THE RAILROAD WEEK IN REVIEW

February 13, 2015

"We are always going to use our free cash flow to pay down debt when we are are between deals."— TJ Gallagher, CFO, Genesee & Wyoming

Genesee & Wyoming reported 2014 fourth quarter and full-year results Feb 10. Consolidated (North America+Australia) operating income gained 20 percent to $113.5 million as revenues increased 6 percent to 415.6 million. Net income rose 50 percent to $87.4 million thanks in no small measure to a combined $11 million decease year-over-year in taxes and interest.

It should be noted here that GWR adjusts reported GAAP results to reflect puts and takes between reporting periods to get more accurate apples-to-apples financial comps. I will pass; our focus here is on North American carload results specifically in order for NA non-Class I carriers to benchmark themselves against GWR results.

Fourth quarter North American carloads came to 455,785, up 10 percent over December, 2013. Frac sand and salt (minerals and stone), steam coal (utilities replenishing base-load stock piles), grain (RCP&E was the winner) and Class I overhead (Tower 55 detours around Fort Worth) were the double-digit percentage gainers. Organic, same-store merch carloads, without Class I overhead moves and 7 months of the RCP&E, increased 5 percent to 419,372 units.

Freight revenues gained 12 percent to $259 million; non-freight (switching, certain small short lines and contract services) added $84 million for total revenue of $343 million, up 11 percent. NA ops expense held to a 6 percent gain (comp & benefits dropped two points to 29 percent of revenue from 31; recall my Rule of 100 benchmark uses a 30 percent standard), yielding operating income of $253 million, up a whopping 28 percent, for a 73.8 operating ratio, a 3.4 point improvement. My only quibble is the inclusion of a $1.5 million gain in asset sales as an offset to ops expense. Absent that, the OR would be 74.3, still a 3.4 point improvement over last year, similarly adjusted.

On the call CEO Jack Hellman drilled down into the non-coal energy revenue picture (slide 9, if you care to follow along). Crude oil vols are essentially unchanged 2013 actual through 2015 estimated. On the other hand, nat gas liquids will post respectable gains with Utica shale producers in Ohio. Frac sand will increase, though at a slower rate, mainly to GWR customers in Ohio and Pennsylvania — wouldn't it be nifty if GWR could source frac sand on one property and terminate it on another? Drill and transmission pipe carloads will grow in support of a large nat gas transmission line between Ohio and Michigan.

During the Q&A on every GWR quarterly call somebody has to bring up acquisitions. Asked about what causes a private short line owner to sell, Jack said most often

> it's the age of the owner of the short line and whether or not they have an interested heir. This is an industry where the owners are typically a bit older and oftentimes there are heirs that don't necessarily want to be in the railroad business… We touch a lot of short lines that are either contiguous or proximate to us and where the owner may be either be willing to sell now or just thinking about it and want to sell later. It's a very personal process and we just want to make sure that we have a good conversation with them when the time comes.

GWR's first call on free cash flow is acquisitions that can bring yet more free cash flow, and, absent qualifying acquisition opportunities, the next call on cash is debt reduction. And you can see that on the balance sheet: net debt/equity is down 4.5 points to 60.3 and net debt to capitalization is down 1.7 points to a highly respectable 37.6 percent. No quibbles there.

Six of the seven North American Class I railroads posted revenue-unit gains in 2014, the only exception being CP, down one-tenth of one percent. BNSF hauled the most — 10.2 million units (based on week 52 AAR car-counts from their website; all others are from quarterly financials). UP was second, 9.6 million units, and NS was third at 7.7 million units. Union Pacific was Number One in merchandise carloads — including auto and crude oil, excluding coal and intermodal — with 4.3 million carloads; CN was second at 3.0 million. Union Pacific also led in percentage change in merch carloads, up 6.8 percent with CSX in second place, up 6.2 percent.

As for financial results, excluding BNSF (Berkshire reports March 6), UP took first place in total revenue: $24.0 million, up 9.2 percent. CN posted the largest revenue gain, up 14.7 percent, growing to C$12.1million. CP takes the honors in RPU change, up 8.2 percent and CN wins the brass ring in merch carload revenues, up 17.0 percent, and in gross ton-mile gains, up 11.8 percent. KCS is the leader in carload percent of total revenues at 71.7 percent; among the Big Six (again absent BNSF), CP leads at 67.5 percent, though CN led merch carload RPU gains, up 12.3 percent (NS barely budged at plus 0.6 percent.).

On the expense side, CP took ops expense down 9.2 percent while NS held the ops expense gain to eight tenths of one percent. UP had the highest operating income, $8.8 billion, up 17.6 percent. CP takes first place in operating income gain, up 26.6 percent, to C$2.4 billion. All of which says unequivocally that the North American railroad carload franchise is alive and well, with every railroad generating about 60 percent of revenues from everything that isn't coal or intermodal. What a great opportunity for the non-Class I feeder railroads.

My good friend Tony Hatch is making his usual rounds, attending many industry conferences and gleaning multiple useful tidbits by the bushel. Of particular note to those in the merchandise carload freight space…

* Big crowds across the board (including disciplines related to MoW & construction as well as sales & marketing, regional markets, and intermodal and Ag commodity specific) echo the rail industry's internal confidence.

* Big capex numbers show the Class One Rails mean business [*and the improving AAR performance metrics YTD are the proof of that pudding — rhb*]
* Oil was on everyone's mind, of course, and obviously more so for those in the railroad construction business – but by month end no rail projects had been cancelled or modified, and non crude-by-rail players were quite optimistic.
* Lower fuel costs will not work against intermodal vols. Shippers aren't moving a lot of freight off of rails with the drop in oil prices, even though diesel fuel is only down half as much as "oil." But, fuel could be an emerging regulatory issue, even as service-related issues subside in Washington's hallowed halls.

What I like about Tony's pithy notes is the way he boils down hours of presentations and "networking" into a number of nuggets of valuable insight. Thanks, Tony.

The CSX Board has promoted Oscar Munoz to President and Cindy Sanborn to EVP-operations, reporting to Oscar, who assumes this new role effective immediately and also remains chief operating officer. CEO Michael Ward cites Oscar's insights and experience first as CFO and then as COO since coming to CSX in 2003. His resume includes C-suite experience at AT&T, Coke and Pepsi, so he knows consumer goods and services.

Cindy has more than 25 years with CSX, coming up through the operating department to a number of senior leadership roles, including vice president of Northern Region operations. She currently serves on the Board of Directors for Conrail, the Belt Railway of Chicago and the Indiana Harbor Belt Railroad.

Both are excellent moves. I've known Cindy and Oscar for years and their combined contributions to executive bench strength at CSX have been incredible.The most hearty of congratulations are in order and I hope to coonvey such personally when at the CSX Shortline Workshop in two weeks.