# THE RAILROAD WEEK IN REVIEW
## AUGUST 19, 2005

**Rail Stocks as of Friday mid-day** continued the sell off from their earlier highs, though CP hit a 52-week high Monday. RRA made the short list based on the charts and the only tech buys by week's end were CP and GWR; all others are ranked hold, pay attention, and be ready to bail.

Please note these tech signals have little to do with the analysts' rankings based on company financials. Rather they reflect how the institutional investors are reacting to what the analysts are saying colored by what else they're buying and selling at the moment. As I've said before in these pages, the individual investor can in no way stay ahead of the program traders and so the trend is our friend.

The *Wall Street Journal* on Wednesday last ran a piece on the gaining appeal of algorithms that "mimic human traders." Evidently the trader sets his goals for the liquid stocks (more than 10,000 shares a day) and turns the algorithm loose to execute trades in small lots so as not to gain a lot of attention. Then the real human can turn his attention to the more challenging trades.

And since none of us can hope to compete with that, better to let the algorithms and program-traders set the trends that we can in turn ride along. Moreover, if you know the industry as we do the rails you can use what you see in the field to confirm or deny the trends. You'll also note that when Jim Valentine or Tony Hatch or any of several others comment on how railroads' actions outside the fundamentals may affect stock prices, these remarks are going to affect the trend.

In this regard I found the RRA note from CF First Boston's Jason Seidl particularly helpful. On the plus side he says "RRA has continued to leverage its strengths" in several areas and to grow earnings "at a solid pace." However, Seidl says that RRA trades at a discount to the RR group due in part to "the company's historical inability to meet investor expectations," though that could change with better operating margins. Fair enough. (*Full disclosure*: I am neither short nor long RRA.)

**Continuing in that vein**, the August/September 2005 issue of *NYSE Magazine* carries a special report on what concerns CEOs most looking out to 2006 and beyond. A sampling of the survey: On performance, 72% of CE0s said the management team will have the biggest impact over the next five years. On what's most important to investors, first place went to operating income growth with 83% whereas EPS ranked *eighth* at 66%. On revenue growth sources, 40% said new products and 32% said acquiring another company. On budgets, 33% said capex will go up most with energy in second place at 26%.

Now put that in the railroad context. The WIR focus is always on operating income because it's the truest measure of what management does with the hand it's dealt. New products, viz., the scheduled railroad, the new UP-CSX produce train (WIR 8/12) are adding revenue and repeat business at record levels whereas shortlines rely mostly on acquisitions to grow. As for budgets, fuel is a fact of life; capex is optional. Thus CSX and UP are to be complemented for having the foresight to put their money in the RR so that more new products may come to the market for transportation services.

**The August 2005 issue of *Logistics Today*** reports that truck drivers' Hours of Service violations are increasing. During a three-day period in June inspectors made nearly 61,000 vehicle inspections at 1,300 locations in North America. In the US almost one in five road checks put the driver (HOS 54%

of the total) or rigs out of service, up from 3.4% in 2004. The o/s rate in Canada was less than half that in the US.

Drilling down to specific carriers, Bear Stearns' Ed Wolfe writes that Arkansas Best (NYSE: ABFS) has *reduced* (emphasis added) its OR to 90 from a historic 95+ range. He also notes that this LTL carrier's 2Q05 long-haul tonnage was off 3.4%, in-line with the industry. It also appears ABFS et al, in Wolfe's words, "have a much greater emphasis on service and return on capital than pricing and top line growth."

Meanwhile, JB Hunt (NASDAQ: JBHT) and BNSF continue to work toward resolution of a rate issue that's been festering for some time. Bear Stearns estimates the revenue split is 50-50 and the question is whether that will be adjusted up or down in a non-zero-sum game in which a benefit for one is a cost for the other. BNSF now handles two-thirds of JBHT's intermodal traffic and the relationship is now more than 15 years old, so it does not look like a divorce scenario. Moreover, JBHT is a major BNSF customer conservatively worth $350 mm a year or more than 10% of IM revenue.

**A friend writes**, "The majors call the tune for most short lines. Many shortlines get a flat fee for delivering cars. Costs are escalating and the majors are not only feeling the pinch, they are raising prices (directly or surcharge). Is any of this flowing back to the short lines?

Yes and no, and it depends on the shortline and its Class I connections' settlement practices. For the first six months of 2005 both GWR and RRA racked up nice revenue gains on modest volume increases, even including any acquisition benefits (see Table 1). Both shortline holcos sport a seven point spread between revenue unit volume and revenue increases. But then, so do FEC and KCS where much of the traffic and revenue growth is organic.

On the other hand, consider the several hundred shortlines with only one or two Class I connections and with annual volumes less than 20,000 revenue units. These are in many cases one- or two-commodity railroads paid on an allowance basis that may or not have escalators or fuel surcharge sharing provisions. Railroads in this group have revenues starting at $6 mm and down and route-miles from a couple hundred to less than 20.

The top 20 shortline operating companies run more than 150 separate rail lines and handle about 80% of the total revenue units touched by shortlines. These are the guys with the clout when it comes to negotiating divisions with the Class Is, not the mom-and-pops who are happy to get their $300 a car. So, yes, there's a nice spread between volume and revenue increases at GWR and RRA, though I'm doubtful it holds across the board. Anybody want to take the other side of the argument?

