THE RAILROAD WEEK IN REVIEW

February 15, 2013

"We believe the breadth of our new North American footprint gives us an enhanced organic profile; our job is to deliver 15-20% long-term earnings growth." -- Jack Hellman, GWR

Genesee & Wyoming North American fourth quarter 2012 freight revenues increased 2.6 percent to $101.2 million on 180,427 revenue units, up 7.1 percent; ARC increased 10.5 percent to $508. GWR took double-digit revenue unit increases in petroleum products, lumber and forest products, farm and food, automotive and intermodal. Double-digit decliners were minerals and stone, metallic ores, coal/coke and, of course, other and haulage.

CFO TJ Gallagher said on the call that coal was down on a combination of a planned maintenance outage and reduced demand (mainly in the Ohio and Illinois Regions); the lumber gains came on the US housing market improvement and were felt most in the Oregon Region. Minerals and stone came down on reduced salt shipments in the NY-PA-Ohio Region. Interestingly, the down 46.8 percent overhead volume hit caused a mere 7.4 percent sector revenue dip as ARC jumped 74.1 percent to $505 from $290 due to a mix change.

North American non-freight revenues, where switching operations and a number of smaller, non-contiguous short lines reside, increased 8.9 percent thanks mainly to more industrial switching and higher container counts in Portsmouth and Savannah. Total North American revenue was $146.4 million, up 4.5 percent.

Total operating expense -- including $23.9 million for the RA transaction -- was $135.8 million, producing ops income of $10.6 million and a 92.8 operating ratio. Back out the RA-related charges and ops income is $34.6 million, up 9.3 percent, and the OR is a more reasonable 76.4, a one point improvement over 4Q2011.

Jack Hellmann said in his opening remarks that GWR took "full control" of RailAmerica on Dec 28, rolling out into nine operating regions, three of which will be under former RA SVPs. They've already taken out $20 mm of the $36 million annual cost-savings target, beefed up the industrial development and customer service teams and added a new Chief Engineer and Chief Mechanical Officer.

GWR expects 2013 total revenue of more than $1.6 billion; had the two roads been combined a year ago, revs would have been $1.5 billion, thus implying a 6.7 percent growth rate in North American sales. The increases will come slowly, however. The usual NA revenue seasonality and the timing of the cost savings will take the OR down to a highly respectable 72 by the end of Q3. I, for one, think the combined properties will create one big economic powerhouse.

It's one thing to watch carloads, revenues, expenses, the operating ratio and operating income, but if you really want to measure the financial health and sustainability of the enterprise, you need to follow the money and see how everything relates. This table compares the Listed Class I roads five ways and then compares what you're paying for what you're getting. I'm not going to bore you with what's behind every line but I will suggest where extra reading may be in order.

YTD Ending	**12/31/12**					
Metric/Name	**KCS**	**CN**	**CP**	**CSX**	**NS**	**UP**
1. Cash flow from ops > net income						
Ops cash flow	$ 673	$ 3,060	$ 1,328	$ 2,946	$ 3,065	$ 6,161
net income	$ 377	$ 2,680	$ 484	$ 1,859	$ 1,749	$ 3,943
OCF as % Net Income	179%	114%	274%	158%	175%	156%
2. Capex < Depr?						
capex	$ 540	$ 1,731	$ 1,148	$ 2,341	$ 2,241	$ 3,738
Depr	$ 199	$ 1,524	$ 539	$ 1,059	$ 916	$ 1,760
Capex as % Depr	272%	114%	213%	221%	245%	212%
3. LTD Change						
4Q2012	$ 1,535	$ 6,745	$ 4,357	$ 8,461	$ 7,739	$ 7,934
4Q2011	$ 1,566	$ 6,475	$ 4,698	$ 7,935	$ 7,164	$ 7,689
YOY Change	-2.0%	4.0%	-7.8%	6.2%	7.4%	3.1%
4. Share count (mm)						
4Q2012	110.08	437.7	173.2	1,040	325.2	476.5
4Q2011	109.83	454.4	170.6	1,089	351.3	489.8
YOY Change	0.2%	-3.7%	1.5%	-4.5%	-7.4%	-2.7%
5. Dividend Payout						
4Q2012	23%	24.33%	46%	30%	36%	29%
4Q2011	1%	23.81%	34%	26%	30%	25%
Pct. YOY Change	na	2%	36%	14%	19%	14%
Valuation						
Metric/Name	**KCS**	**CN**	**CP**	**CSX**	**NS**	**UP**
Share Price	$82.06	$91.01	$101.62	$19.73	$61.84	$125.72
YOY Change	20.8%	20.0%	50.2%	-6.3%	-15.1%	19.3%
Price/earnings	26.10	22.66	27.18	11.56	11.50	15.19
Price/Book	3.36	3.62	2.58	2.25	2.06	3.01
Graham Number	$46.16	59.38	$42.65	$18.77	$60.26	$88.13
Price/Graham Number	$1.78	$1.53	$2.38	$1.05	$1.03	$1.43
Source: Company financials						
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Operating cash flow comes from the Cash Flow Statement and is often called "Cash from Operations" and is what you get when you add back non-cash items like depreciation and changes in accounts receivable to net income. It wants to be greater than net income so the table tells you if it is and if so by how much. That CP is the outlier says you need to look at the 10-K and find out why.

Depreciation is really a set-aside for replacing what wears out and relates to the capex line. The railroads are spending about half their capex budget to replace and repair and the other half on capacity expansion and PTC. What depreciation doesn't cover has to be covered by operating cash flow or debt, so you want to look at how and why debt changes year-over-year. In the case of NS, for example, long-term debt increased by some $570 million as the share buy-back program ate up a $billion more than free cash flow after capex and dividends.

Of course, buying back shares is one way to goose earnings-per-share when business is slow. Norfolk's net income for 2012 was down more than eight percent year-over-year but the share-count was down seven percent, so EPS came down only one percent. That's why I include the change in shares in my analysis. And that relates to dividend payout. Payouts of maybe 50 percent seem to be generally acceptable; when you get north of that the Street gets uncomfortable. CP seems to be pushing the envelope here.

I've mentioned The Graham Number before. It's a function of earnings per share, book value per share and share price. Benjamin Graham found a "normal" range for share price occurs when shares are trading at 15 times earnings and 1.5 times book: (price/earnings)*(price/book)=22.5, so "fair price" is the square root of earnings per share times book per share times 22.5. What I'm showing here is an orders-of-magnitude measure of share price to what one might expect. Graham said you want to buy companies at a discount, say 50 cents on the dollar. My table shows the rails priced at a premium; as it happens NS and CSX are the low-price spreads.

As to why this is, I remain convinced that coal is the culprit and once we get past the rotten comps starting in the second quarter of this year and operating expenses back more in line with GTMs we'll see Graham Numbers go up as the operating ratios come down. I'd be a buyer of either or both here.

Next week WIR will be brief. I leave for Vancouver, BC, Thursday to ride VIA's *Canadian* the 2,723 miles over to Toronto with 60 or so other professional railroaders on what has become an annual outing. We pull out at 2030 Friday and arrive 0930 Tuesday. I'm hopeful WIR for March 1 will have some tidbits from this first-hand view of Canadian National's west end, all of which is new mileage for me. In the meantime, I'll do Jan 2013 RA and GWR carloads separate and together for the Feb 22 WIR.