THE RAILROAD WEEK IN REVIEW

December 13, 2013

"KLW products do more work, consume less fuel, and emit at Tier 3+ levels without the use of after-treatment." — Pete Claussen, President, Knoxville Locomotive Works

Canadian National's two-day Analyst & Investor Meeting in Toronto started, appropriately enough with a safety briefing — details on how CN is "putting Safety First by investing in people, process, technology and investment" for continuous improvement in safety performance. It is devoutly to be wished CN's feeder line network will bring up the safety slides and see where they can follow CN's lead. Slide 3, program elements and slide 14, root cause analysis, are particularly useful.

[Michael Farkouh, VP Safety & Sustainability, led the discussion and I know where he's coming from. He was not long ago Terminal Super at Taschereau Yard in Montreal and, in the course of several guided tours, gave me myriad examples of how attention to the safety aspects actually enhanced the operation.]

Now comes CEO Claude Mongeau on "Deepening our Strategic Agenda." Here again, the slide set is a road map for the ways CN feeder roads can support long-rem goals. Look at slide 4: "Growing at Low Incremental Cost." Three elements jump out for short lines — "supply chain enabling, bundling solutions and driving project growth." Maximizing car velocity, fulfilling orders accurately and showing up as promised (slide 5) are three metrics where short lines can add value.

Chief Operating Office Jim Vena was next up, holding forth on how superb operating metrics make superb and measurable performance in the eyes of the customer. Vena than shows how consistent first-mile, last-mile service makes the railroad a "supply chain enabler," and how building network capacity (slide 16) supports local service reliably (you can use the density map as a measure of service frequency in your area).

With the safety standard, strategic direction and operating processes set, the way is clear for Chief Commercial Jean-Jacques Ruest's observations on the commercial successes built on the above. To begin, revenue growth is the only measure of commercial success because the numbers say right away whether anybody's buying your story. Clearly, they are buying CN's: annual revenues 2010 through 2013 (estimated) have grown at an 8.2 percent CAGR to C$10.5 million from C$8.3 million.

CN has always been a leader in the merch carload sector — nearly 70 percent of third quarter revenue was carload ex-coal, beating out second-place CP by three percentage points. Ruest sees five drivers for 2014 carload growth: the US housing recovery; energy (drilling inputs and petroleum product output); automotive (particularly assembly plants local to CN); the largest grain crop in Canadian history; and export coal. In the end, all new and existing business must meet the three-part sustainability test, i.e., long-term variable cost covering asset replacement cost and contribution per car day, and competitive revenue/variable cost ratio.

[I think Vena's operating guidelines will help CN avoid the trap of using circuitous routings to maximize core route density but in the process driving up car days and flunking the replacement cost test. Quick shortline turns can help avoid the latter.]

JJ predicts 2014 volume expansion in all commodity sectors (ferts remain a question, though), achieving mid single-digit carload growth. The projected 2013 C$10.5 billion revenue estimate represents seven percent year-over-year gain. Updated 2013 adjusted EPS guidance range of $3.05-$3.10 compares with the current consensus of $3.09, and 2014 guidance of double-digit EPS growth over the midpoint of the FY13 range works out to about 14 percent earnings growth.

The technical signs are cooperating, too. The Recognia charting tool at schwab.com has three bullish long-term events to one bearish event; the Street target consensus is $60, up ten percent. Based on the above, I think that's doable and I'm long CNI.

Genesee & Wyoming November North American carloads increased 2.4 percent to 142,454 units including 844 intermodal boxes, more than double what they were ago. Remember, we're comparing combined GWR+RA carloads for this year with a pro forma table of what RA and GWR together posted individually a year ago, realigning what's in the commodity groups make the comps work.

You can see exactly what RA brought to the party in the pro forma by looking at the respective RA and GWR columns on page 3 of the press release. A Rail America number that is significantly larger than the GWR number means RA brought significant new vols to the combined properties. For example, GWR ag did 4,131 carloads in Nov 2012 to RA's 12,784 units; processed food is another one. But GWR had the edge in coal, metals and paper.

Nov Highlights: Metals increased 4,086 carloads primarily due to increased shipments in the Northeast, Southern and Canada regions. Coal & Coke increased 3,582 carloads on new vols in the Central and Ohio Valley regions, though coal vols in the Mountain West Region came in a tad lower. Crude oil and LPG boosted Petroleum Products traffic by 2,991 carloads in the Pacific, Ohio Valley and Canada regions. The catch-all Other commodity group was off 2,047 carloads primarily due to non-recurring Class 1 detour trains in the G&W's Central Region. All remaining traffic increased by a net 4,249 carloads.

Year-to-date, the now-combined roads did 1.5 million units, up 4.8 percent year-over-year. Not bad for a two-percent economy. With four of the top six commodity groups by volume — and accounting for more than 70 percent of all carloads ex-intermodal — in the plus column, one can only conclude GWR is staying closer to customers, putting, say, buyers in Canada together with sellers in the southeast, and doing so across the network. In this way the Class Is become the bridge carriers with GWR working the customers on both ends of the move.

Providence & Worcester third quarter 2013 revenues increased 11 percent to $8.7 million. Freight revenues grew 18 percent as merch carloads and intermodal units increased 21 and 27 percent respectively. Operating expense (after capitalized costs) was unchanged, yielding a 96.6 operating ratio, down ten points.

The Comp & Benefits line on the Income Statement is still the shortline industry's highest percentage of revenues at 49 percent, but that's down from 53 percent a year ago. Fuel was up a point to 11 percent of revs and car hire held at three percent, in spite of total units being up 23 percent. Operating income jumped to $385,000 from a $462,000 loss a year ago; net income was $593,000 vs. a $381,000 loss a year ago. Absent an operating agreement with Amtrak, the net would be $311,000 vs a $554,000 loss.

Cash from Operations year-to-date increased eight percent to $3.4 million; capex dipped five percent to $3.0 million, and free cash flow before dividends doubled to $414,000. Margins remain thin, however, at four percent gross and seven percent net. The current ratio stays a tad over one; returns on invested capital, equity and assets are minuscule. At $20 a share, PWX looks awfully expensive. That share price yields a market cap of $97 million, roughly 77 times the $1.3 million nine-month EBITDA. I'm estimating a full-year EBITDA close to $1.7 million — roughly a 57-multiple at the same share price.

Knoxville Locomotive Works, a Gulf & Ohio Railways subsidiary, has announced plans to establish a $6.1 million expansion of its Knoxville fabrication plant. The project entails purchasing eight acres and two buildings adjacent to its present shop location and will create 203 new jobs over the next three years. KLW (and G&O) Chairman Pete Claussen says KLW is making the first locomotives built in Tennessee. "These competitively-priced locomotives are environmentally advanced, fuel efficient, high productivity machines that use advanced diesel engine technology."

KLW has designed, engineered and patented a process to assemble rebuilt locomotives using new and used parts that exceed EPA standards. Says Claussen, "Our single-engine solutions for switcher and road switcher locomotives offer extremely low emissions, reduced fuel consumption, and increased tractive effort. In essence KLW products do more work, consume less fuel, and emit at Tier 3+ levels without the use of after-treatment." Seems to me an ideal means for helping cost-conscious short lines meet the new emission targets.