THE RAILROAD WEEK IN REVIEW

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“The cost of installing ECP on a single car will be $4,000 to $6,000, depending on the technology.” — Ray Betler, CEO, Wabtec

Wabtec clearly belongs in the woulda, shoulda, coulda category. When I first started tracking WAB a few years ago, shares were in the low $40s. After last week’s earnings announcement, shares closed at $90.67, up 2.3 percent on the day. For good reason, too. Full-year sales were up 15 percent to $3 billion, operating income was up 21 percent to $527 million, and the net grew to $352 million, also up 21 percent. The company earned $3.63 per diluted share, up 20 percent on no change in share count.

The two principal business sectors are freight rail (mainly in North America) and rail transit (mainly not in the US). In freight rail, it’s in brake systems and parts (including ECP), new switchers and heavy-haul loco upgrades, and in taking the lead in PTC product development. In transit, it’s everything you hang on and under the car body to make it go, stop and operate the doors. Total sales split roughly 60-40 between freight rail and transit.

Freight leads transit in sales growth, up 24 percent to 12 percent year-over-year in 2014. The growth last year was a function of higher demand for original equipment freight rail products, PTC electronics, and aftermarket rail products. The earnings call had some discussion about ECP on crude-oil trains, but the consensus is that’s not likely: too much non-ECP equipment around and tank cars need to be available for general service. ECP makes sense in coal service where there are unit trains of equipment that’s not good for anything but coal.

WAB’s strength in the NA freight sector is highly valuable. First of all, it’s mainly private money, not dependent on the kindness of governments. Second, AAR freight volume trends are up and all cars need what WAB sells, regardless of service. Over the past ten years, annual sales have tripled, from $1 billion to $3 billion — a 12 percent CAGR — and the discounted free cash flow fair value is $102, a 5 percent upside. The *Recognia* technical tea leaves chart gives WAB a score of 11 bulls to 2 bears overall. Woulda, shoulda, coulda becomes gotta?

The rate of railroad revenue-unit growth has slowed since Jan 1. Morgan Stanley rail analyst Bill Greene blames West Coast port congestion, now ostensibly solved with Friday’s agreement. Elsewhere, writes Greene,

> Most commodity segments continue to show reasonably healthy growth, with economically sensitive traffic ex. intermodal growing mid-single digits QTD, though admittedly some of this strength is attributable to easy YoY comparisons given the impact severe weather had on 1Q14 volumes. [*The AAR through Jan 31 says all-in vols up 5.0 percent. - rhb*]

Year-to-date shortline traffic through Jan 31 is up 3.7 percent all-in. Chems including ferts (but ex-crude oil and STCC 29 petrol prods) is the largest commodity group at 19 percent and it's up 7 percent. Intermodal is the next largest at 13 percent, down 8 percent, though I tend to disregard it because so few short lines carry any at all. (I suspect it's the likes of IAIS and FEC driving up the intermodal segment and have asked RailConnect for clarification.)

Backing out intermodal, coal and auto to get the pure merch business, the Class II and III roads reported that the merch sector is 75% of their business and car-counts increased 6.3 percent with particular strength in aggregates (includes frac sand; 12 percent of vols) and chems as above. Petroleum products including crude oil plus Waste & Scrap together account for 8 percent of the total and were up 11 and 9 percent respectively.

The AAR Class I car count, excluding intermodal, auto, and coal, is only 32 percent of total vols and increased 7.1 percent Not surprisingly, non-metallic minerals (frac sand and salt) increased 15.0 percent and petroleum products increased 8.4 percent, whereas straight STCC 28 chems including ferts increased 4.6 percent. The only big laggard was the Other category, down 8.2 percent and comprised chiefly of overhead and haulage moves.

Genesee & Wyoming is acquiring 95 percent ownership of Britain's Freightliner Group Ltd for $755 million in cash and assuming some $18 million in net debt and lease obligations in the process. GWR thus broadens its global foot print, builds on the Australian intermodal and open-access skill sets, and becomes the second-largest freight rail operator in the UK. (The Freightrail Ltd subsidiary is Britain's number one rail maritime intermodal operation.) The Heavy Haul subsidiary serves the UK's aggregates, coal, cement, and waste industries.

Moreover, Freightliner Poland serves aggregates and coal customers Europe's second-largest rail market, extending into eastern and northern Germany. Freightliner's ERS sub, connecting the ports of Bremerhaven, Hamburg and Rotterdam, is a natural fit the GWR's existing Rotterdam service base. And in Australia, Freightliner is a coal and ag products carrier based in Sydney and giving GWR access to a previously untapped corner of the country.

On Wednesday's conference call CEO Jack Hellman described the purchase as unlocking opportunities world-wide, meaning GWR can pick up a Freightliner load in the UK and ship it to the GWR port railroad in Savannah or the Freightliner operation in Sydney. My own take is this is another example of the way GWR folds in new properties to contiguous rails or bolts them on to near-by GWR properties. Jack also said on the call they're creating a North American national accounts list whereby the RA acquisition lets GWR pick up a car from Customer A in Ohio and send it to Customer B in Oregon.

In its press release, GWR says that with the Freightliner acquisition we need to look at the company as three distinct parts. First is the traditional North American short line network, expected to bring in 77 percent of annual pro forma income. Second is Australia, where the

Freightliner franchise will combine with the extant South Australia and Northern Territory lines, generating about 12 percent of annual pro forma income. The third piece is the European Region for 11 percent of annual pro forma income and incorporating the Rotterdam service. As a result, North American car-counts, which had incorporated a small number of Netherlands cars, will now be pure North America, simplifying the monthly comps with the NA shortline community. I congratulate GWR for its prescience in taking this strategically important step.

Pat Ottensmeyer becomes President of Kansas City Southern effective March 1. Pat has more than 15 years of railroad industry experience, holding various positions within KCS and previously with BNSF Railway, and will continue to report to CEO Dave Starling. In his new role, Pat will retain his direct responsibility for sales and marketing, and become officer-in-charge of operations, which includes transportation, engineering, mechanical, network operations, operations support, and information technology.

Personally, I'm delighted. Pat is always very candid in telling the KCS story and selling its strengths, particularly the growing KCS pipeline of new business. This is a level of detail we see with no other carrier, and a prime example of the transparency KCS brings to its financial reporting. Congratulations, Pat. I'm looking forward to continuing the conversation.

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