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The Railroad Week in Review 1/26/2002

Canadian National reported some robust earnings this week and after my Tuesday visit to Montreal it's easy to see why. As with the recent UP trip, the morning was spent in conference on shortline matters followed by an afternoon out on the road to see how it all fits.

First of all, financial results. CN again posted the lowest full-year OR in the biz, 68.5, on revenues of C$5.7 bn, up 4% yoy. For the quarter freight revenues increased 10% to C$1.5 bn against 7% more operating expense, generating a very respectable OR of 66.1. Net income for the quarter rose 25% to C$296 mm from C$237 yoy and for the full year adjusted net income was up 11% to C$978 mm yoy. Fourth quarter operating income improved by 18%.

The WC acquisition completed in October was immediately accretive as expected, adding sales of C$129 mm, operating income of C$43 mm, other income of C$11 mm and net income of C$17 mm, or eight cents per diluted share, to CN's fourth-quarter and full-year 2001 financial results. Clearly CN has some compelling cost and service quality stories. At the top of the list is delivering more than 90% of carload freight on time – at the precise time promised to the customer when the sale was made. I asked specifically about that when we were sitting in the control tower at Taschereau Yard in Montreal. Here's how it works.

One of the screens shows how every car in the yard is doing with respect to its trip plan. The YM is charged with assuring every car makes its assigned connection, as most do, helping to drive the average dwell time to just 11 hours. The trip plan for the rare car missing its connection gets tagged with the real dwell and every yard in the route between there and the destination does what it can to get the car back on plan. That's why you'll see merchandise cars on intermodal trains and auto racks with empty coal hoppers. Like we've said before, it's "rugby railroading."

Every one of the CN merchandise carload groups showed increases in 4Q01, never mind the economy. Only intermodal was off, and that by one percent. This has to be particularly good news to the 90 or so shortlines connecting to CN. Collectively they contributed 20% of the revenue on 13% of the carloads, according to Francois Hebert, VP Corporate Development. More important, CN wants to build this business still further.

I've seen the initial program for the upcoming shortline meeting in Chicago (Mar 10-12) and it gets right to the point of enhancing the business relationships. The beauty of the scheduled freight railroad is that it can extend right to the shortline customer – it doesn't have to end at the interchange. All it takes is a commitment on both class 1 and shortline to running the railroad the same way every day and eliminating random events. Shortlines could do worse than hitching their wagons to this star.

Union Pacific likewise posted strong results. For the quarter rail revenues rose 2% to $2.6 bn against a 1% expense increase to $2.3 bn and an operating ratio of 86.0. For the year, rail revenues were up 4% to 10.4 bn while operating expenses rose a point to $8.9 bn for an OR of 85.5. Coal (+12%) and ag products (+4%) were the 4Q01 revenue carload winners and coal alone

(+12%) was the only up commodity for the year. Average revenue per car for the year was up a point with Ag products and intermodal the winners at +3%.

In Thursday's conference call RR President Ike Evans noted that injuries per 200,000 hours worked has fallen to 2.5 events, a 17% improvement since 1999. Evans highlighted the new product success stories – the I-5 corridor, Express Lane (see my upcoming Feb Railway Age column), and the intermodal "Blue Streak" service. The payoff has been an increase in the customer satisfaction index to a record 77%. In is closing remarks, CEO Dick Davidson said the 2002 goals include getting the OR below 80, a capex program in the $1.7+ range, free cash flow $350-$450 mm, and continued improvement in ROIC. Sounds reasonable to me.

Norfolk Southern posted $275 mm 4Q01operating income vs. $116 mm yoy. Unfortunately, there was little change in the revenue stream to report, however operating expenses came down 10% thanks to significant drops in compensation and benefits, materials serviced and rents, and fuel. For the full year, NS brought in operating income of $1.0 bn vs. $633 mm yoy before backing out the $165 mm for workforce reduction expense in 2000, yielding a 6.6% drop in operating expense on essentially flat revenues of $6.2 bn.

