The Blanchard Company
www.rblanchard.com

The Railroad Week in Review 3/16/2002

Shares of the Big Six Class I rails sold off this week, with only BNSF finishing unchanged at $30. NS was hardest hit, shedding 6% from its Tuesday high to close at $24. Genesee & Wyoming (GNWR) and RailAmerica (RRA) both rose more than 3% while FEC and KCS shed a couple percentage points. Volatility was unusually high with hourly candlestick charts showing some wide swings.

GNWR's three-for-two stock split hit Thursday for owners of record Feb 28. As any owner knows, this has been a consistent performer. Shares worth $10 a year ago now weigh in at $23 (split-adjusted). Over five years GNWR share value grew by 75% vs. 45% for the DJ Total Market Index and 15% for the DJ Rail Index.

Meanwhile, RRA shares are up 20% for the year and for five years up a neat double. What's interesting to me is the different approaches taken by the two companies, in North America at least. GNWR has pursued a strictly regional approach and RRA has taken the wider view with many non-contiguous properties. Internationally, each has developed niche franchises with their own unique selling points. And in the process both have beaten the averages handily.

Canadian National hosted its annual shortline meeting outside Chicago this week. VP-Corporate Development Francois Hebert had said he wanted to take shortline relationships "to a new level" and if the response to the session is any indication he's on his way. The high point of this shortline meeting was the commitment to immediate listening and immediate feedback.

CN has 85 shortline partners. About 24% of CN revenues involve a shortline – roughly $C1.3 bn a year. Forest products (65% lumber and 35% paper) account for 22% of CN revenues and two-fifths of this is on a shortline at some point. Metals, 8% of CN revenues, accounts for 13% of shortline revenues. Grains and fertilizers is 20% of CN revenues with wheat and potash dominant. Not surprising when you realize that 40% of all North American potash consumption is within 100 miles of CN or one of its shortlines. Clearly the CN-shortline relationship is broad-based and vitally important to the health of the enterprise.

Thus much care was given to this meeting's content and presentation. Most important, there were four breakout sessions on functional disciplines and six to address divisional matters chiefly from a commercial viewpoint. The four operating sessions were on Responsible Care and Safety Process, Asset Utilization and Car Supply, Data Interface, and Scheduled Railway Service design. Because the outcomes of the functional meetings are still works in progress, it would be inappropriate to get too detailed here, though results are to be posted at www.cn.ca within days.

It was an appropriate mix of operational topics because they are so clearly interwoven. You can't run a scheduled railroad without proper data interface nor can you control asset utilization without a strict operating plan, which in turn allows one to keep track of hazmats and meet the stewardship tenets of Responsible Care. I was privileged to participate in the Service Design group where we talked about extending trip plans to shortlines. In less than two hours we had an action plan and ownership of Next Steps. That's impressive.

While all of this may be well and good, the fact remains that shortlines are part of the North American rail network and as that network goes so go the shortlines. By themselves small railroads can't bring in business the Class I roads can't (or won't) handle and they can't increase revenues faster than customers are willing to increase production or switch to rail from truck.

Non-intermodal, non-coal, non-automotive merchandise business, the bread and butter of shortlines, continues to drift downward. For the week ending Mar 2, each of the Big Six Class I roads saw decreases in merchandise loadings for the week and quarter to date. Of the smaller roads, only KCS was up with plusses in chems and grain.

Looking solely at NA traffic, Feb "same-railroad" carloadings for RRA slipped 2.5% even as same-railroad coal and minerals traffic were up nicely and total system loads rose 22.5%. GNWR's Feb "same-railroad" business dipped 1.2% yet was up 8.1% system-wide in NA. Forest products and aggregates rose while coal and metals posted significant declines. Nearly all these cars hit a Class I railroad at some point and with Class II and III roads accounting for roughly a fifth of Class I carloads, the economic connection is quite clear.

The YTD run-up in Class I stock prices remains a puzzlement. Jim Valentine and Chris Leshock at Morgan Stanley properly opine there are three "buckets" for increased pricing: recovery of lost pricing as merger fallout, better market-based pricing, and improved service relative to truck. However, much of the earnings increases from those three buckets for the next three years is already priced in, leaving little upside.

Which leaves little room for shortlines to see earnings increases from any of the three buckets. However, even as we expect to see more Class I cost savings as they move to scheduled operations, the view from here is there is still a lot of shortline cost takeout to be had. Only this time it will come from better service integration with the Class I roads, from consolidating interchanges and overhead costs (viz. RRA and GNWR acquisitions), and from better asset management.

And speaking of management, GNWR announced some very positive additions this week. Robert Grossman, formerly President of Emons Transportation, becomes EVP, Government and Industry Affairs, while his former CFO Scott Zigler becomes VP Ops and Finance. Shayne Magdoff, a GNWR officer since 1987, was tapped as SVP, Administration and Human Resources. Robert and Scott will remain in York and Shayne will continue to work out of her Rochester office. Congratulations, all.

Forest products (paper and wood) dominate shortline loadings so the *Barron's On Line* article, "Time to Fold Paper Stocks," was met with more than passing interest. The theme is that the group's equity prices may be in for a turn south. Still, the group has consistently brought in double-digit returns. The other shoe dropped when Friday's WSJ reported some positive notes on the group from Lehman Brothers. Both articles comment on the present trend of acquisitions and plant consolidations. Good for the forest products biggies, not so hot for shortlines serving smaller, older production facilities.

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.