The Railroad Week in Review
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"*There are lessons from the Conrail deal the federal government ought to heed if it decides to bail out Ford, Chrysler, and General Motors." — Jim McClellan, SVP Strategic Planning, NS (Retired)*

TRAINS magazine Associate Editor -- and sometime collaborator (we did the August 2007 Iowa Northern story together) -- Andy Cummings posted an intriguing "newswire" interview with NS' retired SVP Jim McClellan the other day. The theme was lessons from the federal creation of Conrail thirty years ago that apply to the present auto industry controversy. With Andy's permission, some excerpts:

"Jim McClellan helped shape both Conrail and Amtrak when the railroad industry appeared to be dying, then helped guide Norfolk Southern in taking a portion of Conrail in the late 1990s. He says there are lessons from the Conrail deal the federal government ought to heed if it decides to bail out Ford, Chrysler, and General Motors.

"Bailing out the Northeast railroads and making them profitable was a two-step process, McClellan said. First, the railroads were merged, brought under the federal umbrella, and rationalized starting in 1976. Then, in the early 1980s, President Ronald Reagan's Secretary of Transportation, Drew Lewis, demanded managers find a way to end Conrail's annual $400 million loss, which the government had been subsidizing. A second round of abandonments, crew reductions (from five crew members to three), and layoffs followed. Finally, a decade after the restructuring began, Conrail went back into private hands, no longer a money-loser.

"Tinkering around the edges wasn't going to get it done. The game plan was to make radical cuts. Savings came from closing unprofitable branches and duplicate mainline routes, shuttering junctions, and moving responsibility for passenger and commuter trains to other agencies. And Conrail had to learn to make intermodal business profitable. Heretofore railroad industry had been avoiding pursuing intermodal business because it saw small profit margins.

"McClellan said they soon learned that any growth would have to come from intermodal, because it was the only way to take business away from trucks. Said he, 'Nobody was going to switch from trucking to carload business. As Conrail pursued intermodal contracts, it figured out how to make them profitable and then changed the product mix. We raised the rates and cut the services. It was not a popular way to go, but it was what we had to do.'

"McClellan pointed out that in Conrail, the federal government was able to alter the thinking but now asks, 'How does government, not known for efficiency, achieve the necessary accountability? They brought some people in who turned out to be intelligent and cared a lot.' While not particularly sympathetic [to the plight of the auto guys] McClellan says, 'Managers are paid money to manage, and whatever hand they're dealt, they've got to find a way to do something about it and not just whine about it.' Like Conrail before the restructuring, the US auto makers "are examples of failed business models."

[In a subsequent exchange of e-mails with McClellan, we agreed there is a certain GM-short line parallel. It is said, for example, that GM has too many brands and dealerships, much akin to a railroad with too many branch lines. But If GM sheds too many brands or dealerships, or a Class I sheds too many branch lines, it leaves the smaller markets open to the competition.

[So let GM scrap the excess brands (Pontiac, GM, Hummer, etc.) and turn those dealers in small markets into Chevy-Cadillac-Buick dealers (short lines) and, for a fee, let them sell the other US makers as well. Paper barriers with an out, if you will. As for "too large to fail," the auto fiasco is sorta like the PRR: Pennsy thought that it was too large to fail and it insisted on controlling everything it did, including building its own locomotives.]

UBS rail analyst Rick Paterson does a neat job of pulling together a number of essentials in this recent note. "Any transport stock can be evaluated based on five key drivers: volumes, pricing, productivity, fuel, and valuation (we've also added FX for CN & CP). In summary**,** the outlook for *volume* is bleak, albeit slightly less so for KCS given some secular growth opportunities. The rate of *price* increases may be slowing but probably OK due to escalators in multi-year contracts. But it's still a source of raging debate -- railroads maintain pricing will be strong, some investors think it's going negative, we're somewhere in the middle.

"*Productivity* momentum in terms of asset turns (velocity & dwell) are strong for UP and KCS; opportunities exist for CP and CSX to be stronger next year. *Fuel* price collapse ($42 today!) a strong tailwind, with UP, BN and CP key beneficiaries; KCS less so given tougher Mexico comps (it rallied less in Mexico during the upswing). *Foreign Exchange* benefits CN more than CP due to more US business. *Valuations* are below the bottom of the long-term 11-16 P/E range across the board, although BNI and CNR are trading at a healthy premium to the sector average P/E."

