RAILROAD WEEK IN REVIEW

November 18, 2016

"U.S. grain supplies are at their highest levels in almost 30 years after three consecutive large crops, incentivizing farmers to store grain until commodity prices increase." — BNSF 2016 Fixed Income Investor Call, November 9

Genesee & Wyoming North American carloads for October came down a mere 2%, but were down 6.5% YTD. A reversal in coal's fortunes helped pull Oct carloads 2% ahead of Sep. If you sort carloads by percent of NA total units, you'll see the top 80% comes from the "heat and eat" categories with a solid materials (forest products, chems, metals) component. Given the initial reaction to the Trump election by both pundits and market performance, this is a very good mix to have.

The accompanying GWR press release notes, "Minerals & Stone traffic decreased 11.6% on decreased shipments of rock salt and frac sand in G&W's Northeast Region; Pulp & Paper traffic decreased 10.5%, primarily due to decreased shipments in the southeast, northeast and Canada; Coal & Coke traffic was up 7.3%, primarily due to increased shipments in G&W's Midwest Region" — if I'm not mistaken, that's PRB coal to an Illinois utility. The Other commodity line pulled back on overhead empties in the Central, Northeast and Canada regions.

Meanwhile, GWR has officially closed its purchase of the P&W for $25 a share or about $126 million. That's more than 20X the 2015 ebitda, but by paring back P&Ws labor expense to a more reasonable shortline 30% of revs from P&W's 50%, and bringing other items into line with shortline norms, one can come up with a very reasonable multiple. Perpend:

If you apply the percentage of revenue G&W puts against each of its own expense line items to the P&W 2015 Income statement, you get total ops expense of $26.3 million for a 75 OR on $35 million in revenue. Ops income is $8.8 million; add back $4.2 mm depreciation and the new ebitda is $13.0 million. From the $126 million purchase price deduct the $12 mm "property for investment" on the balance sheet. Also take the $6.9 mm reduction in ops expense for a net new purchase price of $107.9 mm. That's 8.3x the new $13.0 million ebitda. Reasonable, in-line.

G&W has transferred the stock of P&W to a voting trust with Larry McCaffrey appointed as trustee. That trust will remain in effect until the STB formally approves the transaction, expected this month or next. Once the STB gives the green light, GWR will fold the P&W into its Northeast Region, led by Dave Ebbrecht, formerly KCS Chief Operating Officer.

New England has seen many changes in its railroad landscape over the last 20+ years, from the NH being rolled reluctantly into Penn Central, to the CV acquisition by RailTex, Emons acquiring CN's Grand Trunk to Portland, GWR acquiring Emons, RailAmerica acquiring

RailTex, and GWR acquiring RailAmerica — and now P&W. And let's not forget successive owners of the former CP main across the top of Maine. But the one constant over time is the Boston & Maine/Maine Central combo under the Pan Am Railway umbrella, literally anchoring everything else.

Time to get out the cocktail napkins and start drawing lines between Pan Am Rail and GWR, extending them via overhead or connections with CP, CN, CSX and NS. Include shortline destinations on the other end and possibilities boggle the mind. It's all good.

The RailTrends 2016 outing in NYC was a great success. Independent financial analyst Tony Hatch assembled his usual star-studded lineup of presenters — railroad managers, suppliers, regulators, analysts, and pundits — while *Progressive Railroading* magazine sponsored and organized. And while the agenda tells you what's happening, it doesn't tell you why. For that, I had a chat with Tony.

Says he, "RailTrends presents the links between the players you don't see when you spend time with CFOs or COOs alone. As RT has grown and matured over the years, perhaps RT2016 exemplifies our founding spirit of eclecticism, and cross-discipline thematic discovery as well as any in our history." Tony's point is well-taken.

My takeaway from the conference is the rail industry is faced with declining volumes and slowing rates of new-car construction. Better isn't necessarily faster, and automation is increasing for everything from tracking locomotive performance to inspecting whole trains. We need to do better at monitoring the cost of failure (a locomotive road failure, re-crewing a train) and providing a more nimble transportation product. For example, I learned that a one mph increase in system train speed for manifest trains means 50,000 fewer individual cars for the same RTMs. The reverse holds, too.)

One railroad manager told me he's determined his property has 10,000 too many cars in manifest service, but with better turn-times, fewer over-the-road delays and true market-based pricing he can fit the fleet to customer volumes and charge true market-based rates while doing so. I see where he's coming from. The supply chain trend is toward more frequent deliveries of smaller lots over shorter distances, and once-a day100-car trains don't cut it. Yet the autonomous vehicle approach to truckload operations can put 40,000 boxes a day in a dedicated lane. That's 100 double-stacked trains, if you're keeping score.

For me, the Class I conversations are especially key. They tell us what's working, what needs to be fixed, and what's possible. KCS President Pat Ottensmeyer says they're "optimistic" about the presidential results, particularly with respect to new doors opening in Mexico, popular press comments to the contrary. Dean Piacente, CSX VP for intermodal, said they will open the first double-stack cleared Virginia Avenue tunnel in DC late next month, further supporting the hub-and-spoke approach to intermodal, where 10-year vols increased at a 7% CAGR.

UP's Jon Panzer, VP of Financial & Capital Analysis, stepped in for Beth Whited, VP Chems (tapped that very day EVP and Chief Marketing Officer). He explained how and why UP's core plastics business is booming along the Gulf Coast. Of particular interest to farm-belt short lines, cheap nat gas feedstocks are making domestic nitrogen fertilizer more competitive, displacing the imported product. Conrail's Ron Batory wrapped, discussing "surviving and thriving" as an open-access carrier for nearly 20 years following the NS/CSX split of the original Conrail.

Friday's half-day session (which I had to miss) featured Mike McClellan, VP merch traffic at NS, and WATCO President Rick Webb. Saving the best for last, CN's CEO-Emeritus Claude Mongeau was named the Railroad Innovator of the Year. Tony tells me Claude was selected "as the architect of CN's industry leadership not only in continued cost control but in moving to, as Claude likes to say, the next level."

A friend laments the way the Class Is seem to present the 30,000-foot view and hold back on strategic and tactical information at shortline meetings. I think Regulation FD is the culprit. Formally known as Regulation Fair Disclosure, the SEC in 2000 mandated that all publicly-traded companies must disclose substantive information to all investors at the same time.

As such, Reg FD is meant to eliminate selective disclosure, bringing more transparency to financial results reporting. And in 2013, the SEC decreed that press releases, social media, and web sites meet the mandate. Though shortline attendees are not officially billed as investors, they certainly could be shareholders and their very roles as connecting rails make them investors of another sort. Thus the caution.

The downside comes when you buttonhole a railroad exec at a shortline meeting. Since Reg FD says issuers must disclose material information to all investors at the same time, that exec can only give you the current party line until it officially changes. Writing in *Barron's* this week, Leslie Norton quotes Howard Penney, a managing director at Stamford, Conn.–based Hedgeye Risk Management, an independent research firm.

"I feel that, since Reg FD came about, talking to management teams does you a disservice. If you come up with a differentiated view and want to put that forth to the CEO or the CFO or somebody like that, they give you boilerplate answers and try to talk you out of the work you've done, saying you are wrong. Talking to management can do you more harm than good." And that's why the variety of RailTrends conversations can do a lot of good.

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