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The Railroad Week in Review 4/27/2002

Earnings Week saw one consistent theme through all presentations. Revenues and operating expenses were flat to down but the hiatus in loadings due to the soft economy provided opportunities to make the railroads run better. Consequently, capacity is there to take up carloads and revenues without adding significantly to operating expense.

CSX was first up, reporting per-share income three times what it was a year ago, 32 cents vs. 10 cents, if you ignore a 20-cent accounting charge. Operating income rose 12% to 212 mm from $189 mm even as sales sank 3% to $1.96 bn from $2.03 bn yoy. Below the line interest expense remained unchanged, eating up 60% of gross income in 1Q01 and 54% in 1Q02. And that's where most of the big jump in net profit before accounting charge comes from.

Railroad, incorporating both CSX Transportation ("Tee," as they call it) and CSX Intermodal, saw small changes but generally in the right direction. Sales drifted down 3% to $1.7 bn from $1.8 bn as operating expense fell 4% taking another point off the operating ratio, yet at 88.9 it's still the highest of the class 1s. Operating income rose 7% to $194 mm from $182 mm on essentially small productivity changes.

The high operating ratio remains the biggest drag. The improvements in metrics point to capacity for adding revenue at little incremental cost. What "T" really needs to do is take revenues up at little or no change in operating expense. This quarter's operating expense of $1.5 bn would support $1.8 bn in revenues at an 85% operating ratio. That represents a 5% jump in sales, a tall order in any economy. But it would be a comfort for CSX to head in that direction.

Burlington Northern Santa Fe's Matt Rose opened his call by saying, "It's all about revenue." Even with price increases averaging 2% on the industrial products side, revenues fell 6% to $2.2 bn from $2.3 bn while operating expenses declined by 4% to $1.8 bn from $1.9 bn for an 82.8% operating ratio vs. 81.5% yoy. A 23% lower interest load and 2% fewer shares contributed to a 31% gain in eps, $0.45 vs. $0.34, on $368 mm ops income, down 16% from $419 mm.

Now, as to positioning. BNSF is rolling LOGS (the centerbeam Loading Guarantee Program) to other car types, is adding 25% more guaranteed services (e.g., California to Pennsylvania via NS, announced 4/22/2002), and has just had its 5th – and best -- Customer Advisory Board meeting. System on-time performance was an all-time best at 92.3%, though Chief Ops Officer Carl Ice quipped that if you counted early cars it would have been even better.

The focus is on consistency and reliability, and this in turn means traffic density. That's a challenge in the carload trade, where 94% of the business comes from a third of the stations served. It's going to take a coordinated effort between the business units and the operating department, says Ice, to get density and service offerings in line. Which is as it should be with revenues per mile, per employee and RTM virtually unchanged yoy. The outlook for 2Q02 isn't much better, says BNSF, however the elements are there for a much-improved second half.

Canadian National reported (all in $Canadian) 1Q02 profits of $230 mm vs. $202 mm a year ago, absent the $73 mm gain from the sale of CN's 50% interest in the Detroit River Tunnel Company. Diluted eps on the same basis came in at $1.15 vs. $1.03 yoy, up 11.6%. CN's operating income for the quarter was up 5% while its operating ratio increased 0.6 of a point to 73.1. Revenues went up 8% to $1.5 bn however ops expense was up nine points to $1.1 bn.

It was a tough quarter even for CN as the smaller grain crop pushed down carloads in ferts and whole grains. Coal was off thanks to milder weather and lower offshore metallurgical coal shipments. Intermodal took a small hit from the loss of a move in the overseas segment, partly offset by continued increases in the Canadian domestic segment. There were some bright spots on the carload side as forest prods, chems, mets and mins all saw double-digit revenue gains.

Looking ahead, CN expects its core merchandise businesses will continue to grow as the North American economy improves. The increase in expenses during the quarter was mainly due to the consolidation of WC operating expenses, so that's past. And that may be what's behind some of the slight productivity measure decreases – revenues per route mile and revenue ton-mile (RTM), length of haul and RTMs per employee, carload, and gallon of fuel consumed. That being said, CN's strength in the service-sensitive lanes and its price/value package are there for the long pull.

