The Blanchard Company
www.rblanchard.com

The Railroad Week in Review 12/22/2001

Railroad Retirement enters a new phase thanks to Congress giving the green light to the reforms so long sought. The impact on rail earnings is likely to me modest in 2002 and slightly higher in '03 as the scaled changes kick in Morgan Stanley's Jim Valentine thinks the industry savings – and this includes shortlines and regionals – could hit $350 mm by 2004.

As noted previously (WIR 12/1) the tax liability is a function of payroll size, so the biggest dollar benefit goes to the biggest railroad (UP). The biggest gain in earnings goes to the railroads where yoy earnings are depressed (CSX, NS, still working easy comps from the CR deal). Poor old CP, with the smallest US complement of workers and the No 2 operating ratio in the biz, will probably see the least effect. Small railroads, where every penny has to be closely watched, will have that many more dollars to invest in making things run better.

Who am I? I am a class 1 railroad that has increased yoy revenues in four of the last five years, increased operating income every year in the same period, cut the operating ratio every year and by 650 basis points at that. Moreover, my capex program is less than it was four years ago yet my total gross ton-miles (GTMs) are up 15%. I've reduced headcount by 15% and miles operated by 20%. In the bargain GTMs per available horsepower day are up 20% and GTMs per mile of road are up 43% and GTMs per employee are up 38%.

My road loco fleet is 34% AC power, handling 60% of all road freight. I expect to take delivery of another 51 AC units this quarter. Since the AC program began I have cascaded more than 700 older DC units out of the fleet. The AC power lowered operating expense even as it improved operating practices. An independent customer survey last May put me in the Number One spot among North American class 1s in customers' perception of rail on-time performance.

Agricultural products and coal account for 43% of my revenues, intermodal 23%, forest products 10% and automotive 9%, though intermodal and industrial products are likely to be the best growers through '03. Earnings estimates are flat 2001-2002, however the Street anticipates a nice 20% bump in 2003. The stock is trading at a reasonable 13 times earnings. There are those who would cite history and say multiples creep up as times get better, so a PE of 14 by midyear may be in order. Add to that the 1.7% dividend and one could be looking at 8% total stock price appreciation over the next 12 or so months. Who am I?

RailAmerica (RAIL) hit the news wires in a big way Wednesday. In the first of two releases we learn that it did a private placement of $54 mm in common stock with several of the leading houses. The proceeds will go to complete the Park Sierra and StatesRail transactions as well as toward the further reduction of its debt load. CEO Gary Marino says these actions combined will give RAIL a pro forma debt/equity ratio of under 1.7 to one as of 9/30/2001.

In the second RAIL announced listing on the NYSE. This speaks volumes as the Big Board is somewhat picky as to whom they let in. Listing requirements -- consistent positive earnings, cash flow, minimum trading volumes, etc. -- are shown in great detail at www.nyse.com. Trading over there will begin Jan 2, 2002 under a new ticker symbol TBA. Congratulations are in order.

Wisconsin Central's newsletter, "The Write Track," continues under CN sponsorship. According to Gordon Grafton, WC Division VP, "CP said it would try to keep changes at a minimum and to be as transparent as possible." Continuing the newsletter is part of it. Grafton has praises for "the entrepreneurial spirit" of WC, fitting as it does with the CN's goal to push decision making to the local level.

The December newsletter also notes that WC has adopted the CN's trip plan compliance method for measuring on-time performance. Intermodal shipments must be made available to the customer or the next rail carrier within two hours of plan, four hours for carload shipments. Would that such a standard were in place universally.

Rail traffic figures including shortlines and regionals for Week 50 are 6% ahead of Week 50 in 2000. On the North American class 1s automotive, grain and coal were particularly strong, though the auto financing options could be pulling potential 1Q02 sales forward into 4Q00. UP took top honors, up 12.3% for the week and has the only gain over Week 50 for 1999. The four-week rolling average and quarter to date are both up by less and a point while year to date vs. 2000 continues to lag. Details may be perused at www.railmatch.com.

Short interest holds our interest because it's an indicator of investor sentiment. You can either watch the WSJ toward the end of each month (NYSE and AMEX shorts hit Friday) or log on to www.shortinterest.com. As noted above re CP, rails can be expected to trade in the 12-14x range. When they get out head of that they can be said to be richly priced. The contrarians often show their stripes by shorting such stocks with high PEG ratios.

BNSF is arguably one of the cheaper rails, trading at 12.2x the '02 estimate, followed by CP at 12.7x. For the month ending 12/15 short interest (the number of shares sold short but not yet covered) for BNSF dropped by 29% (CP short interest is nil). As a rule, the lower the short interest the lower the negative sentiment. Carrying this a step further, BNSF leads the pack with a 16.7% potential yoy gain including dividends at a nominal 14x PE for 2001-2002. CP is next at 13.6% while the more richly priced marks do not fare anywhere near as well. The FY 2001 numbers are due a month. Perhaps we can reach some conclusions at that time.

As is our custom, we do not publish WIR the last week of the year, so our next effort will be dated Jan 5, 2002. To all my best wishes for the holidays and thanks for your interest and feedback. Special thanks to those who have already renewed and to those who have signed on for the first time. We look forward to serving you in 2002, our seventh consecutive year.

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.