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The Railroad Week in Review 2/24/2001

While everybody cries doom and gloom about the state of the economy, and the DJIA languishes, rail stocks YTD have been quietly been doing rather well. Among The Big Six class 1s, Norfolk Southern (NSC) and CSX (CSX) are up 28% and 35% respectively as they gain control of the ex-Conrail territories. Canadian Pacific, stuck for so long in the 20's, has enjoyed a nice bump rising 28% YTD largely on breakup news.

Canadian National (CNI) is up 27% powered by its own strength of earnings growth and generally Doing It Right. Less exciting, but still better than an index fund, Burlington Northern Santa Fe (BNI) and Union Pacific (UNP) are up about 7% YTD. For the charts, go to www.fool.com >> Quotes & Research. You can run one chart with as many different companies as you want, though five or six is about the max to retain clarity.

Small- and mid-cap rails are also enjoying the ride. The clear winner is Kansas City Southern (KSU), a break-up, sum-of-the-parts play like CP (WIR 2/17/2001), up 38%. Then comes Providence & Worcester (PWX) up 15% and another asset play, IMHO. RailAmerica (RAIL) and Wisconsin Central (WCLX) are up about 7%. RAIL still struggles because of the debt, however there are signs last year's aggressive debt-reduction plan is taking effect (see WSJ story below).

WCLX is kinda stuck as it's waiting for the other shoe to drop on the CNI deal. That leaves Florida East Coast (FLA), tied with the DJIA, off 7%, and Genesee & Wyoming, of 15% on no news I can figure out. The earnings story is strong, though you have to do some digging, the Western Australia deal went off beautifully, the US properties are doing quite well, thank you, and Mexico is looking better.

Which do you buy, short, or hold? Once you've run the fundamentals (operating ratio, revenue growth, net margins, free cash flow, debt ratios, etc.) a good sanity check is technical analysis. You can get a good feel for any stock's trends at www.schwab.com. Scroll down to Railroads in the Industry Research window and see how the fundamentals compare. Then click on Technicals in the left frame and see the trends. Drill into the details by clicking on the ticker symbol.

For example, all the KSU signs are pointing in the right direction (see Comments window). The Help screen is, for a change, really helpful. Much of the tech terminology can be daunting, however the explanations will get you through what's really going on. Does it work? Well, it helps me keep my long portfolio above the moving averages and my shorts among those below the MAs. The value for shippers and shortlines lies in being able to gauge where your serving railroads are heading and how they are likely to treat you going forward.

Dan Machalaba writes in the WSJ, "RailAmerica Inc. thrived by buying up chunks of railroad unwanted by the industry giants. Now, after a stop to shrink its ballooning debt, it's getting back on the acquisition track." He correctly notes that NSC has announced a couple thousand miles of branchlines will go on the block, and undoubtedly some will find a fit with one or two of the 30 or so RAIL properties in North America.

Other opportunities will come up, too. Even now the Iron Roads group, operator of Maine's Bangor & Aroostook as well as some former CP properties (see my Dec 1996 Railway Age column at www.rblanchard.com), is said to be talking with RAIL about a fit with the New England Central which in turn came to RAIL through the RailTex acquisition. Future fallout in the shortline industry (see following story, also WIR 1/20/2001) will play well for RAIL.

Regarding the debt level, Machalaba observes, “The company said it is on target to reduce debt to about $360 million by the end of the first quarter. But that is still nearly three times shareholders' equity, expected to be about $124 million at quarter's end.” We know CEO Gary Marino doesn't want to increase debt having just paid down more than $100 mm. It’s possible there could be an equity offering, forming partnerships or using other financing methods, however with modest appreciation YTD and a PE of 13, the share price remains depressed. It’s a tough position to be in because the window for expanding the franchise won’t be open all that long. The good news is RAIL is positioning itself to be first in line.

Continuing the thread of shortline shakeouts, Larry Kaufman writes in the JOC, “Many short-lines exist only because class 1 carriers used the freedom they obtained through the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980 to shed themselves of losing branch lines. Those lines weren't economically viable then and [many] still aren’t. They continue to exist because they effectively have been subsidized by the class 1.”

Recall that WIR 1/20/2001 carried much the same theme: “50% of NS shortlines could be handling just 3% of shortline revenues.” It is no coincidence that the shortlines on the short end of this metric fall below the 4,000 cars-per-year minimum threshold warned about in the WIR “Shortline Extra” for 12/2/2000 (www.rblanchard.com/corp/wk-rev/00q4/001202sl.html). Concludes Kaufman, “Short-line railroads either will have to be profitable for themselves and the connecting trunk lines or they will go out of business.” He couldn’t have said it better.

A word on Disclosure. Long-time readers of WIR know this newsletter was started in 1995 when I was the Rail Industry Specialist writing on The Motley Fool (www.fool.com). Most of us “Remote Fools” were active in our respective industries and had been tapped by the Brothers Gardner to host the message boards and generally lead the discussions.

It was expected that we were investors in our industries so we could comment on what was good and bad from our own experience. As noted at The Motley Fool Disclosure Page (http://www.fool.com/help/disclosure.htm), “We don't consider our [staff members] to be journalists, but rather communicators and teachers of financial matters. It's a subtle but critical difference [and] we believe our staff's involvement in managing their own money is critical to their learning more about the subject and their succeeding in their own lives.” And that’s the approach being used in WIR today.

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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.