THE RAILROAD WEEK IN REVIEW
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"One of the biggest challenges we face this year is economic uncertainty and our ability to forecast demand is very limited." – Union Pacific President Jim Young to analysts

Four of the Big Six Class Is reported results for the fourth quarter and full year this week and it was not pretty. To a man, each of the CEOs remarked how the slow traffic downturn year-to-date through October turned suddenly nasty and relentless in the last two months and there's no relieve in sight as of Week Three of 2009. Norfolk Southern CEO Wick Moorman told the assembled multitudes at Thursday's Philadelphia Traffic Club Annual dinner he'd not seen anything like it in his 38 years on the railroad.

You can see it in the quarterly and full-year data. Revenues for the year were up double-digits for all but CN, but even there it was plus seven percent. For the quarter, the revenue gains dropped to low single digits in three of the four with CN at thirteen percent. Full year revenue units were down low single-digits for all but falling to twelve percent (UP), eleven percent (CN) and seven percent (BNSF) for the quarter. Merchandise loads (everything but coal and intermodal, including ag and auto) got hammered in the fourth quarter, down mid-double-digits on all roads.

The revenue results may seem good on the surface but part of the reason for revenue gains is the lag between fuel charge collections and the actual price of fuel. BNSF, for example, was paying four dollars a gallon in July and less than two bucks in December. Fourth quarter fuel burn was 364 million gallons at an average price of $2.62 a gallon. In the third quarter BNSF paid on average $3.87 a gallon and burned 349 million gallons. That's a 32 percent drop in price so you can see what fuel surcharges based on the lower number are going to do to revenue.

True, the fuel surcharge lag helps operating income and the operating ratio. Third quarter fuel expense was $1.3 million vs. $955 mm in the fourth quarter, a 23 percent drop on four percent more gallons. The operating ratio dropped more than three points in the bargain, not out of line with what the other three reported this week. The question now becomes what becomes of these nice revenue gains and operating ratio improvements as the fuel surcharge lag wears off? Yes, all the rails are talking six percent "core" core price increases but if volumes drop more than six percent and there is no fuel surcharge cushion, what then?

I have to add that revenue-per-unit was up double digits in almost every commodity, a theme that continued across all calls. Once again, fuel surcharge contributed – maybe not to the same extent across all commodities and origin-destination pairs, but it was there. All the roads said their price increases are holding and nobody's chasing volumes by lowering rates. On the other hand, my channel checks indicate there is still some of this going on ("any commodity, any place, any price just to keep the cars moving" is typical) so it appears we have a bit of a disconnect.

If there were any positives, they were in revenue ton-miles, typically down in the low single digits, with CN actually eking out a positive two percent. In other words, revenue units were down but RTMs were down less, meaning more revenue ton-miles per unit. A theme we heard across all the calls was that assets were parked (1200 locos and 48,000 cars on UP, for example) and train-starts down (nine percent on UP) but velocity, car miles per day and loco miles per day all improved along with on-time arrivals and departures.

Once again, BNSF came in with the lowest operating expense per thousand GTMs and RTMs while CN brought home the most gross ton-miles per gallon of fuel. Capex for the group remains at twelve to fifteen percent of revenues, about where it usually falls, so there is still money being spent on maintaining the property (80-90% of capex depending on the name) and adding capacity. On the other hand, it does appear the rate of share buybacks may slow because there's only so much cash from operations and something has to give in tough times. Happily, I do not see dividends being cut, now running at 20-23 percent of net income.

For the year, the four roads reporting this week all scored well on my Sell Alert schedule (WIR 12/19/2008). Share prices, while down for the year, did a lot better than the S&P 500. That metric was down 39% and all four rails beat that number by point-spreads in the teens. Operating cash flow was handily above net income, share counts declined and short interest dropped. The only points off are in the increase in net debt year-over-year and the perpetual problem of railroads as a wasting asset, namely that capex is going to run ahead of depreciation in even the best of times.

As to the individual roads' performance, I'm not going to sport with your intelligence by trying to sell you my version of what was important and what to ignore in the calls. The presentation materials and financial reports are on every railroad's website. You can pick the transcripts off seekingaplha.com where you can read, for example, how BNSF's Tom Hund explains the impact of being caught on the wrong side of a fuel hedge. Suffice to say the message from all four calls was consistent and each call was loaded with guidance for every short line wanting to sharpen its contribution. Horses to water and all that.

