THE RAILROAD WEEK IN REVIEW

February 14, 2014

"I would do a deal tomorrow with an 80% operating ratio as long as it earned its cost of capital and was accretive to the cash flow and earnings of the company." - Jack Hellmann, G&W

Genesee & Wyoming consolidated revenue jumped 72.3 percent year-over-year to $392 million for the quarter and $1.6 billion for the year, thanks mainly to the December, 2012 RailAmerica acquisition. The results are riddled with these huge deltas, making apples-to-apples comps next to impossible because (a) RA effectively doubled GWR's organic North American carloads and (b) the one-time charges attributable to the transaction skew the GAAP numbers.

Case in point: a strict GAAP accounting shows fourth quarter per-share earnings of a $1.03 for 2013 and $0.18 cents for 2012. Adding back the 2012 fourth-quarter non-GAAP items yields an adjusted EPS of $0.79. The similarly adjusted 2013 per-share earnings comes to $1.07, a 35 percent increase. But our interest here has more to do with the way the railroad is running than with the financial puts and takes. So, as is my custom with GWR, what follows is limited pretty much to the North American results.

NA fourth quarter revenue units totaled 415,067, up 130 percent, generating $230.8 million in revenue. I think the change in mix is more telling than commodity carload deltas, at least until we get to full-year comps starting in Jan (more on that below). Merchandise carloads increased four percentage points to 87.4 percent of total units and coal dropped four points to 16.4 percent. Ag products gained six percent; small gains were taken in petroleum products, aggregates, chemicals, automotive, and processed foods. Average RPU was off one percent.

North American revenues were $308.5 million, up 110.6 percent, while operating expenses gained only 75.4 percent, leveraging a nearly seven-fold operating income gain to $70.2 million. The operating ratio came in at a respectable 77.2, shedding 1551 basis points vs. a year ago. Back out the RA acquisition items and the NA operating income ratio is 77.4, up 40 basis points from last year's 77.0. So, doubling the size of the railroad and adding less than a point to the adjusted OR tells me savings have indeed been found (comp & benefits, e.g., came down 320 basis points to 31.1 percent of revenues).

The west end of the DM&E will operate as the Rapid City, Pierre & Eastern, running over some 660 route-miles, mainly in South Dakota, extending into Nebraska in the southwest, Wyoming in the northwest and Minnesota to the east. The road will interchange with BNSF at Crawford, Neb., Wolsey and Aberdeen in S.D. Interchange with CP is at Tracy, Minn., and with UP over rights to Mankato. Principal commodities are grain (corn, wheat, soy beans), bentonite (drilling mud) cement and construction materials. Year-one estimates are for 52,500 carloads and revenues of $65 million.

Because the $210 million transaction is an asset purchase, GWR will receive the stepped up tax basis of the assets which creates a large tax shield, or roughly $30 million of present value. The anticipated revenue and volume numbers are exclusive of any "shortline conversions," roughly 10 percent, that GWR generally sees in any acquisition as a result of increased local service and intense local marketing. GWR is assuming extant railcar leases that will roll off over the next three to five years, after which car costs will drop substantially.

Says Hellmann regarding the transaction,

> We like the stability of the Bentonite and cement business. We like the long-term fundamentals for South Dakota agricultural products. We like the pent-up demand from existing customers and we think the trajectory of the business is very positive. The significant investments that CP has made in the rail line over the past few years positions the infrastructure well for the long term.

Moreover, Hellmann said during the Q&A that the RCP is "sort of an island" because it's not physically contiguous to any other GWR properties. However, it folds nicely into the Mountain West Region - smallest of the lot - which has the scale to absorb a transaction of this size without any incremental overhead. In fact, said Hellman, in response to a later question, the NA railroads are still far enough down in volume that they can add carloads without adding train-starts. "And, no, we're never going to get down to a 65 OR because the traffic density on a short line is fundamentally different than a Class I."

On the call we learned the 2014 outlook is mixed. Chems, metals, ag products ought to perform "in the four percent-ish range." Petroleum products out of eastern Ohio could see a 30 percent upside, yet a waste customer in another part of Ohio went out of business cutting into that commodity outlook. Utility coal is looking up, thanks in part to the hard winter, as is nat gas drilling activity. How much of what moves when and where is largely a function of what the Class Is do and how utilities manage their stockpiles.

What I see in GWR is a focus more on incremental return on invested capital than what the operating ratio is at the moment. Says Hellmann, "I would do a deal tomorrow with an 80 operating ratio as long as it earned its cost of capital and was accretive to the cash flow and earnings of the company." Would that others took that approach.

The GWR January carload comps give us for the first time an eye on year-over-year results for the fully integrated RA and GWR properties. Total revenue units were 137,838, down four-tenths of a percent year-over year and up eight-tenths of a percent from December. Among the commodity groups that account for 80 percent of NA vols, utility coal increased six percent on greater steam coal demand; minerals & stone was also up six percent on rock salt and aggregates.

On the earnings call (above) CFO TJ Gallagher said not only did the severe winter weather cause problems in the northeast and north central regions, but it also impacted the deep south where engines lack block heaters so they had to keep the power idling, driving up fuel costs. Even in the north, engine heaters failed below 10 degrees Fahrenheit, adding to the higher than normal fuel burn. Later on the call CEO Jack Hellmann added that 2014 estimates have been changed to reflect these volume and cost hits. The good news is what didn't move in Jan or Feb may yet move in Mar.

A reader writes: "Re WIR Feb 7, I have to disagree with your statement at the top of page three that it will take new revenues to move the needle on the denominator of the operating ratio formula. It made me think of the government official who wanted to close the patent bureau because everything had been invented.

"History suggests that the biggest sustainable revenue/cost improvements were seldom made through rate increases or adding business. Rather, operating improvements on existing business fall quickly and more frequently to the bottom line. Sure, much of the low-hanging fruit has been picked, but I believe there is much more out there that can move the needle faster. Just look at central planning and what computer simulations have done, somewhat quietly, consistently, one chunk at a time.

"On the other hand, look at the results of the biggest chunk of new business to come along in years. The shale oil business is huge and came on rapidly, but has added only about two percent to revenues and moved the [volume] needle at most two percent. New business often requires significant resources and long term capital costs in cars, track, locomotives and crews in locations where you don't have them. Can you handle this business at a significantly better operating ratio? I'm not so sure the answer is always yes; but that doesn't mean you don't move forward."

To which I reply: Granted, the best prospect for new volumes is always the satisfied customer. And being nimble enough to attract whole new lines of business comes in a close second. Look at the KCS pipeline of new business, for example. None of this comes cheap, but it's still carload volume that increases revenue. Like Hellman says above, it's accretive cash flow that counts, and the top line remains the biggest driver of earrings.