Norfolk Southern earnings from continuing operations increased 41% to 22 cents from 16 cents yoy. Operating income rose 17% to $237 mm over 1Q01 though total quarterly revenues dropped 2% to $1.5 bn. Coal was the big loser, down 9% with intermodal off a point and merchandise carload flat. Operating expense was down 6% yoy to $1.3 bn and the operating ratio shed 2.5 more points to 84.2. The theme, as we saw with the others, is one of zeroing in on the price/value relationship and finding the operational efficiencies to support it. As CEO David Goode said in his opening remarks, "We can handle additional volumes without major new costs."

That's as it should be. Chief Commercial Officer Ike Prillaman is looking for coal volumes to rebound (his word) in Q2 and has launched some innovative short-haul initiatives in both intermodal and coal-haul lanes. To be sure, that will lower average revenue per unit but it does wonders for asset utilization. And in a business that's 90% fixed cost, that's good. On the carload side, only auto and ag produced yoy gains, and they ought to stay up with continuing auto production strength and more long-haul feed corn to the southeast. Chems, mets/construction are poised for positive numbers going forward while problems in the paper industry remain.

Chief Operating Officer Steve Tobias reported the Thoroughbred Operating Plan (TOP) is now in its final implementation stages. Terminal dwell, system train speed, and on-time performance are all greatly improved yoy. Loco count is down 5%, yet crew starts remain unchanged as the TOP strives to reduce dwell times by getting cars outta town. Cutting crew starts won't do it, and there are other ways to save. Car hire as a percent of revenue is down 135 BP and fuel use is down 6% while carloads per loco and employee are improved. And that sure ought to support more cars at less cost. QED.

Union Pacific came out even vs. 1Q01. Railroad revenues $2.55 bn, revenue carloads 2.18 mm, average revenue per car $1170. They did take operating expense down 3% so operating income increased 14% to 489 mm and the operating ratio shed 220 BP to 81.6. In his opening remarks Chairman Dick Davidson said "We took a haircut" on some auto rates to get the GM triangulation in place. Maybe so, however even with a 2% cut in revenue per car the auto segment posted a 2% gain. Intermodal was the only other commodity group in positive territory, and that by a point.

Railroad President Ike Evans spoke of the continuing improvement in UP's proprietary "Customer Satisfaction Index," now approaching 80 from its start at 72 three years ago. He backed that up with the "Service Delivery Index," now standing at 74 vs. 65 when it began in 1999. Asked specifically about "on-time performance," Ike demurred, saying that a high degree of customer satisfaction is the best measure. He went on to say there is a "huge unpenetrated market" for reliable seamless rail transportation as evidenced by products such as the Blue Streak and Express Lane, both of which are experiencing double-digit growth. Such new products are worth $75-100 mm a year in high-yield revenues

My take is that UP is a strong player with plenty of capacity *and money* to do basically whatever it wants whenever it wants. Evans sees opportunity in just about every commodity lane and the economic tea leaves say he's probably right. A point or three improvement here and there in such measures as fuel consumption, RTMs, GTMs, RTMs per employee, and length of haul can really add up with you're dealing with a base of billions.

Kansas City Southern nearly doubled earnings to $11.7 mm from $5.9 mm thanks in part to 8% lower KCS operating expense (OR for KCSR 80.1 vs. 85.8 yoy) and a 25% drop in interest expense. TFM equity income fell $6.3 mm, but that was partly offset by a $4.4 mm gain from the sale of the Mexirail interests. KCS revenue gains in coal, agriculture and forest products were partially offset by shortlfalls in chems, intermodal and automotive. South of the Border Q1 equity earnings in Grupo TFM rose $2.8 mm yoy on flat revenues vs. 1Q01.

The TMM dispute resolution gives KCS operational control over Tex-Mex so traffic levels can increase unencumbered. The carload/revenue mix, reduction of debt, and expense control – ops exp down 10% from 1Q01 though up 1% from 4Q01 – will position KCS to reap more rewards from the inevitable economic recovery. The carload business is strong, with yields up 8% yoy driving a system-wide yield gain of 1.1%.

