The Blanchard Company
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The Railroad Week in Review
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Canadian Pacific Railway is a vastly under-appreciated property. Just five quarters ago it was part of a diverse holding company with coal mines, petrochems, hotels and steamships as its bedfellows. Now, in its first full calendar year as a stand-alone company CPR has closed out FY 2002 with record operating and net incomes, double-digit yoy gains in both, and the best operating ratio and safety stats in its history. Never mind the worst drought in 70 years took more than $C118 mm in grain revenues off the table yoy, a drop of 16% in a key commodity.

Freight revenues for the quarter and year were essentially flat yoy at $C887 mm and $C3.5 bn, excluding non-recurring items. CPR calls these "non-GAAP earnings measures" and states right up front in its disclaimer that these results "better reflect ongoing operations at CPR." I agree, and so apparently does the WSJ. Tuesday's paper ran a page B-2 piece in which writer Baruch Lev notes, "Consistence with GAAP is of secondary importance with investors…Auditors would [do] better to focus on business fundamentals." Which is exactly what CPR has done.

Highlights: Non-bulk (coal, grain, ferts) revenues up 11% in the Q and 6% full year. "Same store" -- same commodity, same lane, same car type – prices up 1%. Loco fleet mostly 6-axle AC power, 15% of crew starts using one AC unit capable of lifting 5,000 trailing tons from a dead stop on a 1% grade; CPR's integrated operating plan finalist in global competition for operations research apps in business. Q4 cost per train mile down 3% yoy. Debt-to-cap ratio down to 47.3% (CFO Mike Waites' "sweet spot"), FCF before divs up 26% to $C213 mm, 5.8% of revenues.

Of particular importance to eastern readers, the D&H is coming around nicely. Fred Green, SVP Marketing and Sales, donned his D&H President hat to say that a number of revenue initiatives, the NY State tax break, and an expanded partnership with NS will add revenue to the top line and push the OR below 100 at last. All in all, I'd have to say CPR is coming on strong and the best is yet to come.

Norfolk Southern's 4Q railway operating revenues rose 3% yoy to a record $1.6 bn and 2% for the year to $6.3 bn. General merchandise (all but coal and intermodal) was up 5% in the Q and 3% for the year, another record. Operating expenses were up 3% for the Q and down 1% for the full year taking 20 basis points (BP) out of the quarterly OR to 81.8 and taking out 220 BP for a full-year OR of 81.5. Net income for the Q was $129 mm, $0.33 per diluted share, up 12% yoy. For the year net income was $460 mm, $1.18 per diluted share, up 26% excluding last year's 3-cent per share after tax gain from the 1998 sale of North America Van Lines.

Chief Operating Officer Steve Tobias reiterated the importance of the Thoroughbred Operating Plan (TOP) in bringing added value to the transportation product. He says the TOP is fully rolled out even unto the branch lines, and that merchandise carloads are running 90% to plan. Chief Commercial Officer Ike Prillaman reported revenue increases in all five merchandise categories for the quarter and in four out of five for the year, paper lagging 1% yoy. There was a $33 mm net (new business won less old business lost) revenue gain in truck diversions. Prillaman says it comes from making the railroad "look more like a truck by combining the economies and consistency of rail with the convenience of truckload in meeting order-to-delivery requirements."

Wrapping up the program Financial Planning SVP Kathryn McQuade provided a glimpse at the inner working of the “NS21 Initiative.” This is, she says, a multi-year internal effort to improve performance, focus on customer service and reduce costs of all non-core functions.” In other words, nothing is sacred. Closing the Birmingham Frog Shop shaves $2500 off the cost of a switch frog. Save $20 a rail-weld by closing the Atlanta facility. And so on for another $11 mm in just three disciplines alone.

Areas of present focus include track structure and density, G&A expenses, equipment costs, yard rationalizations and top-line growth. All offer shortlines opportunities to make a difference – preblocking at interchange, total e-connectivity, better car cycle times, and economies of scale. Clearly NS has used this slow period to build a sharper, smarter, more resilient organization that is just itching to show its stuff once we emerge from the current economic edginess.

The CSX presentation Thursday morning was another one of those instances where what you see at first isn’t necessarily what you’re getting. We’re told CSX earned $137 mm, 64 cents a share, more than double the $65 mm or 31 cents in 4Q01. Yet the prior year includes the effect of a $60 mm settlement over the New Orleans chemical fire – 17 cents a share. Absent that earnings are up a still respectable 33%. For the year, earnings rose 32% to $467 mm before one-time items.

Railroad and intermodal operations (which CSX combines under “Surface Transportation”) generated operating incomes of $281 mm and $995 mm for the Q and year, up 14% and 10% respectively yoy, absent the New Orleans item that CSX took as an operating hit rather than pushing it “below-the-line.” Rail and intermodal revenues were up 2% to $1.8 bn in the Q and essentially flat at $7.2 bn for the year.

Operating expense absent New Orleans was unchanged for the Q and down 2% for the year. Recall my earlier comment (WIR 10/25/2002) that 3Q02’s 87 operating ratio was an aberration and that 2Q02’s OR of 84 was more like what we should expect. And so it is. The small rise in revenues plus keeping costs from rising along with revenue got CSX back to an OR of 84.5 in 4Q and 86.1, down from 87.4, for the year.

