The Railroad Week in Review
June 20, 2003
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Factoid for the week: Jim Valentine writes, apropos of CP's grain crop returning to normal, "For every 1 cent change in the Canadian to US dollar exchange rate (on a year-over-year basis), CP will generally experience a half-cent reduction in *annual* Canadian dollar EPS due to its net US dollar exposure. Given that the Canadian dollar has appreciated by 15 cents thus far in 2Q03, we expect 2Q earnings to suffer by approximately 2 cents per share just from the currency issue."

Jim also notes that Q2 gains in coal and intermodal traffic have overshadowed slippage in "economically-sensitive" (merchandise carload to you and me) traffic of late. High natural gas prices have helped the utility coal business while hurting the chems folks who use NG as a feedstock. A potential 2H slowing in auto production could also hurt auto parts and raw material (steel and chems, e.g.) shipments. The AAR reports Week 23 commodity shipments ex-coal down 0.7% Q2TD. These lanes are key to shortline operators like RRA and GWR.

A good near-term indicator is the ratio of negative-to-positive earnings warnings for the current quarter. WSJ's "Ahead of the Tape" for Thursday noted that basic materials – metals, paper, chems – are running at 4:1. Can you say energy prices? Consumer cyclicals like autos and retailing come in at 2.5:1. And consumer staples, stuff one buys regardless of economic temperature, now post a 3.5: ratio. All three sectors affect the carload business.

Recently we wrote about railroad industry stock dividends relative to stock price levels (WIR 5/30). Let's take this a bit further and – again using Morgan-Stanley's work as a start point – see how valuations compare with the historical rail PE norm of about 12.0 (see Table 1). Of the lot, only GWR would appear to be at fair value and RRA a tad underpriced, all other things being equal. If one were holding KSC (KSU), NS (NSC) or UP (UNP) at this point one might consider taking some gains off the table or selling some ATM calls. Next week: getting technical.

TranzRail Holdings (TRH), in a replay of its rebuff to RailAmerica (RRA), said Monday it wouldn't guarantee that future actions [should one read *auctions*?] would meet Toll's terms. The Australian transportation company hiked its bid to NZ$0.95 from NZ$0.75 the previous Friday. Meanwhile, TRH cut the fiscal year ending June 30, 2003 by 15% to NZ$40 mm citing "softer than forecast sales in May and June, particularly in rail services, some accounting changes and additional expenses linked to various asset sales."

Sounds reasonable. A friend who's been there and done that writes, "It's not just the branch line business that was discouraged by the incoming management, but all carload traffic. Unlike the US, most of the carload traffic was concentrated around major metro areas. There was quite a bit that needed doing to bring things up-to-date but the results thus far have been less than encouraging. For example, there were some real equipment ROIC problems, exacerbated still further by parking the very cars needed."

Yet the asset sales continue. TRH said Tuesday there were two offers for its Tranz Link truck operation on the table. A mixed blessing, that. TRH made the strategic decision to push branchline carload business onto its Tranz Link trucks and transloads. If Tranz Link in no more beholden to Tranz Rail, then whither (wither?) the former branch line customers? Or does the rail group try to revitalize the branch line system and compete head-to-head with the trucks?

Reuters reports (Wed) that the Big Six class 1s and the feds have earmarked $1.5 bn over six years to alleviate rail traffic congestion in Chicago. The railroads would put in about $35 mm each with additional contributions will come from Chicago, the state of Illinois, the local commuter rail service and federal sources. The overall plan calls for six new rail-over-rail bridges to separate passenger and freight trains and about two dozen highway grade separation projects. When you consider most of the track structure and design is more than 100 years old (see July *Trains* cover story), it's about time.

According *Progressive Railroading* magazine's annual track survey (Mar 2003), their sample of 19 shortline operators will spend upwards of $140 mm this year on rail, ties, ballast, surfacing and bridge-work. More than half of the track budgets (the expense-capex split is not reported) call for more than $10,000 per route-mile. Using a shortline average of $41,000 revenue per route mile, that says half are spending more than 20% of revenues on track; in one case an actual multiple of revenue. This tells me there's a lot of grant money out there. Of the 19 operators, only four report less than my FRA class 2 standard of $5,000 a mile, though I believe each of these has had some infusion of state money in recent years.

Canadian Pacific will take a C$152 mm pre-tax charge this quarter to shed more jobs and write down assets, including the D&H lines. The actions are prompted by the stronger Canadian dollar (up 15% relative to the US version YTD), the relatively weak economy and fuel costs. The D&H hit will be about $75 mm. It's a break-even operation for years, stuck at about $100 mm in revenues and very much dependent on US connections to get to market.

Says CP in a press release, "[We have] begun discussions with a number of interested parties about ways to generate higher traffic volumes and greater earnings." The question is, who? CP is Norfolk's avenue to Guilford and New England; the Montreal line offers CSX a straighter shot off the West Shore. Both RRA and GWR have potential fits. Back in the day one had the NYC, PRR, Lackawanna, and Erie all feeding the D&H core. Then the *Final System Plan*, in the words of one wag, created the "Delaware & Hudson & Susquehanna & Potomac." It never really worked.

Florida East Coast (NYSE: FLA) sets a fine example of How to Run a Railroad. It's really a point-to-point railroad with just under 400 route-miles. Track speed is 60 but they have reduced it to 55 to conserve fuel and with little degradation of its system train speed of 34 MPH – rock trains, intermodal, manifests. Weekdays FEC runs 22-24 through freights, 10-11 locals and various other yard jobs through out the system. Weekend train starts are about half of that.

Aggregates are now running about 400-500 cars a day out of Miami on 5 different trains. Intermodal is off about 1.7% from last year but average intermodal train length is 8,000-9,000 feet. Siding limitations are 9,600 feet but on weekends trains exceed 10,000 feet on a regular basis to consolidate crews. Since weekend meets are half the number seen on weekdays FEC can schedule the meets where they will fit. Best of all, the railroad is operating 90% to plan, measured within 30 minutes of departure and arrival times on the schedule.

That's thirty, three-zero, minutes, sports fans. Can anybody beat that? Take a number.

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Table 1.
Relative PE Ratios

Historical Railroad PE		12.0						
	Recent	Estimated forward earnings			Absolute PE-Ratios			2003
Tick	Price	2003	2004	12-month	2003	2004	12-month	Premium
BNI	$ 29.00	$ 2.17	$ 2.55	$ 2.36	13.4	11.4	12.3	11.4%
CNI*	$ 51.00	$ 3.63	$ 4.41	$ 4.02	14.0	11.6	12.7	17.1%
CP*	$ 23.00	$ 1.73	$ 2.26	$ 2.00	13.3	10.2	11.5	10.8%
CSX	$ 31.00	$ 2.25	$ 3.00	$ 2.63	13.8	0.8	1.1	14.8%
GWR	$ 20.00	$ 1.62	$ 1.09	na	12.3	3.8	na	2.9%
KSU	$ 12.00	$ 0.78	na	na	15.4	na	na	28.2%
NSC	$ 21.00	$ 1.35	$ 1.60	$ 1.43	15.6	13.1	14.7	29.6%
RRA	$ 9.00	$ 0.79	$ 0.98	na	11.4	9.2	na	-4.9%
UNP	$ 61.00	$ 4.13	$ 5.20	$ 4.66	14.8	11.7	13.1	23.1%