RAILROAD WEEK IN REVIEW

April 8, 2016

"Think not in terms of making decisions but in terms of setting trajectories in motion." — Mencius, Chinese philosopher, 4th Century BC

"Ordinary events have become increasingly inconsequential." — Nassim Taleb, The Black Swan, prologue

I open with these two quotes because the railroad industry seems quite content with dialing back the present tried-and-true (till now) model to find ops savings. Tweaking the present way of doing business takes precedence over re-thinking the entire model. Taleb's complaint is we spend do much time examining the minutiae of events, as we see them, that we miss what might happen if recurring patterns stop recurring.

In railroad terms, we need to think less about how to make what we have work better, and more in terms of what we could have if we set in motion the trajectories that will take us to a sustainable model five years out.

Providence & Worcester closes out 2015 with freight revenues of $33 million, up four percent, on 56,235 revenue units, up less than a point, and RPU up four percent to $586. Merch carload revenue now accounts for 96 percent of the total, while the vest-pocket intermodal contribution shrinks a point to four percent from five a year ago. Though one aggregates customer accounts for more than ten percent of total revenue, that commodity group has shrunk to a fifth of total revenue. On the other hand, chems including ethanol is nearly double that.

The company continues its rather unique process of including property rents in freight revenues. The freight revenue commentary shows clearly where the $33 million comes from, yet the top revenue line in the income statement is $717,000 more; a similar spread occurs in the 2014 number. I am reluctant to have rental income distort the operating ratio, so I put this number below the line.

As a result, I show operating income of $1.9 million, down 24 percent, and a 94.7 OR after taking out capitalized expenses, up two points year-over-year. There is a $million ops expense spread vs. 2014 with payroll, car hire, and trackage rights the major contributors (the last would have been twice as much were it not for an Amtrak credit that expired at the end of 2015). A $500K Other Income reduction and a 70 percent larger income tax provision took net income to $1.8 million, down 42 percent. Earnings per share also sank 42 percent to 37 cents.

To end on a more positive note, I'm pleased to report that P&W has completely updated their website with modern graphics, greater ease of navigation, and the 10-K as a PDF. Moreover, share price (and thus market cap) is much more in line with EBITDA than in the past, commanding roughly a 12 percent premium. But what I think the railroad really needs is a cost-benefit analysis of the six million dollar aggregates business that is largely over Amtrak trackage rights via the Hell Gate bridge over to Queens from south-central Connecticut. I also have to wonder about the yield on 1,200 intermodal boxes making seventy bucks each.

Financial writers appear to equate AAR performance metrics ("service") with "service" in terms of customer satisfaction. That carloads could be "flat to down on a sequential basis" suggests the service product (classic definition, not AAR metrics) does not fully meet customer requirements, and that customer expectations for making promised transit times are pretty low.

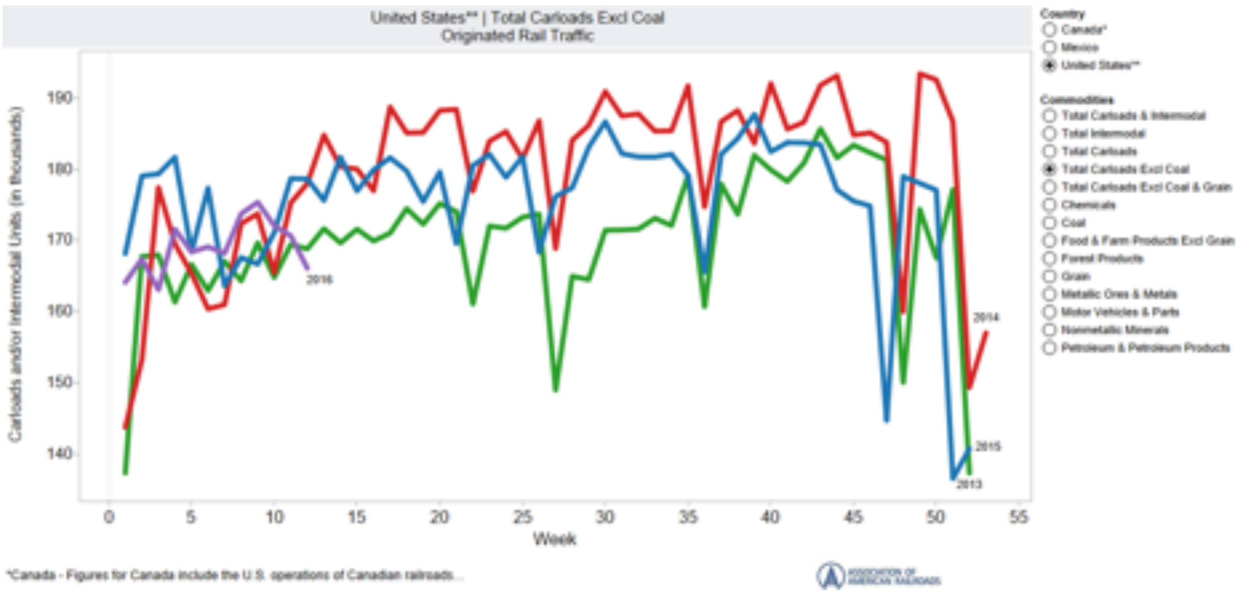
Earlier this week I drove several segments of I-95 in the northeast and saw enough boxes on rubber tires to fill several trains, yet here they are in the interstate. So when truck congestion starts to ease, and when sequential weekly railroad volume deltas start rising, we may be seeing the first glimmers of improved service in the eyes of the customer.

