THE RAILROAD WEEK IN REVIEW

October 1, 2010

"Our merchandise carload business has reached return levels that make reinvestment in equipment and facilities possible." John Lanigan, BNSF Chief Commercial Officer

At this week's sixth annual RailTrends conference there was a generally encouraging air of still better times to come for the railroad industry. That said, there was also general consensus that the New Normal is about 90 percent of the heady traffic volume days of 2006-7. Moreover, as volumes eventually return the mix is going to be a lot different as new business efforts target the higher margin moves and we see the Eyeris discipline (WIR Sep 17) match specific operating and overhead costs to specific customers and moves in real time.

A recurring theme here and elsewhere is how the railroads are moving more units at lower incremental cost. UBS' Rick Patterson once again posited that incremental margins on new business are in significant double digits as we see units increasing at greater rates of change than either train starts or headcount.

One of Rick's charts had to do with locos stored on each of the reporting Big Five (with BNSF being now behind the Berkshire screen, we lose the visibility we enjoy elsewhere) for the peak of the economic downturn and now. Of the lot, only NS has all units deployed -- it being implied there is little remaining power to accommodate an upturn.

I have to take the other side of the argument. During the course of the last year or so I've been out on four of the Big Six roads (CN, BNSF the exceptions) to observe first-hand how they're running and how assets turn.

Start with the Union Pacific. Last fall I rode the head end on a Railex perishables train over 250 miles of railroad from just north of Bakersfield to Roseville in California. We never stopped even though there were ten meets and one overtake. Recall this is ex-SP single-track railroad so it takes deft train handling and crisp dispatching to keep the train running to plan.

About a month later I got on another Railex train, this time on CSX at Frontier Yard in Buffalo, for the dash across the ex-NYC Water Level Route to Rotterdam, NY. Once again, we never stopped, though we switched back and forth between the east-and west-bound mains to dodge other trains -- stack trains, merch trains, ethanol unit trains, Amtrak. Here again crisp dispatching and train handling add capacity.

Then there was the CP ride from Calgary, Alberta to Field, BC over the Rockies and down the spiral tunnels as part of the annual Investor's Day program. During the briefing on the train, we learned that on this challenging stretch of single-track road every train had to run to plan lest the entire division grind to a halt. This is just one of a dozen stack-trains we passed, all with distributed power units both mid-train and bringing up the markers. Again, running to plan adds capacity.

I've already written about the NS improvements on the Crescent Corridor at Riverton Jct., Va. (Front Royal). It's here that NS had to straighten out a spiral coming off the ex-Southern Manassas line and onto the ex-N&W Shenandoah Valley line. This merch train coming off the Manassas line never slowed as it hit the bridge (I'm standing on the original alignment) and the five-miles of double-track from here north keep him moving even in the face of opposing trains.

Also in July I spent some time along the CSX ex-RF&P racetrack between Richmond and Alexandria, Va. Here at Milford in the course of half an hour or so we saw merch trains, stack trains, Tropicana's OJ-1, and Amtrak trains running in both directions on both tracks, something you never could have done in days of yore.

The common thread among all these tales is increased capacity: how you can put more train starts on a given piece of railroad. It takes three things: on-time departures, failure-free track and equipment maintenance, and crews that can run trains to plan.

UP's Jim Young says he has a railroad that can do 200,000 units a week and he's only at 180,000 or so. We also know -- because you can see it out on the railroad -- UP can run the same number of train-starts with 80 fewer loco units with more use of distributed-power. We know UP can effectively add 250 locos to the fleet by increasing system train speed one MPH. CP has taken an hour out of terminal dwell time by substituting a running brake test over a hot-box detector for a standing brake inspection by a car-knocker.

Yet none of these and other clever new uses of technology are unique to UP or CP -- running fast, smart trains adds capacity. So if NS has no locos stored, I'm not about to say they're capacity-constrained. Just look at what the Riverton Jct. speed-up has done for cycle-time and throughput.

Last week I suggested that railroad shares are selling for prices are below what they're really worth -- intrinsic value. Though there is no set formula to determine what a stock is worth, one can get a good sense of what it ought to be worth by looking at this year's earnings, the estimated five-year forward earnings growth rate, attaching a probability that it will come true (I use 50 percent), and comparing it to the return on Treasury bonds.

There are several "intrinsic value calculators" on-line; the one I use is attributed to Warren Buffett: http://www.moneychimp.com/articles/valuation/buffett_calc.htm . Here's what you get for rail stocks with the 2010 earnings estimate, the consensus five-year growth rate leveling off to zero (I'm only looking at five years) and 2.74 percent for the T-bill return.

Railroads	Recent	Int Val	Discount	Chg to IV
CSX	$54.72	$121.56	$0.45	122.15%
CP	$62.49	$134.76	$0.46	115.65%
CNI	$64.50	$117.37	$0.55	81.97%
GWR	$42.97	$64.82	$0.66	50.85%
KSU	$39.14	$88.27	$0.44	125.52%
NSC	$58.34	$110.12	$0.53	88.76%
RA	$10.12	$12.00	$0.84	18.58%
UNP	$78.73	$179.64	$0.44	128.17%

I generally look for stocks selling at 60 cents or less on the dollar; all the Class Is pass. Better yet, some are potential doubles and if you go the extra step and add dividends (NS leads the pack at 2.5 percent) you can boost the returns another point or two -- NS goes to 91 percent, e.g.

So... if there's more capacity to be had with the existing plant while commodity mix changes and better operating practices improve incremental yields, it does look like it's a very good time to be in the railroad business.