The story here is one of a continued and successful push on getting rates up and expenses down. NS handled 20,600 fewer carloads in 4Q01 and 222,100 for the year with really no effect on revenues and a significant effect on earnings. Thus the quarter's OR got kicked back closer to where it belongs – 82.0 for the quarter and 83.7 for the year. The details are in the carloadings by commodity, and for that the reader is directed to the investor's page at www.nscorp.com for the Quarterly Financial Review. Note particularly the changes in traffic and revenue per car on page 9 – auto, forest products, metals. Shortlines should direct their energies accordingly.

Canadian Pacific railroad results improved for the quarter and year however the one-time charges associated with breaking up the Mother Ship overshadowed rail operating results by cutting yoy quarterly earnings in half and for the year by 23%. But since our purpose here is mainly to get a gauge on rail operations we'll cheer on our chums in Calgary for racking up a 12% gain in operating income their first quarter on their own. But for the year freight revenue rose 1.2% while operating expenses crept up 1.7%. Let's hope the quarterly trend prevails.

The tealeaves seem to be pointing that way. Revenues in 4Q01 came to C$951 vs. C$928 and C$3.70 bn vs. C$3.66 bn for the year. Operating income in the 4th quarter was C$261 vs. C$233 yoy and C$841 vs. C$845 for the year. The changes in expense items as a percent of revenues 4Q01 vs. the full year tells us something of what the newly independent company has in mind. Compensation, fuel, equipment rents (mainly car hire), and materials dropped while depreciation and purchased services rose slightly. Could it be they are outsourcing more and writing down old stuff? If so, it gets my vote.

Burlington Northern Santa Fe's 4Q01 operating income slipped 25% yoy and eps declined 12% excluding workforce reduction costs. Revenue for the period was off 1.6% remaining at $2.3 bn while ops expenses rose 5.6% to $1.9 bn thanks mainly to increased compensation-related items. Higher billing for ag products (+5%) and coal (+3%) were offset by declines in merchandise traffic (-3%), and automotive/intermodal (-8%).

For the year revenues didn't budge from 2000's $9.2 bn while ops expenses were up 5% again with the increases pretty much across the board. Consequently operating income drifted down 17% to 1.8 bn and net income fell 25% to $731 mm. The OR added 3.8 points yoy to 80.9. The only bright spot on the commodity scene is ag products, up 6%. Intermodal, automotive, merchandise, and even coal were off yoy. Looking ahead, BNSF says 1Q02 will see lower freight revenues thanks to continuing economic softness, though fuel costs will drop further. The share repurchase program will continue. For the year, assuming the economy behaves as generally expected, there will be "modest" revenue growth which could translate into double-digit eps growth and $500 mm in free cash flow.

CSX earned $65 mm in 4Q01, up 20% from the $54 mm reported in 4Q01. But for the $60 mm New Orleans fire class action settlement it would have earned $101 mm. Operating income excluding the settlement was $281 mm, up 29% from $218 yoy on flat revenues of $2.0 bn. The caveat with CSX reporting is that the corporate numbers include some $225 mm in marine and other operations; our focus remains on "surface transportation" comprised of CSXT railroad and the CSXI intermodal arm, worth $1.8 bn in 4Q01 revenues, unchanged from last year.

Surface transport operating income was $186 mm for the year, down 9% from $205 mm yoy and the OR went up 90 bp to 89.6 in the same period. For the year, corporate reported revenues of $8.1 bn, same as last year. Surface brought in $7.2 bn, no change either. Savings in Conrail fees, rents, and fuel helped ease the OR to 88.2 from 90.2 yoy. Looking ahead, the 87% improvement in operating income (absent the settlement) says the CR problems are being worked out and lowered fuel saving will help the cost side. We continue to think there is room for service enhancement and that should improve yield on the carload side. As we've mentioned before (WIR 12/8/2001), CSXT has made a commitment to growing the carload business. The tools appear to be in place to do just that.

