THE RAILROAD WEEK IN REVIEW
May 1, 2015

"The high levels of debt are the reason for slowed growth in the developed world." — John Mauldin, 'Living in a Free-Lunch World,' March 28

Railroad revenue-unit counts for the first quarter are truly anemic. This chart, courtesy of Bill Greene, Morgan Stanley railroad analyst, tells all. Commodities are percent of book, first quarter is percent change of total book vs last year.

	Merch	Coal	IM	1Q percent Chg All
BNSF	30.4	23.7	45.9	0.8
UP	41.5	16.4	42.1	-2.3
CSX	32.6	15.9	40.6	0.1
NSC	34.0	14.5	51.5	1.1
CN	53.2	7.6	39.2	8.2
CP	50.7	12.5	36.8	3.6
KCS	47.5	6.9	45.6	-0.3
All Class Is	32.7	19.7	46.6	1.6
Source: Morgan Stanley				

I think there's a reason for all this, well-summarized by our friends over at Schwab. Brad Sorensen, Managing Director of Market & Sector Analysis, wrote on April 23:

> Americans were predicted to spend the energy saving windfall they received from the sharp drop in oil prices, but instead recent retail sales readings have been weak. After three months of declines, retail sales finally rose in March, posting a gain of just 0.5 percent excluding autos and gas. While we could see more gains as the weather warms, don't count on a big surge, as consumers seem more intent on saving and paying down debt than in the past. The savings rate of Americans in February was 5.8 percent, the highest level since 2012.
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> Although the consumer discretionary sector has done quite well in the recent past, we think now's the time for caution. The retailing industry's forward price/earnings ratio is 50 percent higher than the broad market and close to an all-time high, according to BCA Research. Additionally, growth in retail sales at stores selling discretionary items is declining, while

> those selling non-discretionary type goods are seeing rising growth. The run in discretionary shares may not be over, but we believe it's a bit late to be jumping on the train.

This is an appropriate analogy since the consumer discretionary sector accounts for much of intermodal (furniture, TVs, appliances) and automotive revenue units. And carrying the theme further, Liz Ann Sonders, Schwab Chief Investment Strategist writes on April 24,

> A continued caution seems to be permeating the United States, as consumers aren't returning to their free-spending ways following the financial crisis as quickly as some had hoped. The expected rise in retail spending from lower oil has yet to come to fruition, with consumers choosing to save or pay down debt rather than spend, as had been typical.
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> The March retail sales number showed a 0.5 percent increase ex-food and energy — positive, but not the jump expected by economists… The number of Americans without a credit card has risen to 29 percent in 2014 from 22 percent in 2008, according to a Gallup survey. And debt deleveraging continues, at least at the consumer level.

In other words, cutting personal debt means less buying, and less buying requires less capex, fewer personnel, and smaller inventories for producers. As a result there's less stuff to move from here to there. And that's why I think the railroads are living in a two-percent world, where GDP growth is about it.

Norfolk Southern's first quarter results disappointed. It was an hour and a half call and pricing was mentioned constantly. The mantra is getting costs down while sustaining the ability to price above "railway inflation," i.e., where prices can increase as better service warrants better pricing. I should hope so.

Total revenue decreased five percent to $2.6 billion from $2.7 billion year-over-year on revenue-units up two percent; revenue per unit sank seven percent (two percent ex-fuel surcharges). Operating expense dipped three percent on a 39 percent decrease in fuel expense; operating income came down nine percent to $606 million and the operating ratio was 76.4, up 1.2 points. Below the line, net income was $301 million, down 16 percent, an even dollar a share, down 14 percent after a one percent decrease in diluted share count.

Merchandise carloads including auto and crude oil increased four percent, though crude had to be the big driver. Agricultural products gained on corn to the poultry feeders, less the effect of fewer export beans. In forest products, housing starts are pushing lumber up nicely and paper keeps going down. The metals & construction group, where frac sand and pipe live, was up in the former and down in the latter.

NS reports what the AAR lumps together as "petroleum products" — crude oil plus STCC 29 nat gas liquids, asphalt, etc., and STCC 131 crude oil — under chemicals, distorting the picture a bit.

The chemicals group, as reported on the call, is up ten percent, though the straight chemicals category reported in the AAR weekly report is up one percent. NS President Jim Squires says they did 29,000 cars of crude oil in Q1, up 34 percent from the 22,000 loads a year ago, and, even with the lower crude-oil price, NS expects a 29-30,000 unit quarterly run rate.

