RAILROAD WEEK IN REVIEW

August 19, 2016

"Providence and Worcester Railroad Company has entered into a definitive merger agreement whereby Genesee & Wyoming Inc. will acquire the Company for $25.00 per share of common stock, or approximately $126 million, in cash." — P&W Press Release, August 15

Genesee & Wyoming continues its North American railroad consolidation with a proposed purchase of New England's Providence & Worcester. I have always said a GWR strength is keeping acquisitions contiguous, where the new railroad either connects physically with an existing GWR property, or is close enough geographically to swap assets and crews. Here, that pattern is writ large.

GWR is based in Darien, Conn. P&W operates out of Worcester, Mass. In New England, GWR owns the New England Central (ex-CV) between the Canadian border north of Burlington, Vermont and New London, Conn.; The Connecticut Southern (ex-NH) between Springfield, Mass. and New Haven, Conn.; and the St Lawrence & Atlantic, ex-CN, between the Canadian border with New Hampshire and Portland, Maine.

P&W nestles neatly into eastern Massachusetts, all of Rhode Island, and eastern Connecticut, with trackage rights over the North East Corridor (Amtrak and Metro North) from north of Providence to a connection with Anacostia's New York & Atlantic and Fresh Pond Jct. in deepest Queens, New York City. (This last is exclusively for certain construction aggregates; CSX has the franchise for such freight as is left on Metro North west of New Haven; P&W has exclusive rights to local freight between New Haven and the Mass./RI border.)

P&W has connections with GWR properties at several locations, as you can see from the attached map, page 4. CSX and NS are its direct Class I connections, with CP and CN access via the New England Central. Pan Am Rail interchanges at Gardner, Mass, and the Housatonic Railroad in western Connecticut interchanges with P&W at Danbury via either South Norwalk on metro North or the ex-New Haven Maybrook line (this last is out of service as of now. I drove it last week and it could be put back in a heartbeat.)

The P&W traffic base includes all the usual commodity groups, though, per the 2015 10-K, construction aggregates is a fifth of total revenue units and pays some $1.5 million in trackage rights annually, most of which, I wager, supports this low-margin business. Happily, chemicals from plastics to ethanol represent more than a third of volumes, and, although P&W does 't break out revenue by commodity group, as chems pols grow (up eight percent in 2015), so does system RPU, up four percent in 2015.

They run a vest-pocket intermodal terminal in Worcester, though volumes are diminishing. At only $70 a box, margins must be thin. And since the railroad revenue base is 96 percent carload, I keep asking myself why they even bother. Intermodal revenue last year was a mere $1.2 million, down 18 percent, whereas carload revenue was a healthy $32 million, up five percent. And every time I take the annual Mass Bay fan trip on P&W, I see more cars of industrial chems and other merchandise carload commodities. It's a perfect fit for GWR.

The P&W expense side has always been worrisome. Here's what I wrote about the first quarter 2016 results (WIR 5/27/2016):

> Operating expense increased 2.4 percent to $8.8 million. Payroll expense was up 2.7 percent or $110 million, now nearly 60 percent of operating revenues, an industry high, and up two percentage points vs a year ago. The operating ratio is a record 124.3, an increase of 360 basis points year-over-year.

That's pretty much the way it is every quarter, and, consequently, the ebitda margins do not excite. Last year P&W generated $6 million ebitda on $33 million total revenue, a margin of less than 20 percent and half what one might expect on a property this size.

Now comes GWR with a $126 million offer, four times sales and 21 times ebitda. GWR projects $35 million of revenue for its first full year of operation, essentially unchanged, and $12 million in ebitda, a double. According to the GWR press release, the secret sauce is the $8 million in immediate savings, the $5 million more savings over time, and the $12 million Providence property sale. Combined, these items reduce the effective price to $100 mm.That's roughly 8x the ebitda they expect and that's high-end ballpark for transactions of this ilk.

What's particularly interesting about the projections is the doubling of ebitda. As noted above, P&W always runs ORs in the 90s or low hundreds when you disallow the rental or property sales proceeds that they report above the line and part of operating revenue. One reason is paying out 45-50 percent of revs in comp & benefits — roughly 150 percent of the non-Class Railroad average. Note too PWX capitalizes some of the ops expense. I tend to disregard that as well, using "ops expense pre-cap" as the better measure of how the railroad is performing.

That said, the connectivity between the two properties reduces duplication of fungible stuff like MOW equip, locos, and even crews in some places. GWR can easily close the Providence HQ, downsize P&W shops (the ex-CV shop in St Albans is HUGE), and centralize purchasing and stores. In sum, I see the savings in plant, GS&A, and personnel.

There's been some on-line musing re potential new traffic flows. Fact is, connectivity brings synergy only if the traffic wants to go that way. Some projects can be home runs. Some, like G&W's acquisition out of Albany, Ga, basically just add to the length of haul, the value of which depends on the purchase price. In the P&W case, connecting their two railroads only has value beyond longer hauls if the traffic wants to go from one to the other and eliminates the intermediate carrier. As in everything, the devil is in the details. The transaction is expected to close in the 2016 fourth quarter. If P&W elects to terminate the deal under certain circumstances, a penalty fee of $3.5 million could be due GWR.