Finally, the new marketing agreement with BNSF brings new profit opportunities in chems and grain (Mex specifically excluded) and, as CEO Mike Haverty noted in the call, complements similar arrangements with CN, NS and IMRL, and by extension DM&E.

Canadian Pacific was able to reduce expenses 8.7% against a 4.7% decrease in freight sales thus taking 3.6 points of the OR to a respectable 79.9. Operating income rose 15.8% to $C176 mm while net income and eps both rose 10% before one-time items. CP saw grain revenues plummet 20% following the worst crops in 12 years, repeating the experience of CN, above. Unlike CN, however, CP's industrial products saw a 7% revenue decrease against CN's heady results in chems and petrol, mets and mins, and forest products.

Yield is impressive, with CP posting the highest revenue per carload among its peers (see chart). Note too that despite its small size relative to its peers revenue per employee and MRTM are "in the ballpark." Not bad for a railroad where bulk products (grain, coal, sulfurs and ferts) represent 60% of total RTMs. CEO Robert Ritchie, in his remarks to shareholders earlier this month, noted that bulk customer expectations re private car cycle time are being met or exceeded thanks to the scheduled railroad.

It should also be noted that the 43 cent eps without the one-time items beat the street and reflects very aggressive cost control. Fuel was down as one would expect however comp and benefits actually fell 2%, contrary to the expectations built up elsewhere. Material and services fell 16%

as improved safety practices and insurance recoveries from previous years more than offset costs relating to a North Dakota derailment.

Florida East Coast Industries lost $416,000 vs. a profit of $2.8 mm yoy. FEC Railroad net income slid 6% to $9.7 mm while the telecom loss widened 12% to $9 mm. Rail revenues actually rose 3% due mainly to increased aggregate shipments for the construction industry plus a new Tropicana contract moving chilled juice to the Northeast. Intermodal units were off 2% and revenues slipped 3%. Rock and intermodal comprise more than 60% of FEC operating revenues.

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.

Comparing the "Big Six" Class One Railroads

Railway Operating Data	BNSF	CN ($Canadian)	CP ($Canadian)	CSX (CSXT+CSXI)	NS	UP
Period ending	3/28/02	3/28/02	3/28/02	3/28/02	3/28/02	3/28/02
Freight Revenues ($mm)	$ 2,138	$ 1,452	$ 840	$ 1,748	$ 1,498	$ 2,662
Operating Expenses ($mm)	$ 1,795	$ 1,103	$ 699	$ 1,554	$ 1,261	$ 2,173
Ops income ($mm)	$ 343	$ 349	$ 141	$ 194	$ 237	$ 489
Employees	37,470	22,501	15,481	34,905	28,909	47,236
Rev Carloads (000)	1,927	999	577	1,698	1,606	2,178
Route miles	33,100	17,896	13,893	22,700	21,500	33,705
Rev ton-miles (mm)	120,122	39,289	26,055	49,800	44,000	127,000

Railway Statistica Data

Operating Ratio*	84.0%	76.0%	83.2%	88.9%	84.2%	81.6%
Revs/mile	$ 64,592	$ 81,135	$ 60,462	$ 77,004	$ 69,674	$ 78,979
Revs/CL	$ 1,109	$ 1,453	$ 1,457	$ 1,029	$ 933	$ 1,222
Revs/emp	$ 57,059	$ 64,530	$ 54,260	$ 50,079	$ 51,818	$ 56,355
Revs/MRTM (cents)	$ 1.78	$ 3.70	$ 3.22	$ 3.51	$ 3.40	$ 2.10
CL/route mile	58.2	55.8	41.5	74.8	74.7	64.6
CL/emp	51.4	44.4	37.2	48.6	55.6	46.1
MRTM/emp	3,206	1,746	1,683	1,427	1,522	2,689
RTMs/CL	62,336	39,328	45,187	29,329	27,397	58,310
Tons/car	80	80	80	80	80	80
Length of haul in miles	779	492	565	367	342	729

*Based on freight revenues