**John Cockle of California's Richmond Pacific** writes, "Last week's meeting of the California Short Line Railroad Association in San Diego was very informative, with good attendance of over 30 people. The general theme was updating on the various legislative activities in Sacramento, almost all of which are detrimental to railroad operations. CSLRA is going to take a much more proactive approach to lobbying in Sacramento, distinguishing the short line model as different from the Class Is. We will, of course, continue to work with our Class I partners, but may not always be in total agreement on approaches to legislation.

"The next 4-6 weeks in Sacramento will be interesting. Two of the hot bills we are watching right now are SB351 (emergency response training for local agencies funded by the railroads) and AB962 (California regulation of whistle post, flagging systems, hazmat tank cars, and RCL operations). A tentative lobbying day is earmarked for early September."

In her report on the meeting CSLRA Executive Director Jalene Forbis writes, “Just to let you know what you missed if you were not there, we heard from Yolanda Benson, Deputy Secretary of Business Transportation and Housing on the Governor's Goods Movement plan; George Elsmore with the CPUC; Charlie Hagood with FRA; Cathy Tarpley with BNSF on public/private partnerships; and Harold Holmes of the California Air Resources Board on Carl Moyer funding.

“We also had reports from UP Shortline Director Warren Wilson as well as UP’s Wayne Horiuchi with a Legislative update. ASLRRA's Steve Sullivan gave a Washington update and our President John Cockle presented outgoing Secretary Jeff Forbis with a plaque ands thanked him for his years of service on the Board. Jeff retired off the Board and was recognized for being the last of the charter Board Members.

“The FRA Short Line Railroad Seminar will be hosted by the CCT in Stockton September 13-15. Dave Bucollo has put a lot of work into making this a very informative seminar and I encourage you to attend. There is a block of rooms set aside for attendees at the Radison. Call 800-333-3333 and mention the FRA seminar to get the group rate.

“Plans are under way for another legislative lobbying day in Sacramento. I'll send out notices as soon as I have the date confirmed. We will be focused on opposing SB 351 which would allow cities, counties and local agencies to set up railroad derailment and evacuation training and bill the railroads. There is no provision in the bill requiring working with the railroads, nor are there limits on how much they can charge. It's literally a blank check!

“Mark your calendar for our Fall Train ride to Reno. We'll be leaving on November 3rd and staying overnight in Reno at the Silver Legacy, then returning on the 4th. There has been a lot of interest expressed already and if you plan to attend please let me know right away as we need to know how many to prepare for, based on initial inquiries I'm expecting a packed train. I have rooms set aside at the Silver Legacy for $39 per night. You should make your reservations right away as we are limited in rooms available at that rate. Call Silver Legacy at 800-687-8733 and mention CSLRA to get the group rate.”

That’s a lot from California however it’s important to see how proactive state shortline organizations can shape agendas. Look for further reports of this ilk in upcoming WIRs.

**Lagniappe.** Regarding last week’s fuel *factoid*, Larry Kaufman writes, “Your factoid is fascinating, but as a former public affairs guy at the AAR who fought against legislation allowing bigger and heavier trucks on the highways some 30 years ago, I would only caution that the ton-miles per gallon really should be specified as the average. Different commodities and different rail operations will affect fuel consumption. Intermodal, for example, because of weight/density doesn't measure quite as well as coal does.

“Of course, the proof is that truckers don't handle coal -- except for some very short haul moves in the east. The rail fuel consumption story is very strong, and the fact that truckload carriers are using intermodal more and more is the ultimate proof of that. They don't do anything out of the goodness of their hearts, and if it weren't to their economic advantage, they would have all those loads on the highway.” Thanks, Larry.

**Table 1.**

**Small Class I and Shortline Holding Company Commodity Carload Comps**

**Quarter ending 6/30/2005**

**Revenue and income in $millions**

**North American Rail Operations Only**

| Metric | FEC | KCS* | GNWR | RRA |
|---|---|---|---|---|
| Railroad revs ($mm) | $58.9 | $178.5 | $92.7 | $110.8 |
| YOY Pct. Change | 17.5% | 16.8% | 25.2% | 15.3% |
| Revenue Units (000) | 130.5 | 267.0 | 181.6 | 327.0 |
| YOY Pct. Change | 10.6% | 4.6% | 18.1% | 8.7% |
| Carload revs | $33.2 | $124.3 | $55.4 | $84.9 |
| Pct carload | 56.3% | 69.6% | 59.7% | 84.8% |
| Pct Intermodal | 42.0% | 9.5% | 0.5% | 0.9% |
| Pct Coal | 0.0% | 15.1% | 14.2% | 8.2% |
| Mdse Carloads (000) | 54.4 | 131.7 | 130.7 | 232.5 |
| Rev/CL | $610 | $944 | $424 | $365 |
| Rev/IM CL equiv | $552 | $343 | $732 | $189 |
| IMCLE/avg CL rev | 91% | 36% | 173% | 52% |
| Operating Income | $15.9 | -$5.3 | $16.1 | $15.0 |
| YOY Pct. Change | 25.7% | 11.8% | 26.7% | 41.3% |
| RR Operating Ratio | 73.0% | 85.5% | 82.7% | 86.2% |
| Price/gallon of fuel | $ - | $1.55 | $1.71 | $1.68 |

* Does not include Mexrail or Tex_mex



***Disclosure: Blanchard may from time to time hold long, short, debt or derivative positions in the companies discussed here. A list of such holdings is available on request.***