# RAILROAD WEEK IN REVIEW

## August 5, 2016

*"The focus right now is increasing same-store sales by providing great customer service and a fluid transportation product." — Wayne Michel, President, Reading & Northern*

**Genesee & Wyoming second quarter North American** revenue was $227 million, down five percent on 386,123 carloads, off seven percent. Total revenue including switching and maintenance services was $305 million, down two percent. NA ops income was $79 million, up three percent, with a 74.1 OR, down a point. (But if you back out items like restructuring cost and the gains on asset sales, ops income gained four percent with a 74.0 OR, down two points.) NA provides on average about 80 percent of the corporate total ops income.

Consolidated revs in Q2 slipped eight percent to $501 million, ops expense came down six percent, so ops income was off 12 percent with an 82.6 OR, down less than a point. Below the line, the net slid eight percent to $48.4 million. Cash from operations was down 12 percent at $162 million, net capex after grants and other items was down 49 percent, though free cash flow before acquisitions was $85 million, a near double year-over-year.

Total debt net of cash is $2.14 billion against $597 million in TTM ebitda, for a multiple of 3.6. On the call, CEO Jack Hellmann and CFO TJ Gallagher said they don't like to go north of 4x, which suggests they can do another $300 million in acquisitions without getting too close to the bone. However, they hinted they'd be willing to entertain "other financial sponsors" if need be to tackle a rich M&A transaction.

Hellmann says each NA region "pulled its own weight." Frack sand was down in one region, another region's construction aggregates helped the STCC 14 line. Coal is getting a little reprieve from hot weather — mostly PRB with some Northern App and Illinois Basin for balance. The ag products line is predominantly grain, with smaller plays in grain mill products from soybean meal to ethanol to DDGs. COO Dave Brown says the smaller vols are changing their train-start mix — fewer unit trains, more mixed freight. That mix can change back as vols return, meaning better incremental margins and potential points out of the OR.

The reported NA system RPU increased 2.5 percent to $588. When you take out the changes in mix, FSC, and FX effects, over which the RR has little control, you come away from a so-so quarter with a three percent-plus gain in same-store pricing — not too shabby. The carload revenue mix is 93 percent merchandise commodities, with coal dropping to seven percent of total from ten percent a year ago. Ag products; STCC 28 chems including ferts; metals, minerals/stone; and pulp/paper make up about half the total.

The second half outlook is for carload vols in the high 300,000s running about plus two percent per quarter. Bake in gains of two-to-three percent per quarter in same-store pricing, the same operating expense discipline, and the way losses in one place are offset by gains elsewhere, and I think GWR will do ok.

**The Central Maine & Quebec Railway** is rising Phoenix-like from the ashes of its ill-fated predecessor. Q2 carloads increased 15 percent year-over-year to nearly 7,000 units with particular strengths in building products, NGLs, and paper-related commodities. Total revenue increased 39 percent to $7.7 million and RPU leapt 21 percent to more than a grand a car.

Ops expense was held to a mere two percent increase, for a 101.2 OR, 36 points better than a year ago (for the six months, CMQ broke 100 by a point, down 30 points YOY). The operating loss was cut to two *hundred* from two *million* dollars, and for the fist six months came out fifty grand ahead.

Appropriately enough, CMQ celebrated by unveiling a spiffy new blue and grey paint job on the 3813, the first of eight GP38-3 rebuilds that will go into general service where 4-axle power typically runs. The 3813 (or one of its sisters) will be on display at the Glory Days Festival in White River Jct., Vermont, Sep 10 and 11.

**The Carolina Lines Railroad** of the R.J. Corman Railroad Group is the beneficiary of a $9.7 million TIGER (Transportation Investment Generating Economic Recovery) grant from the federal government. As part of the County's Moving the Carolinas Forward initiative, the Corman freight rail route between Mullins, S.C. and Chadbourn, N.C., will get more than eight miles of replacement rail, some 50,000 ties, 75 miles of track surfacing, nearly 30 grade crossing upgrades.

The project is one of 29 TIGER grants USDOT doled out in late July, the eighth round of grants in the program. The other awards include rail projects in California, Oregon, South Carolina, Arkansas and Delaware. Twelve rail projects now totaling $135.3 million have been awarded TIGER grants.

**US Steel fortunes are looking up.** A July 27 report from Argus Research raises its rating to BUY from HOLD based on the company's stronger earnings outlook and better prospects for the Basic Materials sector. Argus "expects U.S. Steel to benefit from margin improvement, new tariffs on imported steel, and a stable to falling dollar, and to return to profitability sooner than we previously expected." The share target price is $30, which, combined with the dividend, implies a projected 2017 P/E of 7.5 and a total potential return of 18 percent from current levels. This has got to be especially good news for NS and GWR, with their strong concentrations.