Genesee & Wyoming provides a mirror on the shortline community albeit an imperfect one as the numbers include Australian results that affect mainly the farm & food and minerals & stone commodity groups. Railroads operating under the GWR banner for at least twelve months handled 15,700 revenue units, down eleven percent year-over-year. The decrease was principally due to declines in metals traffic of 2,576 carloads primarily in the New York/Pennsylvania, Canada and Oregon Regions, lumber & forest products traffic of 2,364 carloads primarily in the Oregon and Southern Regions and coal, coke & ores of 2,081 carloads primarily in the New York/Pennsylvania Region and Rocky Mountain Regions. These decreases were partially offset by a 2,777 carload increase in farm & food products traffic primarily due to increased grain shipments in the Australia and Oregon Regions. All other same-railroad traffic decreased by a net 2,709 carloads.

For the fourth quarter same-railroad handled 49,763 revenue units, off eight percent, with declines in metals, coal coke and ores, and forest products (both STCC 24 and 26). All other same-railroad traffic increased by a net 2,094 carloads. For the record, results from the Maryland Midland, the CAGY group, the Georgia Southwestern and the Ohio Central Railroad System, all acquired in calendar 2008, are excluded from these results. Knowing these properties, I can confidently add that same-store results will increase handily in 2009, even with the economy in a funk. These are all strong acquisitions run by seasoned shortline professionals who will continue to bring home the bacon.

Ed Wolfe's channel checks are a useful sanity check against what I'm getting from short lines. In a recent note, Ed writes, "We spoke with a large food products shipper about recent volume, pricing and service issues with the Class I rails. Our contact noted that business levels hung in throughout much of 2008, but dropped sharply beginning in November and remain weak thus far into January.

"However, volumes are currently tracking down only single digits, relatively much better than many other commodity segments. Our contact believes this is being driven by relatively firm demand for consumer staples and the short shelf-life of many food products (e.g. bread products) which prevents any material inventory draw-down. Looking out a year to the 2009-10 crop year, this shipper is concerned about farmers' ability to obtain the necessary capital to buy equipment, fertilizers and seeds given the current credit environment, which could limit grain volumes in 2010."

(During their calls BNSF and UP both alluded to farmers holding back corn against higher prices later in the year while at the same time predicting stronger fertilizer shipments for the 2009 spring planting. December corn closed at $4.33 a bushel, down two cents, and Chicago wheat for July delivery closed down four cents to $5.91 a bushel. April ethanol ended at a buck-sixty-one, unchanged. UP's Jack Koraleski sees growth in ethanol and DDGs, and that's going to take corn.)

Wolfe continues, "On the pricing side, our contact re-priced most of his contracts in 2008 at high single/low double digit rate increases, and he doesn't have much to re-price in 2009. However, this shipper believes that if he were re-pricing his 2008 contracts in today's environment, he could shave off about four percentage points of the rate increases he granted the rails." In other words, the rails may have over-reached and maybe there's some truth to what my short line contacts are saying. Any comments from readers?

I promised you Part II of our "How to do a RRIF Loan" screed, begun in the January 9 Week in Review courtesy of Chris Rooney. He writes, "Let's assume that you don't have a brand new base-load power plant at the end of your line, so how do you present the best possible case for your railroad? The first focus should be on revenue: The FRA asks for five years of commodity carload and revenue history and it's not optional.

"The FRA credit analyst will take this data and turn it into a time-series analysis of carloads, per car revenue and commodity revenue. Envision these as three charts with the commodity volumes on the vertical axis and the years on the horizontal axis. Optimally, these will climb smartly higher year-over-year across the page, but life is seldom optimal. Be sure you can you explain the divergences. While each railroad's revenue stream is highly unique, the composition of a railroad's expense categories tends to be fairly universal across companies.

"That argues for a 'peer comparison' and that is indeed the approach taken in the credit analysis. Plot expense categories as a percentage of revenues on the "y" axis for five years on the "x" axis with the sample variables also shown at the extreme right. This will highlight both good and bad ratio comparisons as well as their trends.

"For RRIF purposes this will focus us on understanding and reinforcing good performance while explaining unfavorable trends and plans for improvement. One objective of RRIF financing is to act as a catalyst for improvement. This can come from realizing untapped revenue sources, i.e. top line improvement, reduced operating expenses or financing costs, or any combination of them. Next time we'll talk about assembling your data into a set of financial calculations leading to your story board."