Coal vols dropped another seven percent due to declines in utility coal burn and export coal, six and 20 percent, respectively. In fact, since the 2013 first quarter, total coal tonnage is off 25 percent. Utility coal, 70 percent of the NS coal franchise, is off 16 percent, while export coal, 18 percent of total, is down 40 percent. US met coal, 11 percent of volume, is off 22 percent.

The merch carload outlook calls for more NGLs and crude; double-digit growth in housing starts should generate more lumber, while plastics, soda ash, and aggregates all share positive prospects. In ag, ethanol moves are expected to rise due to more gasoline consumption; a stronger bean crop should help exports. However, lower oil prices may cut drilling activity and thus NS vols of of pipe, frac sand, etc. The outlook for steel is muted.

On the call Morgan's Bill Greene asked about how and where NS wanted to grow carload volumes. CEO Wick Moorman's response is classic:

> We don't go out and try to grow volume at rates and margins that don't make sense. We're certainly not in the mode of let's just grow volume for volume sake… We see volume growth at good rates as a strength for us… The volume growth we're having right now we see as desirable and continuing to be a good thing for us… We saw some mix effects that didn't help our overall RPU, but even within that, the somewhat lower-rated traffic that was growing is still good-margin business and business that we want to continue to handle.

One final observation. The per-gallon cost of fuel is something NS can't control, yet it affects both fuel surcharge revenue and operating expense. NS was quite candid on the call, showing exactly where and by how much the sudden drop in crude oil price has affected both line items. The way I see it, only by stripping out these swings can one get a true feel for how the railroad is operating.

If you deduct first quarter fuel surcharge revenue from this year and last, and if you hold this year's fuel expense equal to last year, you get an indication of how the railroad is running *without* the effects of fuel. That's where my disappointment lies: adjusted revenues flat, operating expense up five percent, operating income down 26 percent. And in the two-percent economy I described at the opening, the odds for a speedy recovery are slim.

Genesee & Wyoming first quarter consolidated revenues increased six percent to $397 million and operating expense increased eight percent, pulling down operating income by three percent to $73 million and the pushing the operating ratio up to 82.4, a 94 basis-point gain. Remember, however, that GWR completed its Freightliner acquisition this quarter, and tweaked the Australian operation somewhat; back these out for non-GAAP operating income of $87 million, up 15 percent, and taking 184 basis points out of the OR, now 78.2 vs. an adjusted 80.0 last year.

Below the line, reported net earnings came to $24 million, down 40 percent, and 42 cents a diluted share, down 41 percent. However, non-GAAP earnings, after the adjustments noted above, become 83 cents a share, up a respectable 19 percent.

North American freight revenues increased six percent to $243 million on 423,000 revenue units, up three percent. Within the commodity groups, GWR presents a remarkably balanced picture, with no single commodity contributing more than 15 percent of the merch car-count (happily, it's chemicals, ex-STCC 29 and crude oil, and sporting the highest RPU, $779) and with coal down to 19 percent to the total vs. 21 percent a year ago. Intermodal has, thankfully, disappeared as a category — the volumes were minuscule and just cluttered up the page.

Commodity volume highlights include plastics and industrial chemicals, up 14 percent; minerals/stone, up 31 percent on frac sand and construction aggregates; and metallic ores, up 14 percent, though the Australian mine closure took the consolidated number negative). Coal vols dropped eight percent on steam coal and metals came down 16 percent on steel mill products and frac-related supplies. The outlook for the rest of the year is generally positive except for steam coal, shale-related supplies, metals and overhead traffic.

Non-freight revenue of $79 million, up 12 percent, brings the total North America top line to $323 million, up eight percent. Against this, op expense was up nine percent, holding operating income to a two percent gain and the ops ratio to 82.4, up 94 basis points. I'm pleased to report that GWR continues to hold operating expense line items in a reasonable range that might well be used as benchmarks for other operators. To wit, in percentages of revenue: comp & benefits, 35; equipment rents (car hire and leases), 6; depreciation, 11; fuel, 8 (down from 12 a year ago, and still a good shortline comp), and casualty/insurance, 2.

In sum, GWR turned in a solid quarter after you take out the Freightliner acquisition costs and Australian one-time hits. GWR five-year earnings through 2014 have increased at a 19 percent CAGR, suggesting a potential price in the $105-$110 range, a 16 percent margin of safety on the year-end price of $90. Not bad.