THE RAILROAD WEEK IN REVIEW

May 31, 2013

"When I look ahead, I see a diversifying and evolving customer base and an improving field of commodities and products being handled." -- Scott Conti, President, Providence & Worcester

UBS Mid-quarter Rail Refresh. Rail analyst Elizabeth Mielke writes she is revising second-quarter estimates "modestly" upward for all rails on

> better than expected QTD volume growth, downward OR revisions, or a combination of both. Longer term EPS estimates are essentially unchanged for CSX and NSC, but increase more appreciably for KCS, CP, CN and UP. Over the past couple quarters, volume growth for the US rails – particularly in the areas of crude oil, auto, housing, frac sand and intermodal – has been relatively solid. It seems the worst may be behind us in terms of coal, and ag volumes should start to improve later this year -- assuming more normal crop production after two years of drought.
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> As a result of improved fundamentals and investor sentiment, we are starting to use higher [PE] multiples for target prices. Despite raising our targets for all six Class I rails, in light of recent strong stock performance and valuations that we view as fair to somewhat stretched, we don't currently see any compelling buying opportunities over a 12M investment horizon. We remain Neutral-rated on UP, CSX, NSC, CN and CP and Sell-rated on KCS.

I'm not so sure about KCS as a Sell. Yes, it's trading at about 4x book, but so are CP, CN and UP. (By way of comps, AAPL is 3x.) But the difference is location, location, location. KCS is aggressively building its Mexican auto and port franchises plus both sides of the energy play -- drilling materials in and crude oil out. I think what sets KCS apart is four distinct break-out opportunities whereas the other three are doing more of the same only better.

Continuing the Apple comp, the Street is beating up Cook & Co. for what The Street sees as a lack of break-out products. Yet the stores are mobbed and I see more iPhones and iPads out in public than I do any other brand. Buffett again: "Be greedy when others are fearful." That's why I like KCS... and Apple.

The 2013 Pennsylvania Rail Freight Seminar in Harrisburg May 22-23 featured a timely panel, *Marcellus Shale & Rail: A Forecast*, with moderator Todd Hunter, Director of Marketing, North Shore Railroad System, with panelists Ryan Fischer, AVP- Emerging Markets, Genesee & Wyoming, Tom Watkins, Director of Supply Chain Management, Universal Well Services, and Mike Filoni, VP-Sales & Marketing, Carload Express.

Though I was otherwise engaged (Wolfe Transport Conference in NYC), Todd was kind enough to forward the presentation materials. I'm particularly taken with the GWR slides and how they relate to the energy presentations at Wolfe. This picture is from the Fischer slide set and shows the extensive build-out at the $900 million nat gas liquids facility of Utica East Ohio, LLC, at Scio, Ohio, on GWR's Columbus & Ohio River (CUOH).

The so-called "fractionation hub" is the largest integrated midstream service complex in eastern Ohio and GWR's largest customer to date in the Utica Shale. The plant's location was selected based on proximity to the Utica Shale's liquids-rich gas, to key natural gas pipelines and to the CUOH. The railroad has put down eight miles of track supporting 16 loading tracks to handle 55 cars a day as well as storage space for another250 cars. GWR will assign three locomotives to the facility. The plant is expected to originate some 10,000 loads a year.

Opening just this month, the Scio plant will also benefit from a recent $2-million expansion of CUOH's main rail yard in Newark, Ohio, funded by a public-private partnership between CUOH and the State of Ohio. The Newark Yard expansion will facilitate the sorting of 100,000 railcars per year for more than 80 current customers and will also serve several new, Utica Shale-related projects that have located or are planning to locate on the CUOH.

In a related development, GWR's Atlantic & Gulf Coast Railway (AGR) is getting into the crude-by-rail space, serving the recently completed Genesis Energy crude oil terminal at Walnut Hill, Fla. (in the extreme northwest corner of the state panhandle). The 2012 Genesis 10-K tells us, "The new crude-by-rail unloading terminal is capable of handling unit train shipments of oil" and that a "second phase of the terminal will include a 100,000 barrel storage tank." No comment on origins or volumes, though you can figure roughly 70,000 barrels per hundred-car train.

Providence & Worcester first quarter 2013 freight freight sales increased 4.2 percent year-over-year to $6.8 million as revenue units increased 10.3 percent. Unfortunately, carload sales dipped 2.5 percent mainly on ethanol and plastics slow-downs. The new container terminal increased box-counts by a third, but when merch carloads average more than $900 apiece and intermodal boxes bring only $73, it doesn't move the needle much.Total freight revenues including ancillary services increased 3.1 percent to $6.9 million.

Operating expense less capitalized costs were $8.5 million, up 4.1 percent; operating loss was $1.6 million, 8.9 percent worse year-over-year, and the operating ratio was 130 basis points worse, 123.6 percent. As usual, the devil is in the comp and benefits line, still hovering right around 60 percent of revenues. Shortline and regional peers seem to stay in the 30 percent range and if P&W were to follow suit, it would save $2 million a quarter and at least get the OR below 100. Below the line, rentals and other income plus a $392,000 income tax benefit cut the net loss to $1.1 million, 21.1 percent worse year-over year. Per-share amounts dropped accordingly.

One of my favorite Buffet Rules says Retained Earnings should rise dollar for dollar (or better) with market cap. At the end of the present quarter retained earnings stood at $34.7 million, down 3.6 percent since the 2012 books closed. Go back to FY 2006 and retained earnings stood at $37.6 million, so it would appear P&W is burning more earnings than it's retaining. And I still think the comp and benefits line is the culprit.

It's not a bad little railroad, when you come right down to it. Railroad President Scott Conti wrote in his February, 2013 President's letter that the railroad turns 40 this year and half of their 16 largest customers didn't even exist just six years ago. They have extended market reach by adding direct or overhead connections with CSX, NS, CP and CN and expanding operations with its neighbors: CSO, NECR, VTR and PAR.

They've worked hard and successfully with government agencies to expand freight operations at Providence and Davisville in Rhode Island and New Haven, Conn. Last year P&W finished the Willimantic Branch rehab and got all its lines up to 286 -- except for five bridges and they are in the 2013 plan. Scott concludes, " When I look ahead, I see a diversifying and evolving customer base, an improving field of commodities and products being handled, the possibility of generating new traffic through our existing interchange connections, and the potential to maximize our economic opportunities and global reach through investment in the port facilities we serve." Now to get that labor line under control...