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The Railroad Week in Review 9/22/2001

Rail Stocks finished the first full week of trading after the terrorist attacks falling anywhere from 12% to 18% below where they opened Monday. When you consider that the DJIA itself was off 15% for the week, that's not too bad. Friday the rails got enough of a boost to catch the attention of CNBC's Power Lunch. For the day, NSC took top honors, up 8% while CP languished essentially unchanged.

An item on the Dow Jones newswire Friday suggests that the bump in rail shares may be attributed to a shift in transportation-related investments. The DJ Rail Index had fallen some 11% since the Sep 11 attacks but recovered half of that on Friday. Others see money that had been in airlines going to rails as a safer haven, even as we saw formerly tech stock money pushing up rail stocks earlier in the year.

Then there's the argument that rails have been historically good recession investments because they are the first harbingers of an economic spring. Still, times are not good. Drew Robinson of TransMatch writes, "Auto production took a very large hit toward the end of last week. Although the railroads worked last week, trucks were stuck at the Canadian border. The ripple effect from the consumer will probably hit next week. Look for weakness in the metals and forest sector. It's going to be a while before we get back to normal. Years."

Asymmetric Warfare is probably a new term to most of us. Basically, it's all about not "fighting fair," using surprise and weapons such as suicide pilots on commercial airliners. The National Defense University (www.ndu.edu) in its 1998 Strategic Assessment (Chapter 11, Asymmetric Threats) says the military will have to shift from classic "just-in-case" logistics (massive buildups) to just-in-time logistics. The smaller requirements will radically lower the logistics footprint, reduce deployment timelines, and lessen supply chain vulnerability to attack.

The events of Sep 11 put the RRs in a real bind. The war we're in now is not one of massive troop buildups and tanks in the open. The Army War College (http://carlisle-www.army.mil/usawc) acknowledged two years ago that more fighting will be in cities and "communications, computers, intelligence, surveillance and reconnaissance" will dominate.

In other words, having a lot of stuff in one place will no longer work. The WTC bombing was so devastating partly because so many were killed in one location. Likewise concentrations of manufacturing activity are potential targets. A rail yard with a couple thousand cars is an easier target than five yards with 400 cars each. The bad guys look to do maximum damage with minimal resources, so big rail yards with 30-hour dwells just will not do. Nor will large geographic concentrations of industry.

Further manufacturing industry dispersal will mean fewer cars in one place making more trips to more destinations as industry spreads out and away from the present geographic concentrations. Recall the present industrial complexes are the result of historical needs to process raw materials into finished goods close to sources and then shipping to markets. Now, however, faster, smarter transportation makes proximity to either source or market less of a factor.

As the physical proximity requirements are reduced, however, the need for JIT supply chains and better data management increases very rapidly. The railroads that fare best in this environment will be the ones managing transportation systems, not the classic series of independent operating fiefdoms that happen to be connected by rails. Investors take note.

Speaking of systems, CN will have extended its guaranteed empty equipment supply program to all CN-controlled freight cars by November 2001. Thus far about 70% of the CN fleet targeted for the program (excluding bulk commodity car fleets and customer assigned pool cars) is covered by empty car supply guarantees. CN is in talks with its short-line partners to extend the program to off-line customers' sidings.

This program represents a fundamental change, and others would do well to follow suit. Car orders are *commitments*, not forecasts, as was the case in past. Today CN guarantees delivery of empty freight cars on specified “want” dates -- dates agreed to with the shipper -- in exchange for the shipper's commitment to accept the cars on those dates. The program is backed up by financial penalties for whichever party fails to fulfill its commitment. It’s an extension of the penalties the IC used to keep its scheduled railroad on schedule.

Moreover, the car supply guarantees remove one more reason for not using the rails – never knowing when (or even if) requested empties will show up. Being able to order cars with confidence allows customers to manage their inventory and supply chain costs more effectively. It also gives them transportation options. Customers know in advance whether requested cars will be available, given the first-come, first-served nature of the program. If they're not, a shipper can opt to accept alternate cars or defer the delivery date. All this helps squeeze waste from the freight distribution system.

CN says compliance with shipper want-dates is running in the 94-99% range. The program now applies to center-beam flat cars and coil gondolas in Canada and the United States. In Canada it covers double door boxcars, bulkhead flat cars, single-door boxcars, bulkhead boxcars and standard flat cars. This fall CN will expand the program in Canada to grain boxcars, paper/paperboard boxes and miscellaneous car groups. In the US it will apply to flat cars, boxcars and miscellaneous car groups.

Canadian Pacific Limited shareholders met 9/29 to vote on the proposed company split into five distinct companies. Under the terms of the “Arrangement Circular (see www.cp.ca) each share of today’s CR will be divided into 0.5 share of CP Rail (CP), 0.25 share CP Ships (TEU – no, really!), 0.25 share Fairmont Hotels (FHR), 0.166 share Fording (FDG), 6.684 PanCanadian Energy (PCX). Holders may instead elect to receive CP Holding Co Depository Receipts (CP HOLDR) which combines the five separate shares into one unit. Costs you a dime a share, though. A clean option for those in it for the split and planning to split after the split.

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