate from Zacks. The intrinsic value for WC is $19.72 vs Friday's close of $16.06. Genesee & Wyoming's intrinsic value is $83.53 vs. $27.20. Providence & Worcester is worth $44.18 vs the current $8.00 ticker price.

A second measure of investment potential is to look for low PEs of 15 or less, estimated earnings growth greater than 15, double-digit net profit margins, and a stock price greater than $5.00 a share. Each of the three above sports a PE less than 15, however only GNWR has a 5-year growth rate greater than 15 (it's 18). All three have the requisite margins and stock price. This is a thread that will be developed further in the weeks to come. Watch for special report announcements.

On the CN acquisition of WC, Frank Wilner writes in Traffic World that the deal could come apart if the STB reclassifies WC's North American operations as a class 1 railroad. Recall back in Nov the Board told WC the combines revenues of its class 2 and class 3 subsidiaries exceeds the $258 mm annual revenue threshold for class 2 properties.

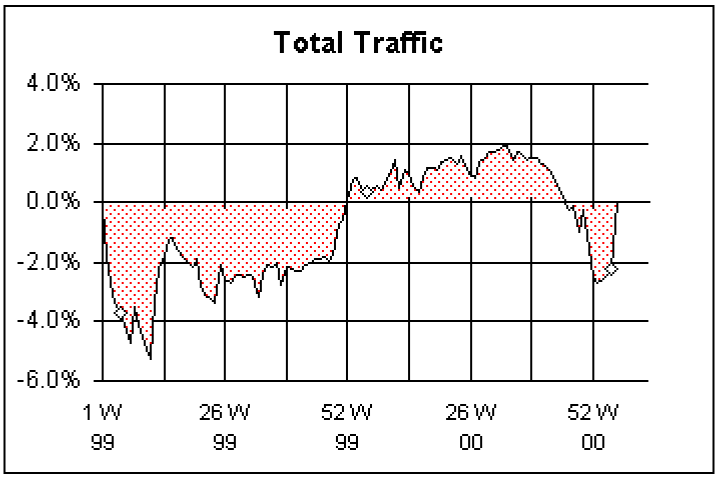
Says Wilner, "Class 1 status would subject the transaction to more costly labor protection requirements. It would also subject the transaction to the STB's 15-month moratorium that expires in June, plus new merger rules that will be issued by the STB this summer." CN President Paul Tellier is not amused, especially when one considers the AOL-Time Warner deal was done in a matter of months, yet the combined capitalization of those two is "six times the entire North American Rail Industry." (Note: last week we reported the CN offering price for WC as $17.50 a share. It should have been $17.15. Thanks go to WC's Ann Thoma for spotting the error.)

Roy Blanchard

Disclosure: Blanchard may from time to time hold long, short, or debt positions in the companies mentioned here. A list of such holdings is available on request.

Total Industry Charts

Year over Year Percent Change
13 Week Rolling Averages



Courtesy ASI's Railfax Carloading Report, www.transmatch.com