Energy & Resources Insider

Michael B. McDonald, PhD Editor

March 2017 | Volume 2 | Issue 3

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Energy & Resources Insider: Energy Markets In Flux

The oil markets are in flux. Different areas of the market are offering different views on where oil is likely to go from here. The futures markets are saying one thing, while refining is saying something else, and Eagle Ford & Permian production numbers are telling a third story.

For investors, this inconsistency is making it particularly difficult to get a read on the markets right now.

Investors expecting rapid price increases may be disappointed given the conflict in the markets. In particular, while hedge funds and money managers have placed record bets on oil rallying further, production numbers are starting to rise in Eagle Ford which could force OPEC to respond.

Net long positions of so-called oil speculators reached a record 852,794 contracts across both Brent and WTI in the week ending Feb. 3. Since each contract represents 1,000 barrels of oil, the total value of these long contracts is worth roughly eight times as much oil as the entire world consumes each day. All of that is a bet that prices will rise.

Still, that is no guarantee – the relationship between long positions and prices is shaky in general. The graph below illustrates Brent prices versus long positions since November. While both figures have risen since that time, there is little indication that prices closely track simple net flows into “paper” oil.

![Graph showing Brent prices versus long positions since November](image-url)
Exxon’s declining production speaks to a problem that is occurring in many parts of the world outside the U.S. – the most easily extracted oil resources have already been developed. That’s not to say the world is running out of oil – just that the low hanging fruit has been consumed.

The U.S. is the new dynamic producer and oil majors from around the world are looking to get into U.S. unconventional oil. As evidence of this, look no further than Exxon’s new bet on the Permian Basin, which is intended to give the super major a much-needed shale output boost. (Exxon is also starting to develop a large offshore discovery in Guyana – a subtle indicator for the beleaguered offshore industry that better days lie ahead.)

This last point highlights the fly in the ointment for oil bulls. U.S. production levels are starting to move higher. Take the Eagle Ford output for instance. While production levels are still well below where they were in early 2015, there are early signs that things are starting to turn around.

The Eagle Ford basin in South Texas is one of the low-cost production regions in the U.S., but despite that, it was hit hard by the downturn in the markets. Drilling all but dried up, and rigs vanished. The recent Baker Hughes data suggest that is starting to reverse. The EIA sees shale output rising by 14,000 bpd in March which would be an important data point if it indicates the start of a trend.

Eagle Ford is not seeing the kind of production interest that
the Permian is, but high prices and capitalization costs in the latter are starting to cause some headwinds for growth. Eagle Ford looks much more like the start of a trend for the U.S. unconventional group versus the Permian which is really a unique market.

U.S. oil production has risen 400,000 barrels since last summer, and the Eagle Ford could be an important driver that takes that production increase up another 200,000 bpd or more.

For all the optimism the smart money has in the oil markets, price gains may not materialize as fast as many expect. That’s not to say that oil is going back down either – just that the markets may trade sideways for longer than many expect. The oil price crash has proven one thing thus far – the consensus wisdom needs to be taken with a grain of salt.

In summary, oil’s outlook is reasonably positive, but there is still a long road ahead and the expected supply deficit could easily disappear or might not even happen if production picks up in earnest around the world.

**March Picks:**

This month we have two stocks we are particularly excited about. One is a small, but fast growing company which continues to see spectacular growth as the U.S. rig count rises. And the other is a beaten down industrial name that could see benefits from a resurgent oil sector.

But first, we want to update subscribers on a past pick. Most of our portfolio is doing quite well – the average pick has an annualized gain of more than 30% right now. Magellan Petroleum (MPET), PDC Energy (PDCE), and the Velocity Shares Daily Inverse VIX Short Term ETN (XIV) all are up by more than 15% since we initially recommended them. We still believe in these names for the long-run. In particular, XIV is very attractive on any short-term pullbacks in our view.

*(Note: Special Situations subscribers – we continue to view XIV positively, but not as positively as some of the long-short ETN trades we have recommended to you in the past. XIV should have average gains of about 30% annually, while the related long-short ETN investment we recommended to you in our January 26, 2017 letter should see upside of more than 75% over the next year. Please review that letter if you have subscribed since January – it is one of our highest conviction picks and*
is up 8% in less than a month.)

