RAILROAD WEEK IN REVIEW

May 5, 2017

"If we're doing our job — deploying capital well, investing appropriately — we should be growing long-term free cash flow per share at 15% to 20%. — Jack Hellmann, CEO, GWR

I always enjoy the Genesee & Wyoming earnings calls because they are loaded with details behind the numbers presented. Regular readers know I'm not a great fan of non-GAAP numbers when used to cloud what's actually going on, but, as in GWR's use of the term, they shed critical light on stuff that can happen in this business. I will attempt to insert non-GAAP numbers into what follows to give you a flavor of what management has to cope with.

Total world-wide Q1 revenue increased 7.6% to $519K, ops income was up 35.9% to $77.5 million, as ops expense increased less than four points. Below the line, net income decreased 2.9% to $26 million due mainly to jumps in interest expense and income taxes. Drilling down to the earnings number, GWR reports a 42 cent EPS "attributable to G&W," down a nickel from last year.

Adding back puts and takes like Australia impairment costs, corporate development expense, restructuring costs and the 45G tax credit, gives you 53 cents this year vs. 67 cents last year, down 14 cents or 21%. Higher fuel costs and flood-related washouts in the west contributed to the softness in North American results, details below.

A word on free cash flow is in order. Though net income attributable to GWR was barely up, cash from operations increased 21% and free cash flow jumped 43%. The press release provides excellent transparency for net cash used: "*Primarily $2.9 million of proceeds received from a working capital adjustment related to the GRail acquisition, partially offset by $2.7 million of costs related to the P&W acquisition. The 2016 period primarily consisted of net cash used for the acquisition of Freightliner and Pinsly Arkansas as well as $0.7 million in cash paid for incremental expenses related to the purchase and integration of the acquisitions."

YTD Cash Flow		**2017**		**2016**
Net Income	$	27,289	$	27,019
Ops cash flow	$	85,016	$	70,041
Capex	$	(22,500)	$	(27,300)
Net cash used*	$	(300)	$	700
FCF before	$	62,216	$	43,441
New biz less grants	$	(2,200)	$	(1,600)
FCF	$	60,016	$	41,841

FCF per share is 96 cents, up 31% over the 1Q2016 number.

North American revenue was $320K, up 6.6%, as carloads gained 5.2%, up 20K units, of which 15K were coal (and which Jack called “a crap shoot” on the call). North America same-store carloads increased 3.1% on agricultural products and coal, yet the downs nearly outweigh the ups. Chief among them were a chemical plant shuttering; a paper plant down for some months after an explosion; trucks dominating paper moves; an aluminum oxide plant going quiet; scrap steel up and pipe down, and so on. Operating expense gained 9.6% so ops income slid 3.4% and the OR was 78.8, 218 basis points worse.

As I see it, these go with the territory and are part of being in this business, though kudos to Chief Commercial Officer Mike Miller for mentioning “supply chain solutions” several times. Says he, we should expect “modest growth” in NA carload revenue ahead in 2017. Yet, as GWR expands ops worldwide, the NA contribution shrinks. It’s now 52% of total revs from nearly 80% not that long ago. It’s still 87% of consolidated ops income, though.

The inevitable line sales question came up in the Q&A, this time in connection with changes at CSX. Jack dodged the question nicely, saying that Hunter has a lot more on his plate than light-density branch lines; they might come up as dessert in the larger discussion. That said, GWR is uniquely positioned thanks to its “broad footprint,” meaning they have enough properties already that almost anything new can be tucked into an existing operation, just as the P&W is surrounded by the SLR, NECR, and CSO.

The 2017 outlook calls for NA revs in the $1.3 billion range, implying $325 million or so a quarter and very close to the Q1 run rate. Operating income after adjustments for certain non-GAAP items looks to be in the $81 mm range, which means they may have some catching up to do. The adjusted OR stays around 75 on 3% carload volume gains and core pricing in the 2%-plus range — a reasonable assumption given so much of their business is ISS and they’ll take their proportional bite of the Class Is’ gain.

Frac sand is increasingly big business for the railroads. Union Pacific and GWR both mentioned growing volumes in their first quarter calls. Now comes the May, 2017, *UBS House View Investment Strategy Guide* with some useful news on energy supply in general and forward production patterns in particular.

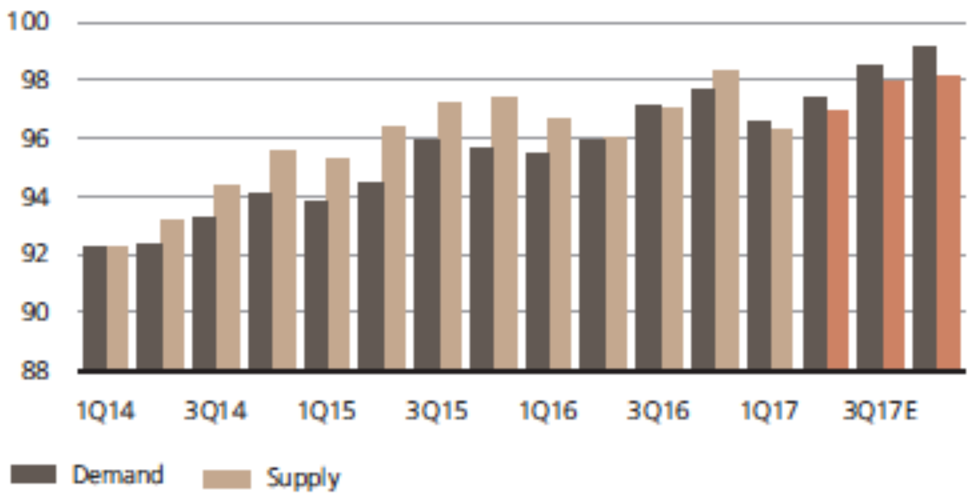
The chart below summarizes the UBS opinion that “the supply overhang is set to reverse” and companies that benefit from higher oil and gas prices will benefit, particularly the North American players. (I would include the railroads that support the energy exploration and production sector in that group.) UBS believes that “elimination of the inventory overhang and robust global demand” underlie their conviction.

UBS continues by saying the best-positioned operators have the edge given their shorter lead time, and I would add horizontal drillers with wells Drilled but UnCompleted (sitting DUCS, if you will) are ripe for tapping, especially since oil prices are expected to settle under $60. Moreover, The shale revolution driving oil and natural gas production growth in the US should continue to push energy infrastructure investments in pipelines, storage, and processing facilities. We expect growth in oil and gas production in the US to support energy infrastructure expansion over the next several years, particularly in the Permian basin in Texas and the Marcellus in the Northeast.

Which bodes very well for three shortline groups: OmniTRAX, Watco, and the North Shore railroads, for example. Among Class Is, CN, UP, and NS are well-positioned.

Fig. 1: Global oil supply and demand estimates

International Energy Agency forecasts a 1.3 million barrels per day (b/d) increase in global demand in 2017, following a 1.6 million b/d increase in 2016



Note: 2017 supply estimates (terracotta bars) assume OPEC's adherence to supply agreement at 50% (versus current level of over 100%). A greater or lesser level of compliance could alter the supply/demand balance.
Source: International Energy Agency, UBS, as of 13 April 2017

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