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Short a short line

In the People's Republic of China, pork is the steelmakers' antidote to flagging profits. Trying to fatten meager margins, as *China Daily* reported on March 7, the steel companies are diversifying into "unrelated" lines of business—livestock, just for instance. For Wuhan Iron & Steel, unrelated means pigs—10,000 head, in fact, if all goes according to plan.

Maybe it would be better for China if there were fewer plans. As it is, waves of state-directed lending and borrowing finance sprawls of state-directed fixed-asset investments. The consequences of Beijing's variant on the so-called Asian development model come in two phases. The short run yields breakneck growth and worldwide acclaim for the genius of the Chinese technocrats. The long run features a towering stock of unproductive assets matched by a teetering pile of debt.

The long run is here. "China is in a hard landing," Adrian Mowat, chief Asian and emerging-market strategist at JPMorgan Chase, told a Singapore audience last week. "Car sales are down, cement production is down, steel production is down, construction stocks are down. It's not a debate anymore, it's a fact."

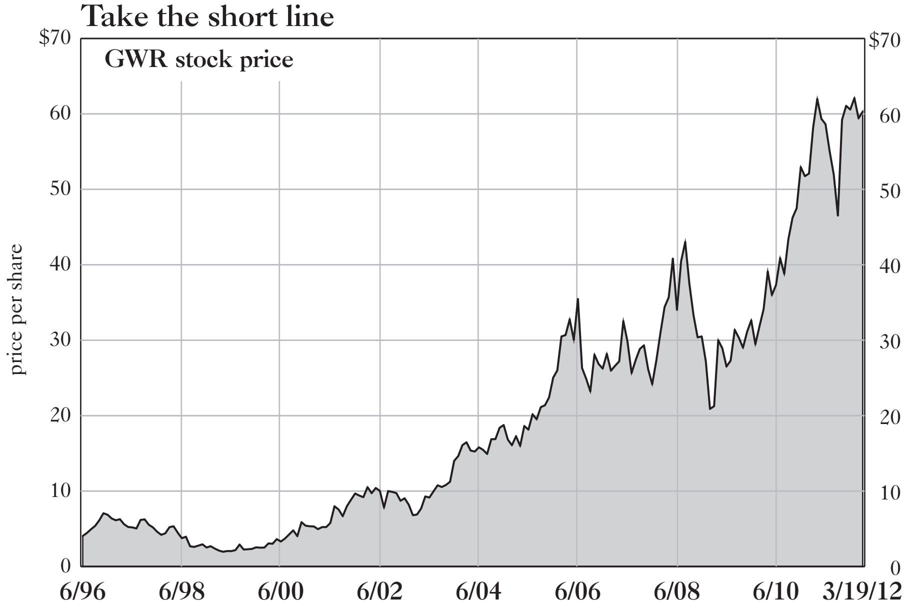
All of which is preface to a bearish analysis of a Greenwich (Conn.)-based railroad holding company. Truly, in today's integrated world economy, the knee bone is connected to the thigh bone.

Genesee & Wyoming Inc. (GWR on the New York Stock Exchange), the railroad company in our sights, is one of the most successful short-sale candidates you will ever read about. Fast growing, profitable and well managed, it labors under the single major flaw of deriving almost a third of its revenue from Australia. Insofar as natural resources are concerned—and Genesee & Wyoming is in the resource-hauling business—Australia is economically joined at the hip with China. While GWR is valued in the stock market as if everything will go right, China has already gone wrong.

The original Genesee & Wyoming was a 14-mile railroad in western New York that connected the contiguous counties for which it is named. A partnership led by Edward L. Fuller purchased it out of bankruptcy in 1899 to haul salt from the mine that eventually became the crown jewel of the International Salt Corp. Scroll forward now to 1977, when Edward's great grandson, Mortimer B. Fuller III, purchased a controlling interest in the railroad—still just 14 miles long—and created a holding company, Genesee & Wyoming Industries, by which to grow and diversify.

Three years later, passage of the Staggers Rail Act brought industrywide regulatory transformation. Now, for the first time, operators could hive off marginal routes. A collection of these putatively nonviable properties, both domestic and foreign, the farsighted management proceeded to collect and consolidate. Just how prescient was the Fuller descendant? Per annum, since

Take the short line



source: The Bloomberg

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1996, the company has compounded revenues by 17.1%, net income per share by 14.8%.

Today, Genesee & Wyoming operates short-line and regional freight railroads in the United States (57.7% of 2011 revenue), Australia (32.7%), Canada (7.8%) and the Netherlands and Belgium (a combined 1.8%). Last year, North America and Europe generated 68% of operating income, Australia 32%. The straw that stirs the drink is the demand for commodities from you-know-where. "The pieces of the pie that have been growing the fastest are Canada and Australia," CEO John C. Hellmann told investors at a bank-sponsored transportation conference last month. "[T]hat's all natural resources-related—things like iron ore and copper and manganese—that are being exported to Asia, principally to China, some to Korea and increasingly to India as well."

The modus operandi of the Genesee & Wyoming is to buy railroads that form contiguous grids within a certain region. "From an operating standpoint," Timothy J. Gallagher, chief financial officer, tells colleague Evan Lorenz, "when you have contiguous properties, you gain synergies around facilities, equipment, people—but even further, operating functions around locomotive repair, car supply, safety, procurement. It doesn't matter if the railroads are next to each other or not. You still get a shared corporate resource."