Yet, one name in our portfolio has underperformed of late. Acuity Brands (AYI) has had a rough 2017 so far, and is down 12.5% since we initially recommended the stock. Acuity had a bad earnings report in January that drove most of the loss.

This is not the first time that Acuity’s stock has hit some turbulence though, and each time the firm has bounced back stronger. Given that and our confidence in the long-term business, we believe the current downturn is a good opportunity to pick up shares at a substantial discount.

In particular, while the market reacted negatively, to AYI’s earnings, they were actually reasonably good by most metrics.

- Acuity Brands reports revenue rose 16% due to a 10% increase in volume and approx. 9% contribution from acquired revenues from acquisitions.
- Sales of LED-based products represented two-third of total net sales.
- Gross margin rate slipped 100 bps to 42.4%.
- Adjusted SD&A expense rate improved 80 bps to 25.6%.
- Adjusted operating margin rate declined 30 bps 16.8%.

The downside in the stock was driven by the fact that AYI missed analyst’s earnings estimates of $2.00 by $0.16, while revenues of $851M missed analyst estimates by $43.7M.

Still, earnings and revenue at the firm have consistently grown over time. This year, it is likely that AYI will see EPS of $8.82, followed by $10.55 in 2018. So while the stock is a bit pricey on a P/E basis at present (2016 EPS of $7.84 gives a P/E multiple of 28x), we think the firm is one of the few putting up true earnings and revenue growth. That deserves a premium multiple.

Acuity beat earnings for eight quarters in a row going into fall 2016, and with that kind of track record, it is little wonder that analyst got a bit too bullish. The earnings miss in January should reset expectations. While the stock may trade sideways for a few months, we think it is a long-term winner in a fragmented space, and believe the company will trade for roughly $300 a share within 18 months.

New Picks:

This issue’s first recommendation is a small-cap frac sand company which we have been tracking for over three years. Demand for frac sand fell along with the sharp decline in oil prices, but the need for OFS supplies like frac sand is now on the rebound and we now believe **Hi-Crush Partners LP (NYSE: HCLP)** is a good way to play this trend.

HCLP got hammered along with other frac sand providers in Friday’s trading following poor results from a peer. HCLP competitor, U.S. Silica (NYSE:SLCA) reported a smaller than expected Q4 loss but failed for the second straight quarter to translate rising sand sales into a profit. Still, SLCA said that Q4 volumes shipped rose 34% year over year to 2.1M tons, giving the firm a 55% increase in revenue for the frac sand segment to $137M. HCLP has similar, but greater benefits ahead.

Despite the firm’s strength, HCLP fell almost 16% in trading on Friday. The stock has increased dramatically over the last year, so many investors were likely looking for a reason to take a profit, and the decline related to SLCA gave them one. Nonetheless, we like HCLP for both the medium and long-term.

Hi-Crush is a publicly traded master limited partnership (“MLP”). MLP “units” trade just like stock. Hi-Crush
make quarterly cash distributions to its unit holders. The distributions are tax deferred return of capital. Unit holders receive a Form K-1 each year that sets out their share of the partnership’s taxable income, which is much lower than the cash distributions.

We are bullish on Hi-Crush because a high percentage of their future sales are locked in by long-term supply contracts. Hi-Crush is also one of the lowest cost producers in the frac sand business and their distribution system gives them a strategic advantage.

Demand for frac sand softened in 2015 and 2016, before rebounding late last year. With several independent sand companies going out of business and others being cut off from the capital they need to develop their sand mines, Hi-Crush is gaining market share, and that should continue going forward. Within its niche in the industry, HCLP is the strongest firm by far, and the best positioned to ride the oil rebound.

If crude oil prices move back to $70/bbl, which we expect to happen by mid-2018, demand for frac sand should double from where it is today.

To ensure profitability, Hi-Crush is focused on internal cost control. Since a high percentage of their expenses are variable costs tied to production volumes, they can easily survive an extended period of lower demand. They have lowered plant costs, freight & logistics expenses, headcount and they are pushing for discounts and efficiency from their own vendors and suppliers.

