THE RAILROAD WEEK IN REVIEW

May 16, 2014

"I prefer companies that can cash-flow themselves quickly so they do not rely on venture capital." — Alice Schroeder, author of Buffett Snowball *biography, at* www.reddit.com

That comment triggered my taking a closer look at cash positions of the Class I rails. My argument: cash flow after capex (no asset sales or other noise in that box) is the best indicator of what's available for share holders or retained earnings. Perpend:

Profitability Growth Pyramid							
YTD Ending	12/31/13						
Metric/Name	**KCS**	**CN**	**CP**	**CSX**	**NS**	**UP**	**BNSF**
FY Revs	$ 2,369	$ 10,575	$ 6,133	$ 10,026	$ 11,245	$ 21,963	$ 21,552
Ops cash flow	$ 798	$ 3,548	$ 1,950	$ 3,267	$ 3,078	$ 6,823	$ 6,205
net income	$ 351	$ 2,612	$ 875	$ 1,864	$ 1,910	$ 4,388	$ 4,271
OCF as % Net Income	227%	136%	223%	175%	161%	155%	145%
capex	$ 595	$ 1,973	$ 1,236	$ 2,313	$ 1,971	$ 3,496	$ 3,918
FCF before divs	$ 223	$ 1,619	$ 565	$ 1,104	$ 916	$ 1,777	$ 2,287
FCFBD s % Revs	9%	15%	9%	11%	8%	8%	11%
Source: Company financials							
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FCFBD is Free Cash Flow Before Dividends. CN returns the most; NS and UP the least. I think this is important in terms of debt service. The table below tells me KCS has eight times more net LTD than free cash flow, CN debt is only five times free cash flow, so it can be paid down faster with less damage to financial stability. And BNSF has a ready source of capital with the Capital Allocator in Chief, Warren Buffet, in the form of insurance float. In their case, net debt is less than half the free cash flow, meaning there's more than enough cash flow to cover the debt.

LTD vs.FCFBD	KCS	CN	CP	CSX	NS	UP	BNSF
LTD less cash	$1,856.9	$ 7,626	$ 4,400	$ 10,321	$ 7,905	$ 8,145	$ 940
FCFBD	$ 223	$ 1,619	$ 565	$ 1,104	$ 916	$ 1,777	$ 2,287
Multiple	8.3	4.7	7.8	9.3	8.6	4.6	0.4

To be sure, these numbers have little direct bearing on privately-held Class II and III railroads. However, the prudent operator who's out there chasing Other People's Money may want to make sure he has the cash flow to pay off the debt in a reasonable number of years.

Genesee & Wyoming North American revenue units for April increased 11 percent largely on coal, up 21 percent for midwest utility coal, and ag products, up a whopping 35 percent in the west, the midwest and Canada. Overhead carloads are also back, with a near doubling to 10,307 from 6,238 a year ago. Oddly, petroleum products (refinery products plus crude oil) dipped 13 percent. Among the commodity groups that represent 80 percent of all carloads, only lumber and STCC 28 chems were down, and by piddling amounts at that.

Year-to-date vols grew by nearly six percent and April was three percent ahead of March. As you know, I skip Australia because readership here is mainly concerned with North America and how their own railroads compare with GWR. For what it's worth, though, North America represents nearly 90 percent of everything that moves on a GWR property.

One finds ideas for comments on railroad shipping trends in the darnedest places. From Tuesdays's UBS "Morning Meeting" notes comes a positive note on the Sherwin-Williams paint company. What's that got to do with railroads, you ask?

The argument is that Sherwin-Williams (SHW) has 80 percent of sales through its own stores, "Primarily for professionally-applied paint." (I'll second that: the SHW store down the street is much more populated by contractors than my neighbors.) Says UBS,

> U.S. pro-applied paint is different than rest of the paint market. Pro-applied paint has much higher price points; average selling prices have never declined; and is sold in a a relatively distinct channel because 90 percent of pro painters buy via specialty paint stores. Moreover, pro-paint is higher performance, sold with with higher service, and goes to the new-build and non-residential markets.

UBS concludes that demand is still about 20 percent below the trend line and last cycle's new build is now entering initial repaint demand, along with maintenance demand deferred during the recession. And before you buy paint you gotta have something to put it on: lumber, panel board and sheet rock, all of which come to market by the (center-beam) carload. Let me suggest you do your own channel check: go hang out at your local SHW outlet, observe the customer flow, and do a little eavesdropping.

In a related note, the *McClellan Market Report*, a daily technical analysis letter, tells us that commercial lumber futures traders have further trimmed the shrinkage of their once-big long positions, something they started in Feb. Says *McClellan*, the Commitment of Traders (COT) Report "has a pretty good track record of acting as a leading indicator for the SP500" and the net-long decline has reversed itself the last five weeks. Citing the link between the lumber COT and the S&P 500, the note concludes the forward trend for share prices ought to be up, and that bodes well for lumber loads on the railroads. And new lumber needs new paint, ergo the importance of the SHW note.

Watco's Stillwater Central Railroad (SLWC) submitted the winning bid ($75 million) to buy the so-called Sooner Sub from the state of Oklahoma.The 98-mile line runs between Del City and Sapulpa. SLWC is already resident on the line, which has been called the heart of SLWC's rail network. Customer support was significant, say published reports.

The sale carries with it the commitment to get the track up to FRA Class 3, good for 40 mph, which SLWC estimates will cost more than two million dollars. Watco has already put $16 million into the Sooner Sub and says it expects to spend some $2-3 million per year on capex and program maintenance over the next ten years on the Sooner Sub. The total forward spend will be around $25 million.

With the purchase of the Sooner Sub, the SLWC will consolidate its 275-mile Oklahoma network that currently runs from Duke through Lawton, Oklahoma City and Stroud, ending just outside of Tulsa in Sapulpa. Trackage rights through Tulsa allows the SLWC to interchange traffic with its sister railroad, the South Kansas and Oklahoma Railroad, which serves customers in Oklahoma and southeast Kansas. The SLWC also has a separate line running from Stillwater to Pawnee.

In an interesting turn, Watco has teamed up with Ed Ellis and his Iowa Pacific Holdings to explore providing daily passenger service between Del City and Sapulpa, eventually working to gain access to Tulsa and downtown Oklahoma City. It's of a piece with what Ed has done in upstate New York on the Saratoga & North Creek to bring scheduled passenger service to the ex-D&H route, connecting with Amtrak trains at Saratoga. Love it.

Providence & Worcester first quarter 2014 freight revenues declined 11 percent to $5.9 million vs. a year ago. Ethanol and plastics vols took weather-related hits and coal vols continue to suffer due to the EPA and cheap nat gas. Carload ARC is up two points to $981 - kudos to Frank Rogers and team. Net ops expense actually came down eight percent with reductions in comp & benefits, fuel and car hire. The operating loss was cut by eight percent to $1.5 million; the ops ratio on ops expense after capitalized items was 123.4.

Sadly, P&W continues to burn cash. Retained Earnings at the end of 2013 were $36.7 million, down from $37.6 million six years ago. At the end of March RE was down another two points to $35.8 million. But P&W held the line on capex in the quarter (four percent of revs vs 12 percent in all of 2013) coming out with $203,000 in free cash flow after dividends.