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The Railroad Week in Review 4/6/2002

Rail stocks this week got set back a bit from the gains of last week. No real reason, though some observers suggest that the "non-professional" buyers of rail stock have left this particular safe haven for the looming lure of re-emerging techs. Taking the broader view, however, some watchers say there is still room for stock price appreciation this year. To be sure, others maintain improved loadings and – until this week – moderating fuel prices had already been baked into stock prices.

But nobody's talking about dividends. Even at two bits a share they still add to shareholder returns and can be used to gauge an issuer's total return potential. A very useful tool is the YPEG: yield adjusted price-earnings-growth ratio. The usual guidelines apply – a reasonable PE and a price-earnings-growth ratio less than one, for example. A quick look at the chart on page 3 says that CP is the most undervalued and BNSF may be a bit pricey.

Note we're using Morgan Stanley's new fuel-adjusted 2002 earnings estimates and Yahoo's proprietary year-end target price. We've added the annual dividend to the earnings estimate and calculated a growth rate based on that sum. Last year's dividends are ignored as we're talking in terms of getting in *today*. The YPEG is the Nominal PE (target price over estimate) divided by the growth rate. Since the PE is theoretically supposed to equal the growth rate, a PE greater than the growth rate indicates a premium price and vice versa.

Canadian National has gone to court to challenge a Canadian Transportation Agency (CTA) decision to hear an amended running rights application by Ferroequus Railway Company Limited (FE). According to a BMW newsletter, FE runs a 1/2-mile steam tourist train operation in St Thomas, ON. Now, using its "certificate of fitness" as a federally regulated railroad, FE wants rights over 1350 miles of CN in three provinces to reach the port of Prince Rupert BC. Moreover, FE wants to solicit business from CN customers along the way.

CN's position is that the amended application is an abuse of process. The CTA has twice set aside FE attempts to gain forced access to CN's network and customers. Clearly this is a real reach, and the unfortunate part is it tends to tar all shortlines with the same grasping brush. And FE is not alone. Recall also that OmniTRAX asked for running rights in Northern and Central Saskatchewan and Northern Manitoba totaling 1500 miles, almost twice the distance over which it currently operates.

RailAmerica (RRA) has sold off more of its under-performing properties as part of a continuing portfolio refinement process begun last summer. The present transaction concerns the Georgia Southwestern (GSWR), a collection of three non-contiguous properties operating 288 route miles and handling some 12,000 carloads a year. Commodities run the gamut from aggregates to chemicals to scrap metal for total revenues of $3.7 mm. As you can see, at 42 carloads per mile traffic density is about half what one needs to run a shortline today. The $308 average revenue per car is on the high side, however.

Approximately 102 miles of track and associated real estate were sold to the State of Georgia for $5.4 mm. In related transactions, a local, private operator purchased the capital stock of GSWR from RailAmerica for $1.0 mm, as well as eight RailAmerica locomotives for an additional $0.7 mm. The operator will continue to operate the railroad on behalf of the State of Georgia.

Norfolk Southern has turned the corner. Back in 1995 NS sported one of the lowest operating ratios in the land – 73.5. Then came Conrail and by the end of 2000 it had climbed to 89.7. In 2001 came the commitments to the scheduled railroad and eliminating random-event railroading with the result that the OR fell back to a more reasonable 83.7. A look at the revenue and expense trends 1999-2000 show expenses increasing at a faster rate than revenues. That pretty much stopped in 3Q01, allowing the year to finish flat in revenues yoy but down 3.7% in expense.

The 2002 estimates look for a point or so increase in sales and two points less for an operating ratio under 81. The theme continues through 2003 and an OR of 78.5. Can they do it? I think so. The first task in speeding up the railroad is to keep cars moving, and that means keeping yards fluid – recall the 12-hour dwell at CN's Taschereau Yard in Montreal (WIR 1/26/2002). Here NS is making strides as shown on the STB Performance Measures page at www.nscorp.com. Of the 19 yards on the list, yoy dwells have gone down in all but two (Harrisburg and Cincy) and remain the same in one (Roanoke). Sheffield (AL) takes the prize for best of class, down 35% to 18 from 28 hours.

The second part is getting trains over the road to make their connections and the newly-hatched Thoroughbred Operating Plan (TOP) ought to do the trick. It optimizes the way trains are built and the network is run and in so doing improves on-time performance, cuts car handling, eliminates yards, shortens routes, gets train speeds up, and boosts asset utilization. According to NS most carload customers ought to see 10-30% better transit times.

Also this week NS announced its new East Carolina Business Unit (ECBU), set up to manage the lines east of Raleigh (NC) with both operational and commercial decisions vested in one individual. The property involves some 485 route-miles of medium-density railroad. The budget looks very much like a shortline's in that the revenue base is a percentage of the line haul revenue accruing to NS from the ECBU and the operating expense targets are set very close to a shortline pro forma percent of revenues.

The ECBU is the first of its kind in NS, though it most likely won't be the last and I suspect will be imitated on other class 1s. The beauty of the ECBU model is that it is similar to a short line railroad but is linked to Norfolk Southern's centralized dispatching, customer service and operating systems. It has the flexibility and speed of a small railroad backed by the industrial development and technological resources of a major carrier. If the ECBU and its successors work the way I think they will, just imagine what kind of message that will send to the Mother Ship.

Headline: "Amtrak Backs Off Elimination Threat." Pity. It says here in the Phila Inquirer that Amtrak has sent letters to the 46 guvs of the states it has a presence. The letter reportedly is an "update" about its $1.2 bn bid for federal funds now languishing in congress. Recall that a month ago Amtrak President George Warrington warned that absent funding 18 long distance trains would come off in Oct. The letter sounds a bit more conciliatory, however the veiled threat remains. Better they come off now and be done with it.

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.

Class I Rail Stocks 2002 Estimated Earnings Plus Dividends
As of 4/5/02

Ticker	Recent Price	2002E eps*	Actual PE	2002 Target**	Nominal PE	Divs	Target+ Divs	Growth Pot'l	YPEG
BNI	$ 28.96	$ 2.10	13.8	$ 31.38	14.94	$ 0.48	$ 31.86	10.0%	1.49
CNI	$ 47.46	$ 3.35	14.2	$ 56.67	16.92	$ 0.50	$ 57.17	20.5%	0.83
CP	$ 20.36	$ 1.40	14.5	$ 25.00	17.86	$ 0.33	$ 25.33	24.4%	0.73
CSX	$ 36.68	$ 2.00	18.3	$ 46.33	23.17	$ 1.00	$ 47.33	29.0%	0.80
KSU	$ 15.66	$ 0.78	20.1	$ 19.00	24.36	$ 0.31	$ 19.31	23.3%	1.05
NSC	$ 22.89	$ 1.20	19.1	$ 27.67	23.06	$ 0.24	$ 27.91	21.9%	1.05
UNP	$ 58.35	$ 4.10	14.2	$ 70.75	17.26	$ 0.80	$ 71.55	22.6%	0.76

* Morgan Stanley fuel-adjusted 4/3/2002
** Yahoo.com