THE RAILROAD WEEK IN REVIEW

May 15, 2015

"Companies in the S&P 500 today spend less than half their cash flow on capital investment."
— Michael Contopoulos, Bank of America Merrill Lynch, in May 11 WSJ

So how are the rails doing in this department? I thought I'd take the above quote and see what happens if you take dividends, share repurchases and capex as a percent of operating cash flow. The reason is, if you don't have the cash to pay for these things, you have to borrow it. BOA's Contoploulos continues, "They spend more on dividends and stock buybacks, sacrificing long-term strength for short-term financial gain."

Measures	KCS	CN	CP	CSX	NS	UP	BNSF
Operating Ratio	70.5	65.7	63.2	72.2	76.4	64.8	63.4
YTD Capex % of Revs	29.5%	15.1%	15.8%	19.8%	15.3%	19.6%	22.7%
Divs+ sh Rep % revs	5.1%	21.4%	35.3%	9.4%	23.2%	22.7%	0.0%
Capex+Divs+SR/OCF	128.6%	160.5%	153.2%	128.0%	163.3%	115.2%	61.5%

For the 2015 first quarter, four of the seven North American Class I roads spent more on dividends and share buy-backs as a percentage of revenue than they did on capex. KCS had no buy-backs and has only just begun paying dividends on its common stock, and BNSF, being a wholly-owned subsidiary of Berkshire Hathaway, has no shares to pay dividends on or buy back.

The accountants in the crowd tell me depreciation expense and capex ought to be more or less equal. That seems not to be the case, with the KCS, UP, and CSX capex spends running at well over twice depreciation; CN, CP, are showing capex spends in the mid-100s of percent of depreciation expense. The money's got to come from someplace, and it's typically more long-term debt.

That can be a vicious cycle. Revenues get hammered when service gets sloppy and shippers put their business elsewhere. The diminished top line diminishes net income, and that lowers cash from operations — the source of funds for capex, dividends, and buy-backs. And it's the last of these that contributes to the demand for shares in the market.

Corporations have amassed large cash stockpiles in the years since the financial crisis, and they have plowed a lot of it into shareholder-friendly activities like buybacks. Such activities have contributed significantly to the six-year bull market, supporting valuations by reducing share counts.

Partly as result of these buyback programs, PE multiples are creeping up, now to the point where the S&P 500 trades at 21 times its companies' net profits for the past 12 months, well above the historical average of 15.5, according to Birinyi Associates. Moreover, S&P shares as of the May 8 close were trading at 2.9 times book value, a far cry from the 1.5 multiple of Benjamin Graham's Day.

The whole crude by rail business continues to get hammered by politicians and newspapers, making statements that are either misleading or just plain wrong. Happily, somebody occasionally gets it right. Minot, ND, blogger Rob Port writes (http://watchdog.org/217981/heimdal-derailment/):

> We learned a couple of very positive things that fly in the face of the narrative pushed by activists and partisan opportunists. This time, North Dakota's first responders were prepared for a derailment and responded to this one in admirable fashion thanks to training they received after the Casselton derailment in 2013. The volunteer firefighters say the training put on by Burlington Northern Santa Fe Railroad in New Rockford after the [Casselton incident] taught them exactly what they needed to know.

Moreover, the cars involved in the Heimdal mishap caught fire but did not explode. Back in April, North Dakota began requiring companies to remove the most flammable gasses from crude oil and lower its vapor pressure before loading it onto trains. "The goal was to prevent an explosion during a crash," according to a story aired on the local PBS outlet. Robert Port again:

> It seems that goal was achieved, at least in this instance.The oil on the Heimdal train was tested at 10.83 psi, about 21 percent lower than the maximum allowed under the state's new rules implemented by the state's Industrial Commission. Here is a case where, at a local level, policies and training implemented by state leaders after the Casselton derailment appear to have worked. That's an important first safety win.

Genesee & Wyoming April North American carloads track very much along the Class Is and non-Class Is as reported in GE Transportation's RailConnect scorecard. GWR did 143,176 carloads in April, down 5.5 percent from April, 2015; take away the newly acquired Pinsly and South Dakota properties, and vols are off 11.3 percent.

Six commodity groups account for 80 percent of GWR carloads in the US and Canada. Coal, the largest at 17.2 percent, was off 15.3 percent or 4,439 cars — roughly equal to the 4,289 car decrease in overhead traffic. Ag products was off a point (a rounding error, if you will), and the metals group sank by 31.3 percent (5,007 loads) thanks to lower vols in the Southern, Ohio Valley, and Northeast regions. Here, NS and CSX are the main connections, and each reports April metals off 15.0 percent year-over-year.

In forest products, STCC 26 (paper-related commodities) was actually up 8.0 percent (8.3 percent of carloads), while the STCC 24 lumber group was essentially unchanged. Petroleum products including crude oil and NGLs gained two percent, as did the waste-products group. Total GWR year-to-date NA carloads for April were up a point, though down two points sequentially from March. RailConnect has the non-Class I rail group down by four percent year-to-date vs last year, with all the usual suspects posting negative deltas (intermodal excluded).

The AAR has total year-to-date carloads including coal but not intermodal down two percent as well. The Class I negative deltas are in — you guessed it — coal, forest products (both STCCs), and other. All of which goes to show GWR, with its 100+ NA properties, mirrors the Class I patterns and is doing slightly better than the non-Class I community, with one qualifier, however.

RailConnect is based on reports from 431 properties, a quarter of which are under GWR control. So if GWR us doing better than average, and is part of the average, it follows that a RailConnect scorecard based solely on the other 300 names might be down even more than four percent.

Norfolk Southern taps Alan Shaw to succeed Don Seale as EVP and Chief Marketing Officer. CEO Wick Moorman had said on the NS earnings call two weeks ago that an announcement was forthcoming and here it is. The appointment is effective tomorrow.

Shaw joined NS 20 years ago and had held down chairs in finance and marketing, most recently as VP Intermodal Operations, preceded by tours as group VP for coal and for chemicals. It's a good fit, I think. Shaw's direct reports will be the merchandise, coal, and intermodal marketing groups, while he will report to NS President Jim Squires.

NS will hold its last ever Roanoke short line meeting June 9-11, before the marketing group decamps to Norfolk in the fall. I expect Alan will have a few words to say during the Wednesday morning presentations and will be around for one-on-ones before and after, following in the custom of his predecessor, Don Seale. As the say in the theater, "Break a leg, Alan."