RAILROAD WEEK IN REVIEW
February 10, 2017

“The US consumer is NOT in fact ‘strong,’ but quite to the contrary. Discretionary spending growth continues to disappoint even as credit card borrowing ramps higher.” — Stephanie Pomboy, Macro Mavens, January, 2017

Digital disruption in the freight transportation and logistics industry is here, and service providers ignore the implications at their peril. Stifel, Nicolaus recently hosted a conference call with Steve Sashihara of Princeton Consultants, who’ve made a name for themselves in their perspective, as Stifel puts it, “regarding the impact of potentially very disruptive technologies.” Sashihara names five that run in the opposite direction from current railroad thinking.

— Disruptive Technology #1: Drones. Drones are evolving rapidly. They are lower weight, more powerful, and more reliable than ever. The payload to tare weight ratio needs to increase, and energy consumption rates need to be improved.

— Disruptive Technology #2: Self-Driving/Autonomous Trucks: This topic has recently become one of the most talked about issues on Wall Street with respect to the broader freight transportation space. With drivers composing roughly 1/3 of truck operating costs, the economics of fully autonomous trucks are compelling, especially when one considers that the autonomous vehicles are not subject to the hours of service rules.

— Disruptive Technology #3: “Uber” for Freight. We concluded that the large 3PL’s and brokers should have a leg up on the start-ups and smaller tech savvy brokers, but they will need to incrementally Uberize at a steady pace over the coming 5-10 years in order to avoid being leapfrogged by either a venture capital backed tech savvy, app developing logistics company or more likely, Amazon, which can buy or invent the technology, hire the relevant talent, and use its own base load volume to prime the pump on its own Uberized 3PL.

— Disruptive Technology #4 and #5: The Internet of Things and Big Data Analytics. With every component, sub-assembly, finished product, package, warehouse shelf, forklift robot, tractor, trailer, facility, ship, rail car, locomotive, airfreight igloo, etc. – eventually tagged with an electronic transmitter/receiver, data will be continuously generated/available for every link in every supply chain.

Think of how destructive all five take-always are to freight transportation by rail. Intermodal is four steps at least: a truck driver at each end plus a train in the middle plus dwell time at each end. Carload doesn't stand a chance with five train starts on average between pull and place. That is, unless the product in transport has a low-enough time value to support long supply chains. Then there’s the equipment cost: see mention of locos and cars in Takeaways 4 and 5.

Meanwhile, we see Class Is shrinking train starts to lower ORs, even as they continue to run miles of low-density branch lines. Short lines prove repeatedly that being Close to the Customer generates more carloads where supply chains permit. Conrail Shared Assets gathers carloads from all over the Philly ADI and gives them to NS and CSX in one place. Yet we don't see the model replicated. Pity, because shorter supply chains and nimble shipping are here.

The continuing oil boom in the Permian Basin is featured in a Feb 6 note from Wunderlich Securities:

> With oil prices rebounding, E&Ps went on a shopping spree, especially in the Permian Basin of West Texas and New Mexico. We are impressed by the steep rig count increases signaled by a number of producers, especially in the Permian. We continue to look for more color on the pace of acceleration in drilling activities, and how companies can mitigate oil service cost pressure and offset the efficiency losses as the basins get more crowded. But it is clear the industry is getting past the troubles of the downturn and will have the growing pains of the upturn to deal with going forward.

The note says the boom continues to be "mind-bending," and that can only be good for the railroads serving the area — the UP is principal player among Class Is, with Watco and OmniTRAX operating a number of shortlines. The latter is unique in that it originates "Brady Brown" sand on its Central Texas & Colorado for customers not needing the white sand (which OmniTRAX also supplies off its Illinois Railroad).

My point is, "acceleration in drilling activities" pressures oil service companies exploration costs, so anything a supplier can do to keep supply chain costs in check will help. Frac sand, pipe, cement, chems all necessary ingredients ideally suited to railroads that can deliver predictable transit times at a reasonable price. Staying close to the customer counts.

Elsewhere, Denis Gartman is cited in Art Cashin's Feb 8 note:

> We are still reeling from the size of the API report yesterday as crude inventories rose a stunning… a truly stunning!... 14.2 million barrels. Product inventories were up 4.3 million barrels and so the aggregated inventory rose 18.5 million barrels. As noted below, the 5 year average for this week of the year was an increase of 1.9 million barrels, so this is beyond surprising; this is stunning.
>
> Imports into the US were up hugely as refiners have apparently chosen to get ahead of any potential border tax increase and have decided to bring in as much crude from abroad as they can and store it, either hedged with crude futures and/or hedged with product futures. This may not be the largest single weekly increase in the aggregated inventory of crude ever, but certainly it is amongst the very "Top 10!"

Genesee & Wyoming reported Q4 and fiscal 2016 earnings Wednesday. Consolidated revenues for North America, Europe and Australia were $516.5 million, up three-tenths of a point over last year. Operating expense rose 10.2% however, cutting ops income nearly in half to $53.6 million, with an 89.6 OR. That said, GWR reports non-GAAP numbers to adjust for non-recurring items, yielding $104.5 million of operating income with a 79.8 ratio. As for me, I tend to ignore non-GAAP numbers, figuring every GAAP line is part of running a railroad and sticking to the GAAP numbers for comps.

GAAP net income for the Q was $8.9 million, ten percent of what it was a year ago, though non-GAAP adjustments take it back to 58.3 million. Similarly, straight GAAP EPS is reported as 15 cents vs. $1.47 a year ago; taking "adjustments" brings EPS to 99 cents. The $29 million 45G tax credit was a big help.

Turning to results for North America and comps with the rest of the short line world, freight revenues increased 2.7% to $232.5 million on 402.9 million revenue units, up 3.8%; RPU lost a point to $577 as shifts in mix among commodity lines (less high rated automotive; more low-rated overhead) degraded the averages. Total revenue increased 7.9% to $322.2 million, thanks largely to the 31.1% gain for the "freight related" line.

Operating expense decreased 1.0% including a gain on asset sales and a restructuring cost; ops income was $238.8 million, up 12.4%, and the OR 74.1, down 103 basis points. Absent these items, operating income increased 13.8%, and the OR is a respectable 73.9. I'm particularly pleased to see how GWR/NA nibbles away at labor cost, now 32.0% of revenue, and has cut fuel burn to 4.8% of revenues from 6.1%.

Total revenue includes a $10 million benefit from a multi-year take-or-pay volume shortfall under a crude-by-rail contract, showing once again the wisdom in making customers commit to volumes before you bring on a new service. [*And, given the number of barely serviceable cars out there, especially in MSW service, I'd make supplying FRA-serviceable equipment part of the contract — rhb*] As on the Class Is, grain was the merch strong suit, abetted (unlike the Class Is) by a surprising 19% jump in PRB coal to a midwestern utility. Paper took the forest products group down and overhead dropped 17.2%.

Separately, GWR has agreed to acquire the shares of Atlantic Western Transportation, Inc., parent company of Heart of Georgia Railroad, Inc. (HOG). Terms of the acquisition were not disclosed. The acquisition is subject to customary closing conditions, including the receipt of U.S. Surface Transportation Board approval, and is expected to be completed in the second quarter of 2017.

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