RAILROAD WEEK IN REVIEW

May 3, 2019

“When temperatures dropped to Tier 3 and Tier 4 — below minus 35 degrees Celsius or minus 40 Fahrenheit — for about seven weeks, we were losing significant train capacity and in some instances, we could not operate during the coldest hours of the night… As we do after every winter, we are now taking the opportunity to right-size our asset base, including the return of leased locomotives and putting railcars into storage.” — JJ Ruest, President & CEO, CN

“We continue to see opportunities to price ahead of railway cost inflation. Our customers have come to expect that from us. We need to be able to price ahead of railway cost inflation so we can handle our customers’ goods to market in a very expeditious manner. Our goal is to be there to grow in lockstep with our customers, and pricing is a key component to that. — James Cairns, SVP, Rail Centric Supply Chain, CN

“If you look in the southeast United States, for example, we’ve got 400-plus mile contiguous rail systems that we’ve built out over time. In northeast United States, the same. That’s seven contiguous acquisitions where we started with the original G&W and added consecutive bolt-ons thereafter. That’s our basic playbook.” — Jack Hellmann, Chairman, CEO & President, Genesee& Wyoming

Canadian National increased RTMs three percent on essentially unchanged revenue units — up 70 basis points. Merchandise vols including automotive were up double that — 1.4 percent with positive deltas everywhere but lumber and wood products, though that may be an aberration as demand remains strong and prices are holding.

Canadian grain vols increased eight percent and US grain jumped 14 percent. The frac sand outlook may be cloudy, but there’s an off-shore market for LPG. The AltaGas Ridley Island (Price Rupert) Propane Export Terminal Project, designed to export more than a million tons a year, opens this month. Crude-by-rail fell short as CN did 250,000 barrels a day of crude by rail vs 300,000 a day projected in December. Then the Alberta government stepped in.

Intermodal units were unchanged at 624,000 boxes and coal was also unchanged at 80,000 carloads. International intermodal traffic holds steady with refrigerated containers and auto parts imports in the wings. Domestic intermodal is nurturing new customers for its CargoCool containers as it capitalizes on the March 2019 TransX acquisition. The company, based in Winnipeg, is a first-mile, last-mile transportation provider, with a growing franchise in the perishables market.

Total revenue increased 11 percent to C$3.5 billion, but ops expense rose 14 percent thanks to weather-related jumps in comp & benefits, purchased services, and fuel as they burned four percent more fuel on less than three percent more GTMs. Ops income was C$1.1 billion and the

GAAP operating ratio was 69.5, up 177 basis points from a year ago. Net income was C$786 million, up six percent; free cashflow after capex but before dividends was C$294 million, down 11 percent.

The main takeaway for me is what the Stifel note called "playing the OR limbo." By that the writer is saying CN isn't playing the "PSR" game (recall it was HH and CN that got this buzz going), opting instead for a more measured approach, a la BNSF and KCS. "In short, the operating ratio is not as important as growing operating income and the company does not want to turn down revenue that is accretive to operating income or is a positive ROIC investment just because the incremental OR of that particular business is less desirable than the corporate average." Ahem.

Genesee & Wyoming reported 393,857 first quarter revenue units for North America, down three percent. Freight revenue, however, increased three percent to $252 million, thanks in part to the six percent jump in system average RPU — V$639. Backing out lower-rated coal and intermodal yields an average $691 merchandise carload RPU, up five percent.

Total revenue units excluding 7,466 cars from last year's leases for the GEXR and SOR in Canada, were only off a point — 4,690 same railroad carloads. Total carloads ex-coal and intermodal (none on these Canadian roads) were down 4,985, making the net loss from these leased lines about 300 cars.

Comparing reported volume changes by commodity against the same-railroad numbers, one can see where the changes lie. Ag products, for example, were up 491 as reported; without Canada, ag was up 1,773 units, a net loss of 1,282 carloads. Similarly, reported chemicals carloads were down 2,414; same-store ex-Canada chems were down 844, implying 1,560 chems on those lines.

Total North American revenue (freight plus "Freight Related" and "Other") came in at $332 million, up two percent, operating expense was up four percent to $263 million, yielding a 79.1 OR, up 162 basis points. All-in revenue (North America+Australia+Europe) was $558 million, down three percent. Operating income was $80 million. Net income, excluding certain items affecting comparability between periods, was $87.8 million, unchanged year-over-year.

Below the line, GWR posted a $32 million income tax benefit associated with the U.S. Short Line Tax Credit for fiscal year 2017 that was enacted retroactively in February 2018. As a general rule, 45G credits go agains the "provision for income taxes line on the income statement. It may be worthwhile for other shortlines enjoying the 45G credit to review their posting, too.

The Q&A following the formal presentation provided some useful insights as to GWR's philosophies and methods. Asked about line acquisitions, Hellmann said they're always looking for places they can "bolt on" contiguous line acquisitions. This contiguous railroad strategy is a real plus, offering myriad advantages over the all-too-common "any railroad anyplace" acquisition pattern.

Buying properties that touch something you already have lets you put small assets together, increase densities on the combined lines, get better asset utilization, and, in some cases, open up new Class I routes as they seek to decrease transit times as they go the PSR route.

Asked about how infrastructure funds might approach the short line business differently than a strategic acquirer, Hellmann said the former is looking for free cash flow and is not asking about carloads or earnings. Moreover, infrastructure funds tend to have a longer investment horizon. Given the nature of their funding, it could be longer term or permanent, and they typically have an appetite for the larger asset. As a result the smaller tuck-in acquisitions, such as GWR makes in its bolt-ons, probably doesn't have the scale or the risk profile to be of interest to the funds.

Even though GWR opted not to comment on the March Bloomberg story about their "exploring strategic options including the sale of all or part of itself," there are those who say GWR may still have a target on its back. The argument is that a GWR's free cash flow history, its ownership in long-term hard railroad infrastructure on two continents (Europe is "above the rail"), and financial presence is an attractive combination. One analyst says that a sum-of-the parts valuation falls someplace north of $110.

And of course there was the inevitable question about PSR, which can work either for or against the single-carload shortline franchise, depending on the Class I and the commodity O-D pairs. The GWR approach is to find the best operational fit with the connecting Class I operating plan. Doing so creates the best of both worlds for the short line *and* the Class I. In a nutshell, consistency from the Class I improves short line asset utilization — and car turns — thereby lowering variable cost for the move.

So, even though North American EBIT fell to its lowest level in four years on weak volumes and bad weather, GWR maintains its core strengths are still intact. GWR expects to recover more than half of the first-quarter income shortfall in North America from the winter weather. Second quarter organic same-railroad growth in North America is expected to be one to two percent. "Other" income from Class I empty car traffic is totally unpredictable and is likely to decrease as CSX and NS start moving cars more quickly and more reliably on their own lines.