THE RAILROAD WEEK IN REVIEW
May 29, 2015

"The average railway company in Q1 significantly outperformed the S&P and the broader economy in both earnings growth and margin." — Tony Hatch

Providence & Worcester first quarter revenue increased 15 percent to $6.8 million on a seven percent gain in revenue units. The carload side of the house saw vols jump 24 percent to 7,036 loads and the intermodal side saw just 4,311 boxes, down 13 percent year-over year. Carload RPU slipped six percent to $922 per car; intermodal boxes brought only $70 each, down a buck.

Personally, I don't understand why they even bother with intermodal. For all of 2014, PWRR handled 21,000 boxes at $71 each, contributing nine percent of total revenue. According to the Company Profile at www.pwrr.com, the intermodal service is for "an approved customs-bonded intermodal yard in Worcester, primarily for the movement of container traffic from the Far East destined for points in New England."

Which suggests to me this is a short-haul, labor-intensive operation, involving a lift and a local move each way. Perhaps this is one reason PWRR comp costs seem stuck at 50 percent of revenue while the shortline benchmark is more like 30 percent. However, in his 2015 President's Letter, Scott Conti cites "a modest increase in container traffic," which it certainly is — from 11,000 boxes in 2011 to 21,000 last year for a three-year CAGR of 24 percent. RPU, however, hasn't budged. It's still $70 a box. I'd love to see a P&L on this, but so far the 10-Q is mum.

Over on the carload side, the latest 10-Q tells us only that most commodity vols increased year-over-year with strength in ethanol, plastics and automotive. Changes in mix, origins and fuel surcharge fees caused the RPU slippage. However, if we go back to the President's Letter presented at the recent Annual Meeting, Scott reminds us that metal products, aggregates, propane, and Davisville outbound auto imports are strong. In fact, aggregates carloads from Connecticut to Long Island over Amtrak and Metro North are now 20 percent more than they were just five years ago.

Here again, one has to wonder how profitable this business can be. It's essentially crushed stone, one of the lowest-rated commodities out there. Except for the origin and destination switches, the run is entirely on rights, for which PWRR pays $1.2 million a year. Total 2014 aggregates revenue was $6.2 billion. PWRR doesn't provide carloads by commodity, but the aggregates business is 20 percent of total revenue. For argument's sake, say it's also 20 percent of the carload volume, which implies 7,000 cars a year or less than $100 a car.

The railroad last year sold five four-axle GE slug units and leased five six-axle units partly for the NY aggregates franchise. Conti says in his Letter these trains can run to 100 cars each and take four six-axle units to make the run, whereas the same run needed eight four-axle units. GATX is handling the lease of these radial truck, six-axle SD60 locomotives.

Operating expenses increased nine percent against the 12 percent total revenue increase, producing an operating loss of $1.5 million, down one percent. As usual, comp & benefits ate up more than 50 percent of sales, and diesel fuel, oddly enough, given the 40 percent price drop that CSX and NS posted, rose 24 percent over last year's first quarter. No explanation in the 10-Q.

Net loss for the quarter was $846,000, so 24 percent worse than last year. The operating ratio after capitalized expenses came in at 120.7, a 270 basis-point improvement. The company continues to burn cash, as shown by the three percent drop in retained earnings. But the company *still* demands a significant market cap/ebitda premium, some 15x at today's $18 per-share close.

Norfolk Southern shares are truly in the doldrums, but the S&P sees hope. Their May 23 note:

> Following a 3.4% increase in 2014, NSC is likely to see a 4% drop in revenues in 2015 before growing 6% in 2016. Our 2015 view incorporates a 5% drop in coal volumes with a similar decline in coal pricing, offset by improvement in volumes in other commodity groups. Fuel surcharge revenue will likely be down on sharply lower fuel prices. NSC will take additional freight away from trucking companies along the Heartland and Crescent corridors, in our opinion, as new terminals are opened. NSC will achieve gains in oil shipments headed for refineries in the East.

The coal drop needs no further comment, though the key take-away is the S&P recognition that other commodities are filling the gap, even as Wick promised at the 2013 short line meeting and again last year. Through Week 20 (May 23) NSC total vols were up three-tenths of one percent (CSX was off a like amount) with coal 14.3 percent of units vs. 15.4 percent Mar 31. Intermodal is once again 51.5 percent of all units, tied with BNSF.

Year-to-date chemicals are up 1.6 percent; the metals and construction group is off 9.1 percent (I suspect pipe and frac sand); petroleum products (NGLS plus crude) are up 27.9 percent — although, at just three percent of total vols, this is barely a drop in the bucket. But, with shares in the $92 range, the dividend is now 2.5 percent, and that ought to be worth some extra consideration.

The Delaware-Lackawanna Railroad (DLRR), part of the GVT Rail System, has won a five-year extension of its operating agreement with the Pennsylvania Northeast Regional Railroad Authority (PNRRA). The Authority owns 90 miles of the former Lackawanna and D&H Railroads extending from Scranton east to the Delaware River, north to Carbondale and south to Taylor Yard via rights over the former D&H (recently CP, now NS) to Taylor Yard.

PNRRA traces its roots back to the Monroe County Rail Authority (1980) and the Lackawanna County Rail Authority (1984), both formed to preserve freight service on Conrail lines up for abandonment as redundant. These agencies combined in 2006 to form the present PNRRA. GVT, a privately-held regional railroad operator out of Batavia, NY, was awarded the operating contract in 1993 and has been largely responsible for the 15 percent revenue-carload gain 2007-2014, a growth rate roughly triple the national average.

NS is the principal interchange partner, with connections at Scranton and Slateford (CP access continues via a haulage agreement with NS to CP at Saratoga). DLRR serves some 20 rail-dependent industries with more than 2,000 employees among them.

The road to this point has not been without its bumps. In December, 2013, the nearby Reading & Northern, which also gains access to Taylor Yard (but over former DLW track which it now owns), sued the PNRRA seeking to stop what R&N is calling a "no-bid" contract for rail service. According to a *Railway Age* item published at the time, R&N said PNRRA last sought bids for operating the line in 1993 and since then has "continually renewed the contract with the current operator without notice and without consideration of whether other operators could increase the value for taxpayers." Moreover, said R&N,

> We connect with the Authority's property and have extensive operations in the area today. We realize that given an open process with fair bidding that there may be others who [may be able to] win the right to operate. However, we know taxpayers and shippers will be better off as a result of this process and we will have had a fair opportunity to participate.

The present announcement of awarding the contract to DLRR is the result of PNRRA's deliberations, though R&N sources tell me that, as Yogi Berra was wont to say, "It ain't over till it's over."

Union Pacific President President Lance Fritz appeared on Jim Cramer's *Mad Money* Wednesday. He acknowledges that 2015 has not been off to good start, falling short of 2014's seven percent revenue-unit growth rate Jan-May. The railroad was down two percent in Q1 and thus far in Q2 is off four percent vs last year. The West Coast port strike took its toll, but the backlog is now cleared and the railroad is running better.

UP's AAR performance metrics for Q2 to date have all improved over the same period a year ago, though commodity carloads are still down ten percent with coal and grain down more than 20 percent each and aggregates slipping 13 percent. As of Thursday noon, UNP shares were $101, some 13 percent below the SMA-20, and Deutsche Bank had cut its target price to $123 from $126. I peg support around $102 and resistance in the neighborhood of $104.