Hi-Crush Partners LP (HCLP) is a pure play, low-cost, domestic producer and supplier of premium monocrystalline sand, a specialized mineral that is used as a proppant to enhance the recovery rates of hydrocarbons from oil and natural gas wells. Their reserves consist of “Northern White” sand, a resource existing predominately in Wisconsin and limited portions of the upper Midwest region of the United States, which is highly valued as a preferred proppant because it exceeds all American Petroleum Institute (“API”) specifications.

Hi-Crush owns, operates, and develops sand reserves and related excavation and processing facilities and will seek to acquire or develop additional reserves and facilities. The company’s 651-acre facility with integrated rail infrastructure, located near Wyeville, Wisconsin (the “Wyeville facility”) enables processing and cost-effective delivery of approximately 1,600,000 tons of frac sand per year. Hi-Crush also owns a 98.0% interest in Hi-Crush Augusta LLC (“Augusta”), the entity that owns a 1,187-acre facility with integrated rail infrastructure, located in Eau Claire County, Wisconsin (the “Augusta facility”), which processes and delivers 2,600,000 tons of frac sand per year. Sand is purchased from a sponsor’s production facility near Whitehall, Wisconsin (the “Whitehall facility”), a 1,447-acre facility.

The majority of the frac sand produced by HCLP is sold to customers under long-term contracts. During the three
months ended March 31, 2015, temporary price discounts were provided to contract customers in response to the market driven decline in proppant demand.

**HCLP Strengths within Peer Universe**

**We like HCLP for a number of reasons compared to its peers.**

- Long-term contracted cash flow for many of its customers with several take-or-pay contracts that have been extended in recent years in exchange for lower sand prices until oil prices improve further.
- Low cost producer with more than 75% of production capacity contracted
- Long-lived, high quality reserves as its Northern White frac sand is in high demand
- Prime portfolio of assets exploiting its strategic network in the Marcellus/Utica

**Market Strategy**

- Focus on stable, long-term take-or-pay contracts with key customers. HCLP markets the vast majority of the sand that it produces under long-term take-or-pay contracts that significantly reduce its exposure to short-term fluctuations in the price of and demand for frac sand. This strategy mitigates HCLP’s exposure to the spot market price of frac sand and provides long-term cash flow stability.
- Expand proved reserve base and processing capacity. HCLP seeks to identify and evaluate economically attractive expansion and facility enhancement opportunities to increase its proved reserves and processing capacity. At Wyeville and any future sites, HCLP expects to pursue add-on acreage acquisitions near its facilities to expand its reserve base and increase its reserve life.

HCLP has a competitive advantage due to its infrastructure and logistics set-up. The strategic location of HCLP’s Wyeville facility and logistics capabilities enable it to serve all major U.S. shale basins. HCLP’s transportation network includes three 5,000 foot rail spurs off the Union Pacific mainline that are capable of accommodating unit trains, allowing its customers to receive priority scheduling and expedited delivery. HCLP is one of the few frac sand producers capable of delivering API grade frac sand cost-effectively to all major U.S. shale basins by on-site rail.

**Low Operating Costs**

HCLP’s business operations are strategically designed to provide low per-unit costs with a significant variable component for the mining and processing of the sand. The low operating costs are made possible due to the following:

- Shallow earth overburden at the Wyeville facility allows the use of surface mining equipment instead of the more costly underground mining operations.
- The sand reserves do not require blasting or crushing to be processed.
- Processing and rail loading facilities are located on-site which reduces the cost of trucking sand to either facility.

**Valuation:**

Friday’s selloff in HCLP was overdone. The key issue that investors are overlooking here is that while HCLP is still facing a recovering market for its primary product, all of its competitors are also facing that same market. Hi-Crush sells an essential product for fracking, a process which is not going away. Hi-Crush is one of the few producers that can emerge much stronger in five years than it is today thanks to opportunities created by the downturn. The company is poised to pick up the pieces from competitors that have gone bankrupt or left the industry.

Despite industry chatter about reducing the need for frac sand over time, the reality is that doing that is very difficult.
In fact, with oil prices now moving higher, the trend towards increased frac sand consumption will likely revert back to a normal increase over time. Fracked wells run out very quickly, and Hi-Crush should benefit over time as E&P firms are forced to drill new wells to maintain production levels.

We believe, given our forecast for market conditions, that HCLP is worth roughly $26 per share based on 35% growth in revenues as the industry recovers from its slump over time. Investors should use downturns like the one observed on Friday to pick up best of breed companies, and HCLP is definitely in that category.