Every single one of CSX’s nine commodity groups including auto posted increases in average revenue per carload (ARC) vs. five out of nine in Q3. Chief Commercial Officer Mike Ward attributes this to better lane pricing and mix management. He estimates “same store” lane-commodity-equipment combo rates were up 3.5% on average, largely service-driven. He went on to say customer perceptions of improved service could be worth another $100 mm in 2003. In other words, what we saw in Q3 *was* an aberration and we can expect the spread between revenue and expense levels to widen as we move deeper into 2003. What a terrific start for Mike Ward as newly-tapped CEO of the CSX corporation. Go get ‘em, Mike!

Kansas City Southern earned $17.4 mm on sales of $144 mm in 4Q02 and $54.2 mm on sales of $566 mm for the year. On a per-share basis it works out to 28 cents and 87, up 55% and 71% respectively with US operations contributing about a third of the Q net and half of the year’s earnings. Commenting on the results KCS President Mike Haverty noted that the computer problems that killed 3Q02 are largely behind them.

The “integrated framework” of the core rail network, the domestic partnerships (NS, BNSF mainly) and the NAFTA strategy is now in position to provide “substantial benefits” long term. Moreover, KCS has cut LT debt by another $75 mm to a commendable debt/equity ratio of 43%. This in spite of rail revenues being down 4% for the Q and 2% full year. The 70% merchandise carload traffic base posted a 1% gain in revenues in the face of a 6% carload slip. COO Gerald Davies attributes this to shippers regaining confidence in the KCS product following last summer's computer problems and to better lane-by-lane pricing.

Not bad when you consider KCS started 2002 about 6% ($33 mm) off from the prior year's revenue levels thanks mainly to drastic changes in the coal, coke and auto areas. Gains in chems, forest products and intermodal made up two-thirds of the shortfall, combined with a 7% gain in ARC. The forest products group was a particular success with pricing accounting for 5.7% of the revenue gain and volume but 2.8%.

Operationally, system train speeds are up and terminal dwells are down. Slow orders can be counted on the fingers of one hand and gallons consumed per unit hauled are down 8%. No doubt KCS is a different kind of class 1 where short hauls and heavy switching abound, so ORs in the low 70s may never be seen. However, once the lane-service-price equation is fully solved and the Mexican partnership gets really rolling KCS will be in full stride.

All told, it was a very satisfying quarter and year for the industry, given the state of flux in which we find ourselves and the word. The table below reworks the estimate chart (WIR 1/17/2003) to show actual performance yoy. Note I've removed the one-time events to give a clear picture of yoy core business performance. Note too that a low PE doesn't necessarily mean a stock is "cheap." A better measure is the relationship between the PE ratio and the expected yoy growth rate. By this measure one might look first at NS, CSX, BNSF. Next week we'll compare operating metrics and look for correlation with the expected growth in earnings.

Roy Blanchard writes and consults on railroad commercial, financial and operating best practices for shortlines and shippers. Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies mentioned here. A list of such holdings is available on request.

Ticker	**BNI**	**CNI**	**CP**	**CSX**	**KCS**	**NSC**	**UNP**
Website	bnsf.com	cn.ca	cpr.ca	csx.com	kcsi.com	nscorp.com	up.com
Price ($USD)	$ 26.86	$ 41.17	$ 20.20	$ 29.06	$ 12.50	$ 19.63	$ 60.19
Shares (mm)	376	202	159	214	62	389	278
Market Cap*	$ 10,099	$ 8,316	$ 3,212	$ 6,219	$ 775	$ 7,636	$ 16,733
Earnings**	21-Jan	22-Jan	28-Jan	30-Jan	30-Jan	29-Jan	22-Jan
4Q01a	$ 0.54	$ 0.97	$ 0.51	$ 0.48	$ 0.18	$ 0.30	$ 1.06
4Q02a	$ 0.57	$ 0.89	$ 0.49	$ 0.54	$ 0.28	$ 0.33	$ 1.10
Change	5.6%	-8.2%	-3.9%	12.5%	55.6%	10.0%	3.8%
FY01a	$ 1.87	$ 3.21	$ 1.56	$ 1.55	$ 0.50	$ 0.94	$ 3.77
FY02a	$ 2.00	$ 3.41	$ 1.67	$ 2.19	$ 0.87	$ 1.18	$ 4.30
Change	7.0%	6.2%	7.1%	41.3%	74.0%	25.5%	14.1%
FY03e	$ 2.23	$ 3.43	$ 1.74	$ 2.48	$ 0.84	$ 1.40	$ 4.74
Change	11.5%	0.6%	4.2%	13.2%	-3.4%	18.6%	10.2%
# Analysts	10	8	12	11	6	11	11
Fwd PE	12.04	12.00	11.61	11.72	14.88	14.02	12.70
Fwd PEG	1.05	20.46	2.77	0.88	(4.32)	0.75	1.24

* $USD mm

** Core business, before one-time items

Source: Company earnings reports

Stock prices on 12/31/2002

$USD1.00 = $C1.53