The Creating Customers thread continues. Harking back to Tom Peters and his 1993 classic, *Thriving on Chaos*, the purpose of any business is to create customers "by providing top quality, **as perceived by the customer**, as a basic value-adding strategy." (emphasis added) Yet it seems to me the rails spend too much time measuring their own costs and not enough time measuring things like what one reader calls "collateral delay to other trains." He adds,

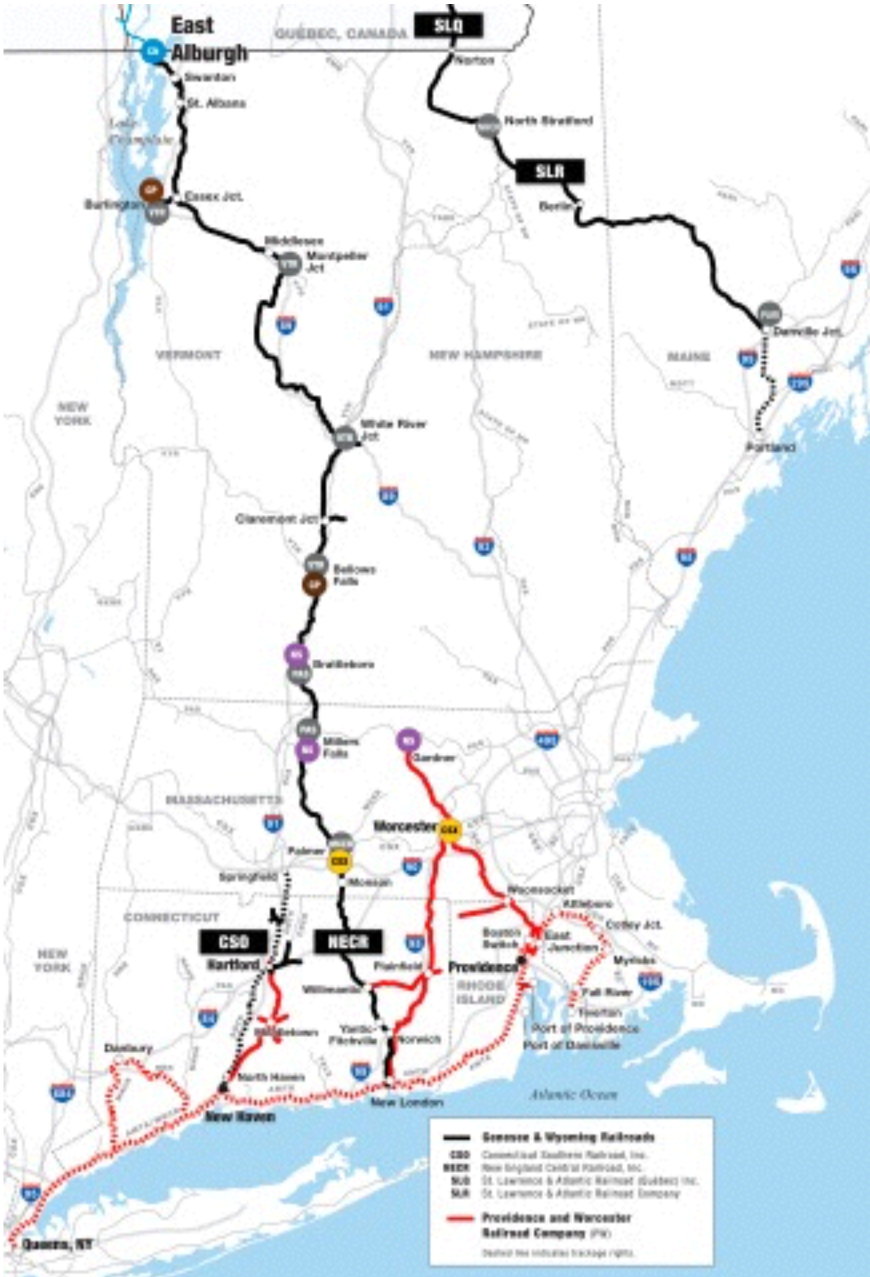
> On a branch line this might be zero. On a busy line double track line in or out of Chicago, for example, having a train blocking one track can create delays for dozens of other trains and congestion that can take hours or more to clear up, especially once trains go dead on hours and get parked waiting for a re-crew. And seldom do the measurement systems capture and attribute this delay to the initial problem.

My friend Jim Blaze, who's made a career measuring railroad economics, writes re collateral damage, "The rails have traditionally ignored as of no consequence shipper/receiver inventory delay cost functions." Not good for creating value. Consider: *Random Lengths* quotes 1,000 board feet of lumber around $300. You get 100,000 board-feet on a center-beam. That's $300,000 worth of inventory that your customer can't get to and turn into cash from *his* customers.

Say rail transit days for the lane runs 10 days vs the truck's five days. (Yeah, four trucks to the car, but we're talking inventory expense here.) So that's five days worth of $300,000 lumber the customer can't sell. Not a good candidate for Peters' *top quality as perceived by the customer*.

The customer frustration with rails has to be that quality in his eyes is rarely addressed, and it's a continuing concern. Exactly 14 years ago I wrote (WIR 8/23/2002) about the strong interrelationship between and among trip plan compliance, the scheduled railroad, and customer satisfaction. At the time, UP was surveying more than 2,500 customers a year, getting a 95 percent response rate, and consistently scoring high 90s across each sample.

This just in: Wick Moorman takes top job at Amtrak effective Sep 1. At last — somebody who understands the delicate dance between Amtrak and its freight-railroad hosts!



Genesee & Wyoming Inc. announced today that it has agreed to acquire Providence and Worcester Railroad Company (Photo: Business Wire)