(Please find more financial data on EVI in the datasheet below).

**Pick #2: Trinity Industries (TRN)**

One of the problems with the current market is straightforward but challenging for investors; everything “good” is “expensive”. Virtually all of the names that investors as a group are optimistic about have rallied considerably since November. While some commentators offered misplaced calls that the market would decline because of political risks, so far stocks have generally been pretty much immune to any changes from the new Trump administration.

Against that backdrop, investors looking for opportunities need to look in one of two places – names that are flying well under the radar (see our pick above), or firms that look questionable to many investors.

Our second pick for this month falls distinctly into the latter category.

Trinity Industries is a beaten down industrial conglomerate that faces a major liability lawsuit, nagging concerns left over from the oil price crash, and an excess supply of one of its major products that could leave sales at depressed levels for a year or more.

On the positive side, the firm is cheap, it has a durable business, and its earnings are likely at trough levels, all of which means it has substantial upside from here over the next two years. Our price target on Trinity is $40 per share.

For those who are not familiar with the firm, Trinity Industries makes products for the energy, transportation, chemical, and construction sectors. It operates through the following segments: Rail Group, Construction Products Group, Inland Barge Group, Energy Equipment Group and Railcar Leasing and Management Services Group.

The Rail Group segment manufactures and sells railcars and related parts and components.

The Construction Products Group segment manufactures and sells highway products and other steel products for infrastructure related projects and produces and sells aggregates.

The Inland Barge Group segment manufactures and sells barges and related products for inland waterway services.

The Energy Equipment Group segment manufactures and sells products for energy related businesses, including structural wind towers, storage containers, tank heads for pressure and non-pressure vessels and utility, traffic, and lighting structures.

The Railcar Leasing and Management Services Group segment owns and operates a fleet of railcars as well as provides third-party fleet management, maintenance, and leasing services.

Trinity’s stock has come down considerably from where it
was a few years ago, largely based on two unrelated factors.

First, the company’s primary end market of railcars has been hammered badly by the oil price collapse. In 2015, the company earned $4.36 per share. For FY2017, management is guiding for $1.00 to $1.35 per share.

TRN’s tanker railcars are used by many oil firms to ship product to market. As discussed earlier in this letter, production in oil has plummeted, especially in areas like the Bakken. While oil is starting to come back, the railcar markets are still dramatically oversupplied because TRN and its peers were slow to stop production (a common issue with suppliers operating further from the end user).

That oversupply in railcars will likely persist through the end of this year. The good news is that the company really is seeing trough earnings levels here. The company has bought back about 5% of outstanding shares over the last five years, and it is sitting on plenty of cash - about $550M, with assets of $9.1B and liabilities of $5.2B. The firm is in fine shape to ride out the storm.

The other issue which is hanging over TRN and has contributed to underperformance versus competitor Greenbriar (GBX), is an outstanding lawsuit related to another product of TRN’s.

Trinity makes highway guardrails, and a few years ago the company was accused of making defective guardrails and then overstating their effectiveness through testing.

In June 2015, the company was hit with a $663M adverse judgement by a district judge for allegedly defrauding the U.S. government in the case of its highway guardrail safety system tied to at least nine deaths.

That penalty was $138M more than the one imposed in a 2014 federal trial in which jurors found TRN cheated the government by selling its ET-Plus guardrail system without disclosing changes made in 2005. The ruling follows the unsuccessful end of settlement talks ordered after the October verdict; the judge was considering a final judgment in the $525M-$709M range.

That judgement is significant, but not earthshattering for Trinity – the firm has a market capitalization of roughly $4.4B. Still, as one would expect, Trinity appealed the matter.

According the firm’s chief legal office on the Feb 16, 2017 conference call, “the False Claims Act judgment entered against Trinity Industries and Trinity Highway Products in June 2015 is currently on appeal to the U.S. Fifth Circuit Court of Appeals. While our argument in the case was heard by the three-judge panel on December 7, 2016, the court could publish its decision at any time.”

Trinity should see a major spike higher if it wins on appeal, but the market seems to be anticipating a loss given the firm lost in its last two rounds in court. Given that, there is probably limited downside for the stock if the judgement is confirmed.