**The drop in oil prices** comes from an increase in U.S. supply and the lack of OPEC response, writes Schwab's Brad Sorenson, Director Financial Research, in a July 21 note. US oil production gains from fracking efficiency, now four times what it was four years ago, has dropped the average breakeven price $50 and falling. Moreover, whereas it could take a month to drill a Bakken well eight years ago, last year it took 18-20 days and now it takes only 13-15 days. Brad says these technological improvements in the oil arena appear set to continue, in our view, which should help keep a lid on prices.

He concludes, "U.S. drivers set a new mileage record in 2015, according to the Department of Transportation, and through March 2016, miles driven were 5 percent higher than through the same time a year ago." And from that I conclude it's got to be good for ethanol thanks to the blend requirements. That in turn is good for short lines such as the Iowa Northern on the producer end and the Greenville & Western on the receiver end.

On the other hand, crude by rail isn't doing so well. The US Energy Information Administration reports carloads cut nearly in half Jan-May 2016, with half of that being shipments to the northeast. The USEIA cites as chief culprits "narrowing price differences between domestic and imported crude oil, the opening of new crude oil pipelines, and declining domestic production in the Midwest and Gulf Coast onshore regions."

**From the readership come two examples** of places where local market knowledge wins carloads. A friend who worked with the MKT when it was a stand-alone railroad writes,

> The Katy lived on rock, a sixth of its total volume. Unit revenues were low, but margins were impressive. Our big competitors were the MOP and the Frisco. Both could beat us on transit time from St. Louis or KC to Dallas or Houston. Which meant that they got into the destination service areas around midnight, whereas the poor old Katy came in 5 -6 hours later.
>
> But you know what? Because we had little pocket yards, we had to fan it quick, to make room for next day's train. And that meant that customer got consistent delivery -- the earlier arrival time on competitors did not mean earlier delivery to customer; in fact it tended to be erratic. Helped us a lot.

A more current example comes from Pennsylvania, where the Reading & Northern has been selected by CAN DO, Inc, a private non-profit industrial/economic development corporation in Hazleton, to provide freight service into and around its Humboldt Industrial Park. R&N will provide the same service window guarantees (scheduled time plus or minus two hours) now in place across its system, and expects to add more than 4,000 cars a year to its traffic base.

R&N President Wayne Michel writes, "The focus right now is increasing same-store sales by providing great customer service and a fluid transportation product. Toward that end, we have implemented a new fast-freight train that is dedicated to taking traffic direct from the NS interchange at Reading to Humboldt so as to reduce cycle time and improve service."

Michel adds that there are signs customers will use the new service to switch more inbound material from truck or transload to rail direct as certain legacy contracts expire. And the customer list is impressive: International Paper, Cargill, Office Depot, Quad Graphics and two packaging companies, to name a few. Having visited the site with Wayne, I can confidently say having the railroad headquarters in the next county was a big selling point. And NS benefits by having that local presence turn opportunities into carloads in short order.

**FreightCar America is clearly moving out** of its open top (OT) hopper comfort zone. In a recent research note, Cowen's Matt Elkott mentions the company's "traditional core strengths," a reference to the fact that FreightCar started out 100+ years ago as the Cambria Steel Company building OT hoppers for mining.

Twenty years later the company became the "Freight Car Division" of Bethlehem Steel, building OT hoppers and introducing the first aluminum-bodied BethGon(r) coal car in1986. Beth Steel got out of the car business in 1991, selling to newly-formed Johnstown America, operating as JAC Holdings. The name was changed to FreightCar America in December, 2004.

Though predominantly an open-top car builder, FreightCar says in its 2015 10-K, "The company has in the past five years added 31 new or redesigned products to our portfolio," including covered hoppers, mil gons, intermodal spine cars, non-intermodal flats, and several types of aggregates cars.  At the end of 2015 they had delivered 9,000 new cars and had a 10,000-car backlog.

The K isn't telling us volumes by car type, but the May 2016 investors slide set shows 2015 deliveries as 38 percent coal and 62 percent non-coal, having morphed from just 8 percent non-coal in the 2008-2012 period, and suggesting the backlog is mostly non-coal.

That's clearly what Matt meant by the shift from core strengths and its "somewhat improved position" in non-coal car types. Still, that makes FreightCar America the new kid on the block for other than OT cars, though its traditional strength here will help in meeting the demand for OT aggregates cars.

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