The Railroad Week in Review
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Rail stocks this week handily outperformed the broader DJIA (see chart) with only one in ten failing the test (FLA). What's intriguing here is that as the broader averages tussle with the vagaries of interest rates, the jobs picture, oil futures, upcoming elections and the war in Iraq, the rail group remains steadfast with most beating the DJIA in all three periods. To my mind, though, the best stories are GWR, NSC and BNI – positive in all columns.

Year-to-date RRA and GWR are ties at 8.6% with FLA third at 7%. The Class Is have not fared quite so well. Only NSC and BNI emerge on the plus side with gains of 3.2% and 1.6% respectively. CSX, UNP and CP are all down double digits. Recall that both Canadian Roads are affected by exchange rates. Late Thursday the ratio was $C1.37 per $US1.00, up seven cents Canadian since December 2003. Congestion continues to plague UNP.

Going back three years we get beyond the latest industrial slowdown and back to the time when a US greenback bought a buck and a half Canadian. It's before CP Rail became its own public company, so there are no comps. CNI bested all US class Is by a factor of four-plus. Of the latter group, only NS was up double-digits with CSX bringing up the markers with negative double-digits. Leaving the best for last, GWR's steady pace of improvement sent the name up by a multiple of nearly three, again echoing the tech stock performance of which we've spoke before.

Harmonic rock as a potential cause of derailments (WIR 5/28/2004) drew some insightful and helpful comment. Let me hasten to point out the underlying cause of harmonic rock derailments is inadequate track condition, not inattentiveness by train crews. Watching won't stop the rolling, but may help bring it under control before there's trouble.

The fact of the matter is that track that nominally meets FRA standards for class 2 can still give rise to a derailment through harmonic rocking action, and loaded grain cars can be among the worst culprits. The caveat is that just because track meets FRA class 2 doesn't mean it's derailment-proof. Moreover, one simply can't get from 10 mph to 25 mph without going through the critical 13-19mph speed range (or vice versa).

The only long-term solution is to maintain track surface to a higher standard. That may mean more frequent surfacing, or might mean relaying curves with CWR if the existing rail is end-bent. So unless you're out there relaying all your curves and grades with CWR (which I doubt) jointed rail will remain a matter for concern and needs to be maintained appropriately – probably more than the FRA minimum when grain traffic is concerned.

Lately I've been getting a lot of calls from investment bankers, stock brokers, and institutional investors who, for a variety of reasons, have suddenly become interested in railroads in general and shortlines in particular. Typically callers want to look under the hood at how the small railroad business works, the potential upsides and downsides, and the general outlook.

As for performance metrics, the downloadable Benchmarks spreadsheet on my website is as good a starting place as any. It's set up to measure one target company against a shortline average (which I'm in the process of updating, BTW) however you can edit/fill/right to your heart's delight and get comps on as many RRs as you like.

Another tool is the Rule of 100 spreadsheet. I don't have one up though the premise is one needs 100 revenue cars per route mile of railroad per year to support that railroad. This gets to the issue of traffic concentration and density and starts with the fact that one needs to run FRA Class 2 track as a minimum (subject to the harmonic rock caveats above) to get out and back before outlawing. Open your 49CFR to Part 213 and see that you need eight good ties per 39-foot rail length or roughly 1100 per mile. I use a pro-forma 30-year tie life indicating 36 new ties per mile every year.

At $50 per tie installed and 50 cents a foot tamping and surfacing it works out to about $4500 per mile per year, which I round up to $5000 to make the mental calculations a bit easier. A 40-mile railroad thus ought to generate at least 4,000 revenue loads a year. Why? Because at a shortline average of $250 per car, that's $1 million in revenue of which track will take 25%.

Comp and benefits will take another 30% and car hire yet another 10%. Fuel, believe it or not, comes out to 8-10 gallons per carload: call it 40,000 gallons at $1.50 (if you're lucky), $60,000 or 6% of revenue. Add depreciation at 9% of revenue and you're up to 50% of revenue even before you buy and maintain any locos. With a target operation ratio of 80, it gets thin fast. There is a happy ending, however. The same comp, loco, depreciation and overhead costs needed for a ten-mile railroad will pretty much support a 60-mile railroad.

There is a definite need to develop the shortline brand, and one of the first people to make the challenge was Rich Timmons, ASLRRA President, in his opening remarks at the recent Annual Meeting in St. Louis. Rich made some very timely observations. "First, before a shortline rep even walks in a prospect's door that target individual should already have heard that short line railroads are an up-and-coming mode of transportation that can move product more economically and efficiently than the competitors.

"Second, when you negotiate with the Class I railroads their planning and marketing staffs must really believe that shortlines are an important source of profit and a reliable way of collecting traffic. Third, when you visit your state or federal officials they should understand that shortlines are no longer the mom and pop operations of decades ago, but critical players in their states' transportation networks."

Branding in the rail environment requires mastering three things. One is alignment with the marketplace. Watco's AOP thesis (WIR 5/21/2004) and the North Shore's short haul brand are among the best shortline examples. Second is building a reputation for reliability. This is where BNSF, CN and NS shine thanks to their operating control and feedback systems.

All three have said publicly and repeatedly they want shortlines to participate in those systems. Third is building alliances. Just as consumer products makers do it with retailers, so do railroads with their connections. It's really the only option for extending the franchise. I think UP is way ahead of the curve on this one and that's really what brand management is all about.

Railroad stock performance

Tick	Friday's Close (USD)	Diluted Shares (mm)	Mkt Cap	1 Week	Price change YTD	3 Years
KSU	$ 13.68	64	$ 876	**5.0%**	-5.8%	-4.3%
CNI	$ 41.34	289	$ 11,947	**4.0%**	-5.4%	48.1%
NSC	$ 24.81	391	$ 9,701	**3.1%**	3.2%	10.9%
GWR	$ 22.71	27	$ 613	**3.0%**	8.6%	187.8%
CP	$ 23.25	159	$ 3,697	**2.3%**	-19.6%	na
BNI	$ 33.68	342	$ 11,519	**2.0%**	1.6%	6.7%
CSX	$ 32.25	215	$ 6,934	**1.7%**	-12.0%	-14.7%
UNP	$ 59.27	263	$ 15,588	**1.5%**	-15.5%	3.4%
RRA	$ 13.02	34	$ 443	**1.4%**	8.6%	-4.7%
FLA	$ 35.81	38	$ 1,361	**-2.0%**	7.0%	-9.2%
DJIA				**0.5%**	-2.5%	-8.0%