Either way, once that judgement is out of the way, it should begin to clear up the investment case for Trinity. The oil markets are clearly recovering, construction and infrastructure demand is improving which should help the firm, and in a normalized situation Trinity should earn at least $2.80 a share in earnings – still well below the 2015 peak, but much higher than shareholders are giving the company credit for today.
With TRN shares changing hands around $29 a share today, the stock looks modestly valued.

In addition, once TRN’s legal issues are behind it, the company should be in a better position to consider strategic changes to the firm such as asset sales. The barge business is doing miserably right now, largely because of uncertainty around infrastructure spending by the government, but the wind tower segment looks reasonably strong, and the highway construction group had a banner year in 2016.

Trinity’s railcar leasing business is also under pressure, that business is showing early signs of turning. When it does, TRN’s stock could take off in a matter of days. (See Textainer Group – TGH for a comparable example in the oceangoing container space.)

The two keys to an improvement in the railcar business are stabilization in the energy markets (already underway), and stabilization in the cross-border trade business with Mexico (likely to occur within the next twelve months as businesses settle into the new political realities in Washington). At present, railcar orders are as low as they were in 2009 and are well below the replacement rate needed for the fleet as a whole. That situation cannot continue for long in a growing economy. In the medium term, utilization levels and car rates have to rebound.

Railcar deliveries have undershot estimates from third-party economists in 2016, and it’s likely they will see a rebound in 2018.

Against this backdrop, investors should look closely at TRN. The stock may be up versus year ago levels, but this is a company which still has considerable opportunity. Solid turnaround stories do not come along every day, and we believe Trinity is just such a story.

Please find more financial data for Trinity Industries below.
**HCLP Data**

**Shareholder Equity**
- Shares Outstanding: 63.7 M
- Institutional Ownership: 32.09%
- Number of Floating Shares: 42.6 M
- Short Interest as % of Float: 3.03%

**Financial Strength (MRQ)**
- Quick Ratio: 2.24x
- Current Ratio: 3.46x
- Debt/Equity: 0.65x
- Debt/Assets: 0.36x

**Valuation (MRQ)**
- Price/Earnings (TTM): 0.00x
- Price/Sales (TTM): 6.25x
- Price/Book: 4.39x
- Price/Cash Flow: --

**Profitability (TTM)**
- Gross Margin: 4.08%
- Operating Margin: -23.03%
- EBITDA Margin: 1.50%
- Net Profit Margin: -29.97%

**Management Effectiveness (TTM)**
- Return on Assets: -13.19%
- Return on Equity: -29.55%
- Return on Inves. Capital: -14.20%

**Operating Ratios (TTM)**
- Asset Turnover: 5.89%
- Inventory Turnover: --
- Receivables Turnover: 4.84%
- Effective Tax Rate: --

**Company Officers**
- Chairman: James M. Whipkey
- Chief Executive Officer: Robert E. Rasmus
- Chief Financial Officer: Laura C. Fulton
- Vice President: William E. Barker
- Vice President: Chad M. McEver
- General Counsel: Mark C. Skolos
- Director: Jefferies V. Alston
- Director: Gregory F. Evans
- Director: John R. Huff

**Company Contact**
- Employees: 0
- Headquarters: Suite 1550, Three Riverway
  HOUSTON, TX 77056
- Phone: 713-963-0099
- Fax: 713-963-0088
### TRINITY INDUSTRIES DATA

#### Shareholder Equity

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#### Financial Strength (MRQ)

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#### Management Effectiveness (TTM)

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#### Growth Rate (TTM)

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#### Dividend (TTM)

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#### Operating Ratios (TTM)

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#### Company Officers

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<td>Chairman</td>
<td>Timothy R. Wallace</td>
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<td>Chief Financial Officer</td>
<td>James E. Perry</td>
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<tr>
<td>Senior Vice President</td>
<td>Melendy E. Lovett</td>
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<tr>
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<tr>
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<td>D. Stephen Menzies</td>
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<td>Schuyler Theis. Rice</td>
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<td>W. Relle Howard</td>
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<td>Vice President</td>
<td>Mary E. Henderson</td>
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#### Company Contact

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<td>214-631-4420</td>
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<td>Fax</td>
<td>302-655-5049</td>
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