Genesee & Wyoming is diversified by revenue source as well as by geography. Income from freight accounted for 70% of its $829 million 2011 top line. Coal and coke, with 13% of the mix, was the largest freight segment, with farm products (12%), pulp and paper (11%), metallic ores (10%) and metals (9%) close behind. Railcar switching was by far the biggest source of non-freight revenue, followed by railcar rental, fuel sales, demurrage and storage, and car repair.

Growth by acquisition naturally requires financing—in the case of Genesee & Wyoming, debt financing. Management borrows to buy, trusting that the acquisition will generate enough cash flow to pay its own way. At year-end 2011, net debt totaled $599 million, or $14.87 per share, compared to the current share price of not quite $60. To keep itself in its banks' good graces, Genesee & Wyoming must hold net debt plus the net present value of operating leases to a maximum of 3.5 times EBITDAR, or earnings before interest, taxes, depreciation, amortization and rent. At year-end 2011, net debt to EBITDAR came to 2.8 times.

Genesee & Wyoming vs. the field
(in $ millions)

name	mkt. cap	EV/Ebitda	P/E	div. yield
Genesee & Wyoming (GWR)	$2,502	12.5x	21.8x	0.0%
Kansas City Southern (KSU)	7,913	11.7	24.0	0.0%
CSX Corp. (CSX)	22,866	6.8	13.0	2.2
Norfolk Southern (NSC)	22,103	7.7	12.1	2.8
Union Pacific (UNP)	53,691	8.0	16.7	2.1
Average		8.5	16.8	1.8

source: The Bloomberg

The company's grand design, Gallagher tells Lorenz, is to achieve 10% annual revenue growth through acquisitions, organic growth and price increases. The target for annual growth in earnings per share is still loftier, 15% to 20%. What makes the profit goal attainable in a business like railroading are the lush margins achieved on incremental gains in volume. Says Gallagher: "The cycle of levering up, paying down, levering up and paying down has worked out pretty well over the last 10 to 15 years."

That the next few years will faithfully conform to script is implicit in GWR's valuation: 21.8 times trailing earnings and 12.5 times enterprise value to EBITDA, compared to multiples of 16.4 and 8.5 times, respectively, for such near comps as Kansas City Southern, CSX Corp., Norfolk Southern and Union Pacific. Of the 17 analysts on the GWR case, just one says "sell." Short interest comes to only 4.5% of the 39.2 million-share float.

As noted, Genesee & Wyoming expects big things from Australia, including a significant improvement in operating efficiency. In the rail industry, doing more with less is expressed as a ratio of operating expenses to operating revenue; the lower the operating ratio, the higher the EBIT margin. Last year's operating ratio came to 76.9%. This year's, management projects, may tumble to 75%, an improvement chiefly driven by an investment of more than $100 million in locomotives to serve a new Australian customer, OneSteel, a maker of products used in mining equipment and mining-related construction. Indeed, Gallagher tells Lorenz, when the OneSteel contract begins to deliver the volumes expected of it, Genesee & Wyoming could be generating an operating ratio Down Under in the high 60s, compared to the 77.1% actually registered in 2011. While OneSteel derived 80% of its revenue from Australia in the 12 months to June 30, 2011, the customer behind the domestic customers is, of course, China.

It has not been quite true that, as the economy goes so goes Genesee & Wyoming, the railroad industry's sensitivity to the pace of business activity notwithstanding. For example, in unprosperous 2009, company-wide sales fell by a mere 9.5%, compared to an average decline in revenue of 21.6% for the group of companies named in the valuation comp. Mitigating factors included five acquisitions that, in sum, added $49.2 million to Genesee & Wyoming's corporate revenue. For another, management took a chain saw to costs. And, for a third, to quote Gallagher again, "our business to China increased rather than decreased." It was a striking display of managerial nimbleness considering that so-called organic revenue—i.e., same-store sales—plunged by 17.7%.

But good management or bad, past performance is no guarantee of future results. If China is landing as hard as we think it is, the slump would weigh on Genesee & Wyoming. In 2009, the United States generated 74% of the company's revenue, Australia and Canada, 24.1%. In 2011, the United States accounted for 57.7% of company revenue, Australia and Canada, 40.5%. Then, too, Lorenz points out, "the only recent acquisition that will flatter 2012 results is the Sept. 1, 2011, purchase of the Arizona Eastern Railway Co. And inasmuch as the acquiree's main

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customer is Freeport-McMoRan's largest copper mine and smelter in North America, an operation that would surely be hurt by a slowdown in Chinese investment, the Arizona railroad may not be of much countercyclical help. And while management made hay by slashing costs in 2009, there may be fewer such opportunities the next time operations slump. Then, too, the power of incremental change works to pressure margins on the downside as well as to raise them on the upside; a revenue reversal could push the company uncomfortably close to breaching its debt covenants. Finally, or semifinally, Genesee & Wyoming is directly exposed to a fall in the Australian dollar exchange rate."

Coal, of course, presents another problem—the collapse of natural-gas prices helped to lop 10% off Genesee & Wyoming's coal business in the fourth quarter. And there is regulatory risk in the shape of the push by the American trucking industry to field vehicles weighing 97,000 pounds, up from the current maximum allowable weight of 80,000 pounds (the green Swedes set a ceiling of 132,000 pounds). When asked about this regulatory black cloud during the company's Feb. 2 earnings call, CEO Hellmann replied that the competitive impact of super-large trucks on American highways "would be severe."

For us, the clear and present danger to Genesee & Wyoming is the infernally maladjusted Chinese economy. The share price makes no allowance for a macroeconomic comeuppance that, when it finally occurs, will make people shake their heads. "Now how could we not have seen that one coming?" they will rue over and over, in many different languages.

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