THE RAILROAD WEEK IN REVIEW

April 11, 2014

"Don't buy these railroad stocks until you read this." The Motley Fool, April 4

The subject of course is CP and CN and the argument is "three of the most powerful forces on earth" are working against them - the weather, the government and the unions. The writer then touches on what you read here last week, viz. how the record cold, the bumper crop and a threatened strike could conspire to hamper first quarter results.

But I say they won't stop the rails. Like Kosmo says in *Moonstruck*, "Everything is temporary." The government either relents or it doesn't, and, if it doesn't, CP and CN will adjust service patterns accordingly - "price around," as Rob Ritchie so eloquently put it. Railroading is an outdoor sport and is played in all weather. Sometimes that hampers efficient operations, but the rails have always recovered. Strikes, like the poor, are always with us. You deal.

Personally, I'd take any dip in CNI shares as an opportunity to buy more, and CP, though frightfully overpriced for the nonce, will at some point come back to earth and then it'll be time to add shares to your book. The railroads are in place, have established business models, and, unlike the trucks and barges, own and maintain their own rights of way. So, maybe you don't buy CP or CNI till you consider the weather, the government, and the unions. Then pick what Captain Jack Sparrow calls "the opportune moment."

Providence & Worcester's 2013 10-K looks OK on the surface. Operating revenues increased 11 percent to $32.7 million as the carload franchise, 96 percent of revenue and 65 percent of volume, posted a ten percent revenue gain to intermodal's 16 percent. Carload vols gained ten percent with a two percent hike in RPU; Intermodal vols increased 18 percent but took a two percent RPU hit. So far so good.

Construction aggregates, though, represent 21 percent of total revenue units and 21 percent of revs, with half coming from one customer that uses Amtrak trackage rights extensively to reach Long Island customers. P&W paid $1.2 million in trackage rights last year and that - if it's all aggregates on Amtrak - was 19 percent of the aggregates revenue. Consider also that P&W spends 50 cents out of every revenue dollar on labor and 11 cents on fuel. Makes one wonder what's left to keep the lights on.

Coal, a $600,000 business, dropped 80 percent to $120,000 as coal-fired utilities either closed or went to nat gas. Ethanol, however, helped push chems revs up ten percent to $11 million, making the chems franchise the largest single commodity group at 37 percent of total freight revs. Vols at the Providence Motiva terminal drew in more than $31 million.

Where all that money goes continues to be of concern. As noted above, comp & benefits gets half of every revenue dollar (benchmark: non-Class Is do about 30 percent here). Fuel and car hire get 11 percent each. Equipment maintenance, trackage rights (see aggregates, above), and T&S materials gobble up another 20 percent.

All-in operating expenses are 113 percent of total operating revenue. The railroad then backs out "capitalized costs," bringing net ops expense to 96.4 percent of revs - the OR, as we know it, and the highest of any publicly-traded railroad operator, and by some 20 points at that. Operating income was a mere $1.2 million, down 39 percent year-over-year.

Below the line, there is no interest on debt as the debit items on balance sheet are deferred items and there's half a $million in income tax credits. As a result, net income is $200K more than ops income, $1.4 million. That's vs. $3.5 million a year ago when P&W recorded a net $2.7 million gain from a permanent easement settlement dating back three years. (It's not in the current 10-K, but it's on page II-6 of the 2012 K if you insist.)

Finally, EBITDA and share price. The former dropped 12 percent to $5.7 million from $5.3 million while shares jumped by 43 percent to $20 from $14 and the EBITDA multiple to 20 from 13 times. The only reason I can think of is as an acquisition potential. GWR, for example, can see P&W locos going by on the Metro North main from their Station Plaza offices in Darien and owns two other New England properties. Fortress won the MMA bid in Maine and is looking to increase that footprint. I don't see PAR as a player as they are busy strengthening their existing franchise. But what I really think is P&W will keep on keeping on. The status quo likes me lots.

I'm shocked. Shocked. John Larkin at Stifel in Baltimore did a conference call with Ray LaHood, immediate past-secretary of the US DOT. Lead item in the Stifel note: "Transportation is not a priority in Congress, right at the moment." After listing the usual transportation project suspects, Larkin concludes with what could be a positive for the rails. Congestion, poor highway maintenance, and a gridlocked federal government will continue to get in the way of efficient highway freight movement. If the feds don't get the infra fixed and stop over-regulating everything, "It's only a matter of time before freight rates will accelerate, reflecting an overall shortfall in supply."

I don't see the "Unless" happening. These things will *not* come to pass and the NIT League will continue to pressure the rails for a way out. As I wrote last week, if the serving RR will not cooperate in reasonable rates to points not local to their lines, the affected shippers will have to go elsewhere. But if elsewhere is trucks, and external pressures ranging from CSA to lane closures prevail, then trucks will he hard-pressed to meet demand. Better the rails step up to get everything on the rails they can, never mind who's local to whom.

Last week's NIT League argument stimulated more thought about the shortline paper barrier/ Class I access question. When I started this consulting gig 20+ years ago, I had a client who operated one of the first Norfolk Southern Thoroughbred Short Lines. As I recall, the TSL program was unique because it didn't limit access to other Class Is; the catch was that you had to make cash payments for the lease if you did not match prior year NS carloads. The NS view at the time was that anything that would keep traffic on the railroad was a good thing.

Seems to me the imaginative Class I could say to the NIT League something like, "If my route is, say, over 125 precent more circuitous than using a competitor, let's open the door to access." Or say to the customer, "The door is open for movements less than X miles," which, in fact, mirrors some paper barrier conditions I've worked on for short lines. Or, to take a page from the TSL program, if the customer continues to match a base year's revenue to the owning railroad, he is free to roam. Any reader objections, and, if so, why?

The Historical Guide to North American Railroads, copyright 2014 Kalmbach Books, deserves a prominent place on every serious railroader's working book shelf, especially if one is in sales, marketing, or pricing. The reason is the nature of the business: using expensive, non-fungible assets with route structures laid down before we were born to make a profit in a wi-fi world.

You can think of it in terms of the present NIT League access argument. I said last week that Back in the Day one had routing options over myriad Class Is (never mind the AAR revenue threshold for being a Class I was much lower, but that's another discussion). Knowing where those "Alphabet Routes" were and why they worked could well help one construct an efficient route using the railroads operating those lines today.

The *Guide* lists 171 names, including all seven contemporary Class Is plus principal present-day non-Class Is like the Indiana Rail Road and Iowa Interstate. The company thumbnails are arranged in alphabetical order to help readers connect the railroad dots with their maps, histories, and photographs. Now in its third edition, the volume is, according to Kevin Keefe, Editorial VP at Kalmbach, "a labor of love for two generations of railroad editors at Kalmbach." I've been reading those editors since I was ten and yet, just dipping into this book, learned new stuff.

For example, I never knew the Alabama, Tennessee & Northern switched a refinery in Mobile and still has the terminal business, though the main was bought by the Frisco and later merged into BNSF. Looking for a direct route to the Mobile terminal? Start with BNSF.

[To bring matters even closer to home, the KCS auto train photo on page 19 is the one we used as the lead for my KCS story in *Trains* last November.]