Rick has prepared a chart to accompany the narrative that puts all this in graphic form showing red for negative expectations, yellow for a neutral position and green for positive expectations. The only red is for volumes, and it applies across the board. Everything else is green save for productivity at BNSF, NS and CSX. Rick also assigns pluses and minus in all the blocks to indicate "relative magnitudes" of all the metrics. Following the chart is his customary summary table of "Valuations, Ratings & Targets" for the Big Six plus KCS. Drop me a note if you'd like to see the full nineteen-page report.

The relatively high revenue-cost ratios enjoyed by the STCC 28 Chemicals group have become a holy grail of sorts for railroads of all sizes. Given STCC 28's importance, Tony Hatch was on hand for the recent American Chemistry Council (ACC) Situation and Outlook Seminar that the NY Society of Security Analysts sponsored. He writes, "The most important stat was shipments, of course – from a high of 12.5% growth in 2005, decreasing to an estimated +5.3% in 2008, -1.5% in 2009E and back to +2.5% in 2010E.

"The industry represents US annual revenues of $664 billion and is moderately cyclical as 96% of all manufactured goods contain chemistry products (both autos and construction are key end users, but chems as a whole aren't as volatile as those sectors). Rail tonnage increased in every year but ten following the Staggers Act in 1980 hitting an all-time high of 176 million tons in 2007." [AAR US chems carloads -- 11% of US revenue units ex-intermodal -- through Nov 28 were off 1.3% year-over-year. -- rhb]

Of particular interest to short lines, "plastics were a $303 billion revenue producer in '06; price and feedstock swings have created exceptional volatility (along with environmental regs and end-user slowdowns, of course). At current natural gas prices the ACC did not expect further loss of domestic production."

On the rail regulatory environment, Tony writes, "Peace talks? New ACC leader Cal Dooley echoed the bottom line that reining in rail rates on 'captive customers' was a high ACC priority for 2009. However, in private conversation, he suggested that unlike the more belligerent public tone, negotiation rather than legislation could still win the day. Perhaps buoyed by recent STB decisions Dooley added that TIH/hazmat risk issues should be easy to solve, and that all ACC/AAR (for want of a better rail proxy) issues can be put on the discussion table. In fact, three of the US Big 4 rail CEOs had already paid him a visit in his two months in office."

Last week I promised some notes on how to use Charles Schwab & Co's "Sell Alerts For Individual Stocks" to measure any railroad's staying power in terms of cash flow and investor confidence. There are six measures and we'll be looking at third quarter 2008 results for the Big Six, KCS, GWR and P&W. First, does operating cash flow exceed net income? The amount of noise on the income statement between operating income and net income can eat up profits and ruin a good operating ratio if not controlled. All but P&W are on solid ground here.

Second, are they spending more in capex than they have in depreciation? The railroad industry, being an asset-consumer (you use stuff up and wear it out providing the service) is capex-intensive so we have to give this test a bye, though it is instructive to note that BNSF scores lowest with capex 144% of depreciation. Third, is long-term debt creeping up? The answer is yes, though the 3Q07-3Q08 delta is lowest for BNSF (4%) while P&W has no debt.

Fourth, what about share count? Lower is better because of the impact on earnings-per-share. It's down for six of nine names though CP, KCS and P&W were up five percent or less. Fifth, has the year-over-year share price increased at least as much as the S&P Index? The S&P was actually down 24% so I calculated a point spread between the railroad delta and the S&P. Top honors go to KCS with a 62-point spread, followed by GWR (54 points) and NS (52 points) with UP bringing up the markers with a negative 13 points as its share price dropped 37%.

Sixth, are analyst revisions up or down? I compared downward revisions for the present quarter with the total number of analysts reporting for each road and the picture is really pretty good with maybe one or two downs and as many as 18 analysts reporting (P&W excused from this one). Seventh and last, are there more shares short now than a year ago? As I've noted before, there are those who say the rails ran up too far too fast and in this environment think they have gotten ahead of themselves. Only BNSF, CN and UP escape unscathed and again we excuse P&W for lack of visibility.

So what does it all mean? Schwab says the more "sell alerts" the weaker the performance and has the track records to prove it. Their data shows that a company failing on four or more of these metrics may merit a Sell rating. All the rails missed on capex vs. depreciation and on increasing LTD; CN and BNSF held the line here. CSX, NS, UP and GWR garnered threes with the remaining lines getting fours.

The take-away for private companies that do not have analyst ratings, short sales or share price changes in the stock tables, is that they retain accountants who can tell them what their companies are worth and that can be tracked on a periodic basis. This tool provides a means to an evaluation and growth end. It's up to the short line investor to pick the right data and read the tea leaves accordingly.

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