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The Railroad Week in Review 3/23/2002

Quote of the Week: "Inefficiency was the carbuilders' best friend," Mike McClellan, VP Intermodal, Norfolk Southern, in Railway Age.

Trinity Industries (TRN), a major player in the new rail car business, keeps popping up in the tech analysts' charts as a possible short play and in the past month short interest rose to more than 4 mm shares from 1.6 mm shares, a 148% increase. TRN closed Friday at $24, down from its 52-week high of $28 reached last December. Coincidentally, the rails themselves are running smarter railroads with better asset utilization, seeing rising stock prices stock prices YTD, up anywhere from 5% (BNSF) to 30%(NS).

Of late, however, rail stock prices have continued their sideways ways. BNSF has been in a dollar trading range between $30 and $31 for two weeks. CN is stuck at $50, CP at $21, and CSX after a run to $40 vacillates around $38. NS has drifted back to $24 from $26 and has slipped below its 200-day average. KCS on the other hand has crept ahead of its SMAs, and is now back at $15. Likewise, GNWR is ahead of the curves at a split-adjusted $23 while RRA has been hanging around $11 for a month. Even UP, which hit $65 mid-month, has drifted back to a $60+ range.

But there is a way to make a few bucks in a sideways market. You do it with options. If you are long the stock, sell covered calls slightly out of the money or OTM (strike price greater than the underlying). Say you bought Union Pacific (NYSE: UNP) at $55 and the underlying is at $60. You can sell an April 65 call for $1.00 which lowers your cost basis to $54 and guarantees you a profit of $11 if the stock is called away. If April 19 comes and goes and UNP remains below $65 you pocket the buck and sell the May 65s.

But what if expiration date is closing in, UNP is approaching the strike price, and you don't want to sell? Simply buy back the call you sold and sell another OTM call for the next month. A word of caution, however. Try it a few times on paper before doing it for real. And check out the educational centers at www.cboe.com or www.888options.com.

EBITDA is an interesting concept. On the one hand, it can tell you what a railroad is doing with its core assets; on the other hand it obscures heavy debt incurred by aggressive capex or acquisition programs. And the trouble with debt, as every investor knows, is that it must be serviced regardless of revenue stream or anything else. High debt service in a low revenue environment can hurt earnings. QED.

Now comes the WSJ on the subject. In Tuesday's "Heard on the Street" writer Aaron Elstein notes that the increasingly popular measure has been called into question of late because it's "always positive and inevitably looks better than earnings per share." Moreover, and this has always been my complaint, it can be anything you want it to be, not having any GAAP definition as does, say, net income or depreciation. What exactly are "earnings," for example?

Depreciation lets you wear out an asset so as to invest capital to replace what you wear out, so capex and depreciation are component parts of operating cash flow. Money spent on interest isn't available for operating cash flow, so backing that out is a distortion. At the end of the day, the solid company ought to have an operating cash flow margin (operating cash flow as a percent of sales) equal to or greater than the net margin. EBITDA won't get you there.

RailAmerica total revenues for 2001 rose 3.4% to $369.6 mm, 2/3 of which was generated by the North American rail group of some 36 properties operating on 6,200 route miles of track. NA sales were $245.4 mm, up 6%. Offshore revenues dropped 1.2% to $123.5 mm. Total operating expenses, including depreciation and excluding gains from asset sales (to keep an apples-to-apples comparison I prefer the class 1 reporting model) grew less than a point to $301.3 mm yoy. Operating income computed thus comes in at $68.3 mm vs $58.9 mm in 2000, generating system operating ratios of 82.0 and 73.5 respectively.

North American "same railroad" carloads increased 4% to 885,579 for an average of $277 per car. The NA rail group achieved a respectable 75.6 operating ratio for total operating expense of $185.5 mm. Offshore the operating ratio shed two points to 79.6 for operating expense of $98.3 mm. Total rail operating expense comes to $283.8 mm.

NA rail sales in 4Q01 were up 2.5% to $60.7 mm while offshore sales dipped 1.3% to $30.2 mm. Total sales rose $1.3% to $91.0 mm. Operating expenses were flat at $77 mm yoy. The NA group posted a 76 OR while the Offshores brought theirs down 4.6 points to 84.7. Total rail expenses were $72.5 mm out of a total $77.4 company-wide. Net income from continuing operations quadrupled to $5.2 mm yoy. Plugging NA performance into my Benchmark spreadsheet (available at www.rblanchard.com) RRA compares favorably with other shortlines in operating ratio, revenues per mile, revenues per loco, and carloads per route mile. One might wish for some improvement in revenue per car, revenue and expense per employee, however.

On the financial side, RRA has really gone to town in debt reduction, reducing LTD to 137% of equity from 291% and to 56% of market cap from 73% yoy. This is most helpful, especially when interest payments are eating up most of the operating income -- $52.4 mm out of $68.3 mm for the year, e.g. Also the high debt hurts net margins – 2.7% in 2000 and 4.75 in 2001.

From Chris Burger comes this mind teaser: "How good a switchman are you? Imagine an old-time single-track road where a three car train meets a four car train. Between the two is a side track long enough for one loco or one car. The balloon-stack locos have long pilots and are not equipped with any coupling devices on the pilot. How do you get the two trains by each other? No use of poles or fly-switching." Let me know if you figure it out.

Matt Rose became BNSF Chairman effective Thursday. Matt has been President and CEO since 12/7/2000. Rob will not stand for re-election to the Board of Directors and will retire as a Board member effective with the April 17, 2002, Annual Meeting of Shareholders. To my mind, it was Kreb's vision that combined the resources of the former Santa Fe, GN, NP, CB&Q plus all their predecessor lines to become a real industry powerhouse and leader. Best wishes to you, Rob, and thanks for keeping the door open. Matt, I'm grateful to you for your kind remarks and candid observations. We'll be in touch, I'm sure.

Roy Blanchard

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