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London's *Financial Times* (www.ft.com) is a very useful newspaper. In Monday's edition Andrew Hill writes in his "Global Investor" column about the increasing investor concern about valuing the so-called intangibles – brands, patents, staff skills – that make up a company's competitive posture. Brands come under particular scrutiny, as in the case of Coke vs. Pepsi or Macy's vs. Saks or Wal-Mart vs Target (or Tar-*jhay* if you prefer the French pronunciation).

In my humble opinion a brand's value is measured best by the income statement and yoy changes. The dominant brand enjoys top share of the consumer's mind and so has to spend less in promotion to create mind-share than the second or third place brand. Yes, the leader spends a ton to maintain mind-share, but it's like train's use of fuel: you use less per ton-mile in run-8 at 75 mph than you do in run-8 at a crawl, so momentum counts.

What does all this have to do with railroads? Simply that a solid brand is worth building and preserving, as CP discovered with its St Lawrence & Hudson moniker. Canadian Pacific was an established brand; SLH was not, and the energy spent to get SLH the mind-share needed could be better invested enhancing the Canadian Pacific brand. Exit SLH.

CP is further to be applauded for going the next step and splitting up the Canadian Pacific holding company into five pieces, three of which retain the CP name: CP Railway, CP hotels, and CP ships. Each has a long and enviable history. Mom's cutting the apron strings can only make for stronger kids.

My good friend Scott Flower of Solomon Smith Barney has released the annual iteration of his "Zen and the Art of Railroad Management" theme. Scott's particular focus is on Return on Invested Capital (ROIC) and its relationship to railroad profitability, stock performance, and longevity.

The western and Canadian roads, not surprisingly, are doing the best. Neither Norfolk nor Jacksonville has quite gotten back on their feet following the Conrail transaction, and, says Scott, it's doubtful they will for a while given the amount of capital already invested and the sluggish revenue growth to up the returns.

Part of the reason may be the more complex networks of the eastern roads as well as some of the oldest, twistiest, and hilliest routes on the continent. The difference between say the PRR route between NY and Chicago and the BNSF west of Kansas City is the ratio of straight flat to curving hilly railroad. The old SP line through the Tehachepis is one tough RR, but 2000 miles of fast, flat Santa Fe profile to the east sure helps the BNSF averages.

On the PRR from NY to Chicago you never got decent stretch of straight flat rail west of Frankfort Jct. in North Philadelphia all the way to the Ohio border. The B&O was worse as it wended its way across Maryland into West Virginia and southwestern PA. These are slow railroads that in no way can compete with the Interstates and they are frightfully capital intensive.

Flat revenues come of non-competitive service, and flat revenues with operating ratios stuck in the mid 80s and worse leave little free cash flow to repair and replace. Like Scott says, it may be a while before the eastern roads can return to the days of double-digit ROIC.

Some class 1 rail stock prices appear to be enjoying some fairly aggressive multiples yet the wide spreads in operating ratios indicate all is not well (see chart following). CN has the lowest OR so is the most profitable in terms of the core railroad business. It logically follows the best run business has the best chance to increase earnings. Higher forward earnings potential equals higher multiples, right? Or do they? CSX and NS trade at higher multiples and lag CN's league leading OR by 1,418 and 1,856 basis points respectively. What's wrong with this picture?

What's wrong with this picture is "easy comps." These two are emerging from the Conrail debacle with large yoy earnings increases driving low PEG ratios that are picked up by value investors' screens building momentum almost like we had with the dot-coms. The downside comes when the easy comps are gone (2Q02 vs 2Q01, e.g.) and prices drop back to the multiples they deserve. CSX at 12x the 2002 estimate is around $31. Norfolk's fair value for 2002 looks like $16 and change. And so on.

At the same time there continues to be anecdotal evidence from the class 2 and class 3 roads that their class 1 "partners" are not delivering a consistent product. Moreover, it's at its worst on the roads with the higher ORs. What we're seeing is a persistent disconnect between senior management's quarterly message to the analysts and what's really going on in the field. Recall the feeder lines contribute 10-15% of class 1 revenues and, as railroads, can pick up on systemic missteps shippers might miss. Therein lies the rub.

A shortline sees a missed interchange but nobody sees a missed interchange between a class 1 local and the core system. A shortline sees boxcars returned empty to the class 1 when loads are available but rates are not. Who's policing this on the class 1 local service lines? Every railroad investor knows the biggest driver of net income is revenue growth, not expense control. The disconnect between top management's message and field performance has got to go away.

Providence & Worcester earned seven cents a share in 2Q01 vs 23 cents in 2Q00. Net income dropped to $301,000 from a $million yoy chiefly due to no asset or easement sales this year. Operating revenues dropped to $5.7 mm from $6.0 mm yoy as manufacturing declines cut into merchandise carloads. At least operating expense declined apace. However, PWX stock goes for 21X trailing 12-months (ttm) earnings and $1.5x ttm sales and that seems a tad rich.

My friend drew Robertson in NYC runs the railfax site providing many delightful facts about carloadings and car management. The latter, naturally, extends to the fortunes of car builders and equipment suppliers. He writes, "There are some horrific numbers for orders, builds and backlogs for the car builders this week. The picture is not pretty. ABC-Naco (Nasdaq: ABCR) reported huge (almost internet sized) losses yesterday. The stock is at $.50 and you can buy the entire company for $9.7 million. A bargain." Drew has still more. Watch this space.

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.

Price Multiples vs Operating ratios
Revenues and expense in $mm

Railroad	10-Aug price	est 2002 eps	PE	2Q01 Ops revs	Ops Exp	OR	BP Variance
CN	$ 45.04	$ 3.68	12.2	$ 1,392.0	$ 948.0	68.1%	-
WC**	$ 16.90	$ 1.42	11.9	$ 93.7	$ 67.8	72.4%	426
CP*	$ 39.21	$ 3.96	9.9	$ 931.4	$ 725.8	77.9%	982
BNSF	$ 26.63	$ 2.66	10.0	$ 2,240.0	$ 1,840.0	82.1%	1,404
NS	$ 20.43	$ 1.36	15.0	$ 1,592.0	$ 1,310.0	82.3%	1,418
UP	$ 54.98	$ 4.71	11.7	$ 2,998.0	$ 2,554.0	85.2%	1,709
CSX	$ 39.40	$ 2.64	14.9	$ 1,827.0	$ 1,585.0	86.8%	1,865
KCS	$ 13.80	$ 0.79	17.5	$ 143.2	$ 130.3	91.0%	2,289

*Price includes all subs; OR is rail only
** Price relatess to entire corp; OR is North America rail only