Investing in railroads carries certain risks, both to property owner and shareholder. The risk of economic downturns and high capex exposure are at the top of the list. As I watch the global economy for the unintended consequences of ZIRPs, Quantitative Easing, and other government attempts to manage behavior, I become less upbeat about long-term prospects for the rails. Because rails move stuff, and less stuff moves in uncertain times.

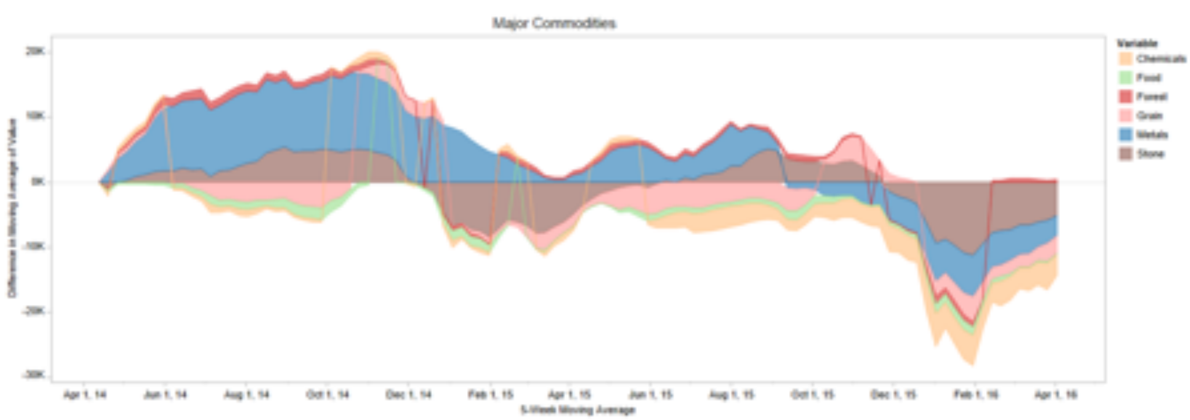
A crummy economy hurts the rails. Coal, metals/ores, oil and gas-related commodities are all down, and recovery of last-named could take a long time. Rails can bring on incremental vols w low incremental cost but the competitive advantage to supply-chain customers is lacking, and right-sizing the network is taking too long. Operating ratios come down more from rate increases than smarter ops practices, and some commodity lanes (ethanol, e.g.) are too dependent on the regulatory environment to predict future volumes.

The chart below compares revenue units ex-coal but including intermodal for US railroad operations through Week 12. The measure is the rate of change of a five-week moving average number of revenue units, so as of now average number of loads originated is lower than it has been since the 2014 Week 12. Separately, weekly AAR data shows Week 12 year-to-date merchandise revenue units (grain excluded) down six percent year-over-year, with STCC 28 chems including fertilizer flat, lumber up four percent, and paper down a like amount.

The non-Class I group Week 12 loads ex-intermodal, coal, and auto are off three percent. STCC 28 chems, grain, and aggregates are the three largest merch categories for the group, down five percent, flat, and down 15 percent respectively. (However, I think the feeder railroads could control more of their own destiny if they adopted an intermodal model, sending cars to each other as drayers with the Class Is doing FAK hook-and-hauls in the middle.)



Drilling down further, the Class I railroad five-week moving average of week-to-week sequential changes shows essentially no growth save for a blip in forest products. My suspicion is it's lumber moving from the PNW to the DFW area where the new-housing demand is better than elsewhere; the AAR weeklies say the STCC 26 paper group is flat to down, which doesn't do much for the non-Class I roads in the PNW, southeast, and New England.



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