RAILROAD WEEK IN REVIEW

November 10, 2017

"By increasing track speed to 25 MPH, we improved reliability for our customers and reliability for our interchange partners." — Ryan Ratledge, President and CEO, Central Maine & Quebec

Central Maine & Quebec reports 3Q2017 total revenue of $8.3 million, up 12% year-over-year, on 6,254 revenue units, down 5.8%. Chemicals including fertilizers were up 29% and fuel/propane jumped 71%, becoming the third largest commodity after forest products, down double-digits. Mix was a factor, with more higher-rated line-haul commodities such as chemicals and energy products, and the elimination of lower–rate haulage traffic

Operating expense also increased 12%, leaving a 7% operating income gain to $507,000. The operating ratio remains north of 90 — 93.6, to be exact, a 29 basis-point deterioration since last year, partly due to a timing difference in recognition of 45G tax credits, higher compensation and benefits, fuel, and car hire line items.

CMQ assumed control of this mostly ex-CP line from The Montreal, Maine & Atlantic in 2014, following the Lac Megantic disaster. Since that time, the new owners have made considerable investments in both the physical infrastructure and in regaining the confidence of its service area. The 481-mile railroad is now fully 286-compatible, and has a capital plan running through 2020 which calls for yearly expenditures averaging $4 million.

For 2018, CMQ targets an annual adjusted EBITDA of $10 to $12 million, projects carload growth of 8%–10% from 2017, assumes the renewal of expected 45G tax credit of some $1 million, and includes $3 – $5million of adjusted EBITDA from a new service line, which I am told will be a fairly high-margin business. Clearly CMQ is on the mend, posting trailing 12-month revenues of $32 million, an increase of more than 6%.

Burlington Northern Santa Fe Railway brought in 3Q revenue of $5.3 billion, up 3% vs. a year ago. Operating expense increased 2%, leveraging an operating income gain of 4% to $2.0 billion and an operating ratio of 63.2, down four-tenths of a point year-over-year. Net income increased 2% to $1 billion. Year-to-date free cash flow after capex (15% of revs vs 20% last year) rose 13% to $2.4 billion.

BNSF boils its commodity groups down into four: consumer products (auto and intermodal), coal, ag (grains and grain mill products with processed foods in the industrial group), and industrial products (everything else plus "other"). In the quarter, consumer revenue units increased 8% on increased market share; coal picked up a couple of points on higher nat gas prices. Ag slipped 12% on export volumes, partially offset by more domestic grain; industrial products gained 2% on drilling support commodities, though crude oil vols came down.

The BNSF report is light on details (no slides or conference calls), yet the sense I got from the recent shortline workshop was one of maximizing return on assets, and equipment velocity is an essential consideration. Though "equipment rents" is a smallish expense line item (less than 4% of revenue), it's still a $750,000 per year expense, and reductions go straight to the operating ratio. BNSF made no bones about its serious desire to reduce dwell on short lines, ideally to a two-days average from the present five (some short lines are still logging more than ten).

The Class I railroad results for the quarter are all in, and this time I'm including KCS comps with the other Class Is, even though its $657 million quarterly revenue is only 12% of the UP's $5.4 billion quarterly revenue. But percentage changes count, and KCS scores six winners out of the nine comp categories I use. KCS scored the best percentage changes in total revenue, merch carload revenue, system RPU, operating income, and point change in operating ratio.

CN won the brass ring for greatest increase in revenue units, CSX managed to take total ops expense down 10 basis points vs. positive deltas elsewhere, and CP rang up the greatest increase in manifest carloads including auto. These seven Class I roads generated $37.3 million in revenue on 11 million revenue units and did it with an average OR of a respectable 62.1.

Genesee & Wyoming held its Investor Day in NYC this week. The five-hour session covered operations and successes in North America, the United Kingdom, Europe and Australia. With some 200 slides in the PowerPoint deck (available on the GWR website investors page), the day amounted to a very good primer on short line and regional operations.

GWR operates 122 railroads on three continents, runs 16,000 route-miles of track across nine autonomous operating regions, has a payroll of 8,000, handles about 3.4 million annual revenue units for roughly 3,000 customers, and does it with 1,344 locomotives (92% EMD, 42% 6-axle). Since its 1899 beginning as a salt carrier in upstate New York, GWR has grown by acquisition, the largest being RailAmerica (46 names) in 2012 and now has a market cap of nearly $5 billion.

While the track record of consecutive successes in the UK, Europe, and Australia are not to be given short shrift, I'm going to limit my observations with what GWR does in North America and why. To frame the discussion, in the U.S., GWR owns 107 (18%) of the 600 or shortline names, has 22% of the route-miles, 21% of the employees, and generates 28% of the shortline revenue. In Canada, GWR owns 8 of the 50 non-Class I carriers (16%) and generates 22% of shortline revenues with 17% of the employees.

To get here, GWR has kept (and still keeps) a sharp eye out for acquisitions, keeping in mind that "bread and butter" North American short lines remain the most attractive place to invest. There are still about 500 short lines GWR does not own, so acquisition opportunities abound. Excluding the 200 or so names already in holding companies (Watco, Anacostia, Gulf & Ohio, e.g.), many are not only contiguous with existing GWR properties, but also are Staggers-starts that have been under the same family run businesses for decades, and some may wish to retire.

There are bound to be more Class I spin-offs, and there are ports, terminals, transloads, etc. that may need switching services, all of which GWR is equipped to handle. Moreover, GWR's industrial development pipeline averages more than 150 active projects at any given moment, mostly in the population centers in its Northeast, Central, and Western Regions, with more than half the traffic in STCC 28 chems, aggregates, and metals. In sum, GWR sees the NA volume and pricing market as largely favorable.

Pricing power is essential, and that comes from how GWR gets paid. Two-thirds of revenue units are under what GWR calls "pricing freedom," which is really ISS rules. The other third is under "rail inflation indexed rates" — handling line allowances. Regardless of settlement method, you still have to create value for customers. To this end, GWR generates a service plan for every car: event, date, time, place, train designation, point of interchange and connecting Class I. This gives the customer at least some visibility for the first-mile (and last-mile with GWR on the other end).

What emerges here is a determination to control one's own destiny — from local management at the regional level to managing the Class I interline service package to "white glove" customer service. Which means moving trains predictably and dependably, and that in turn means managing the assets. And it's why each regional org chart shows VPs for mechanical and engineering. And it's why GWR is moving support work to in-house and away from contractors.

Take mechanical. The locomotive philosophy is simple. Own everything you can, do your own maintenance, and lease power only where you can't help it or where non-owned units come with an acquisition. Buy good used power for a quarter of the cost of new, use 6-axle for big, longer-haul trains and 4-axle for yard and small local jobs.

The engineering forces are charged with the annual testing of some 17,000 track-miles and inspecting more than 9,000 bridges, and GWR saves $2 million a year by insourcing. Whereas prior to 2015 track capex was 100% outsourced, the work is now 60% in-house, reducing core US capital by up to $15 million a year while installing half a million ties a year and doubling production to 1,000 ties a day from half that.

As I said above, this wide-ranging session is loaded with Best Practices that can be applied on any short line. Now just go do it.