Before closing it should be noted that there's a common theme behind the railroad earnings picture – higher benefits costs. Morgan Stanley's Jim Valentine writes in his BNSF report, "The railroads are encumbered with one of the richest health and welfare plans. For two years in a row annual premiums have risen by nearly 20%, pushing the annual cost per non-union employee to roughly $10,000, all of which is paid by the railroad." He goes on to say that this exposure could negate productivity gains elsewhere and that "long-run growth rate could be impaired."

This issue of WIR runs a bit longer than usual but then it's not usual we get all six major class 1s reporting in a four-day time frame. It's a lot to digest, and there's a lot of help behind the scenes. Readers are encouraged to visit the investor pages of the individual railroad websites to get the full flavor of what's happening out there. To whet your appetite, I've attached a summary of benchmark metrics so you can compare The Six all in one place.

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.

Railroad Statistical Data based on earnings presentations the week of Jan 21,2001

Benchmarks	**BNSF**	**CNI**	**CP**	**CSXT**	**NS**	**UP**
Railway Operating Data				**"Surface Tr"**		
Year Ending	12/31/01	12/31/01	12/31/01	12/31/01	12/31/01	12/31/01
Ops Revs*	$ 9,090	$ 5,457	$ 3,699	$ 7,194	$ 6,170	$ 10,391
Ops Exp	$ 7,453	3,607.08	$ 2,858	$ 6,287	$ 5,163	$ 8,916
Equipment rents (1)	$ 740	$ 332	$ 272	$ 581	$ 433	$ 1,214
Employees	39,217	22,868	15,480	36,189	29,675	50,523
Rev Carloads (000)	8,155	3,821	2,423	7,118	6,625	8,916
Route miles	33,000	17,986	13,893	23,400	21,800	38,654
Locomotives	5,000	1,800	1,825	6,500	3,575	7,007
Diesel Fuel Used (mm gals)	1,737	351	266	580	478	1,287
Rev ton-miles (mm)	501,800	153,095	110,622	206,600	182,200	503,723
Gross ton-miles (mm)	896,566	293,857	211,157	***NA***	348,700	957,668
(1) CSX incl building rent						
Railway Statistical Data						
Op Ratio	82.0%	66.1%	77.3%	87.4%	83.7%	85.8%
Equip Rents as % RR revs	8.1%	6.1%	7.4%	8.1%	7.0%	11.7%
Revs/mile	$ 275	$ 303	$ 266	$ 199	$ 283	$ 269
Revs/loco	$ 1,818	$ 3,032	$ 2,027	$ 1,107	$ 1,726	$ 1,483
Revs/CL**	$ 1,115	$ 1,428	$ 1,527	$ 1,011	$ 931	$ 1,165
Revs/emp	$ 231,787	$ 238,630	$ 238,953	$ 198,790	$ 207,919	$ 205,669
Revs/MRTM (cents)	1.81	3.56	3.34	3.48	3.39	2.06
CL/route mile	247.1	212.4	174.4	196.7	303.9	230.7
CL/emp	207.9	167.1	156.5	196.7	223.3	176.5
CL/loco	1,631.0	2,122.8	1,327.7	1,095.1	1,853.1	1,272.4
RTMs/gal	289	436	415	356	381	391
MRTM/emp	12,795	6,695	7,146	5,709	6,140	9,970
Load to empty ratio	56.0%	52.1%	52.4%	#VALUE!	52.3%	52.6%
RTMs/CL	61,533	40,067	45,655	29,025	27,502	56,497
Tons/car	80.00	80.00	80.00	80.00	80.00	80.00
Length of haul	769.16	500.83	570.69	362.81	343.77	706.21

***** Railroad operating revenues and expense. CSXT includes CSXI. Load/empty ratio is revenue-ton-miles divided by gross ton-miles. Locomotive count based on most recent available. Tons per car my arbitrary choice.***