RAILROAD WEEK IN REVIEW
DECEMBER 14, 2007

"Based on the facts of this case, we find that MCR would not be sufficiently independent of NSR to be deemed a separate "person" for purposes of section 10901(a)(4). Therefore, the proposed transaction would not come within the scope of section 10901." – STB in FD-35063 re proposed NS-Watco Joint venture in Michigan

Norfolk Southern has known for years that the auto parts franchise in Michigan was in trouble. Just last June in an analysts' presentation Mike McClellan, NS vice president for intermodal and automotive marketing, showed that the NS auto parts franchise in 2006 was about half what it was in 2002. Waybill samples for the first quarters 2005-2007 show a 21% decline in revenue units, e.g.

The planners at NS felt there was a franchise worth saving, but the deteriorating traffic levels could not support the capital and operating resources required to keep the doors open. A short line sale would not work because of the Amtrak lanes (eight trains a day) and the requisite high levels of infrastructure investment. Neither would a classic "Thoroughbred Lease" work for the same reasons. However, the Joint Venture model that's doing so well with KCS on the Meridian Speedway seemed a natural to try here.

And so it was that Watco Companies, a short line operator out of Pittsburg, Kansas was selected to operate the railroad through a joint venture to be called Michigan Central LLC. Thus was resurrected a fallen flag name, the Michigan Central which, as part of Conrail (and before that the NYC), had gone to NS with the Conrail split. The thesis was that the reconstituted MC lines would support a growing cadre of potential, albeit smaller, carload customers not related to the auto business.

NS realized early on that its centralized sales force with its focus on large accounts was not really equipped to provide the personal touch needed to turn these small customer opportunities into operating cash flow. Watco Chief Commercial Officer Ed McKechnie told me at the time that they had identified some 250 such customers and it is this core that will let the new MC "grow its way to prosperity," to use his phrase.

The new MC would operate on 384 route-miles including the east-west core between Ypsilanti and Porter on the MI-IN border (Kalamazoo-west on trackage rights over the Amtrak-owned segment) plus Jackson to Lansing and Grand Rapids south through Kalamazoo to Elkhart. The arrangement gives NS some degree of equity and operating ownership -- a significant consideration in the present case given the interests of Michigan in preserving the corridor.

Now comes the STB to say "not so fast." In their 11-page December 10 decision the Board took great umbrage over the amount of control NS would retain over the JV. The nub of the argument appears to be that "acquisition of a railroad line by a noncarrier [MCR LLC] requires Board approval. However, to qualify as a noncarrier, MCR would need to be independent of NSR [Norfolk Southern], not controlled by NSR."

The decision then describes the two-part test to determine "whether a transaction under section 10901 that purports to transfer control is, as the labor interests characterize the transaction, a sham to avoid labor protection." The first test is "whether the noncarrier was created to purchase the line for legitimate and substantial business reasons and not solely to avoid labor protection." The second is "whether the noncarrier subsidiary is sufficiently independent of carriers with which it is affiliated." And, "If the affiliated carrier is a mere investor, with the responsibility for operating, financial and business decisions residing in the new carrier, then the transaction properly comes within the scope of section 10901."

"Mere investor" evidently does not fly: "The proposed transaction involves NSR's contribution of hundreds of miles of rail lines to a noncarrier entity coupled with NSR's retention of extensive control over those lines, including a significant ownership interest in the new entity. NSR's actual influence over MCR [would be substantial] because NSR would retain the right to veto almost all of MCR's significant financial and operational decisions."

The Norfolk Southern and Watco responses were understandably critical. Wick Moorman, CEO of NS, said in their press release, "It is a sad day for rail transportation in Michigan. The proposal was a creative, farsighted response to the long-term trend of shrinking rail volumes in the region. It was designed to spur infrastructure investment and leverage the talents of an experienced short line operator – all to the benefit of the state, its freight rail customers and rail passenger service."

The Watco release was more sanguine. "While we are disappointed with the STB decision, we continue to work with the Norfolk Southern to assess the ruling and determine how Watco can help the NS expand rail service in Michigan. We appreciate the help of the many Customers and communities that supported the transaction. Most of all we appreciate all the time and commitment of the many members of the Watco and NS teams that worked so hard on this project."

The decision is a particularly interesting read for me because just the day before it was announced I was at the STB visiting some friends I had known since the days before they went to the STB. And though for all the obvious reasons we could not nor would not discuss any matters under deliberation, I came away with the strong sense that the STB's mission is to be sure the laws now on the books are fairly and accurately applied.

Still, it's not an easy decision to understand because it might actually mean less rail service in a region that is trying to attract new industry and unclog the interstates, particularly the parallel I-94 which I am told is in practically permanent gridlock. My sense is, as Yogi Berra once said, "It ain't over till it's over." Stay tuned.

Last week I promised the beginning a new series of occasional articles under the general rubric of Follow the Money." Let's start by peeling back the onion that is *working capital*. In its most basic form, Working Capital is current assets less current liabilities. One looks for a current ratio (current assets/current liabilities) > 1.0 and the higher the ratio the greater the ability of the firm to pay its debts – liquidity in other words.

However, there are limits. Too high a ratio may mean money that ought to be in "property, plant and equipment" (PPE) isn't working as hard as it would were it in something other than current assets. The rule is that fixed assets generate a higher rate of return than current assets. Ergo financing with current liabilities rather than LT debt may mean lower interest rates yet there is greater liquidity risk as one loads up on current liabilities *vis a vis* current assets.

Internal sources of working capital include *retained earnings* generated by free cash flow (cash from operations less capex), depreciation, deferred taxes and the like. External sources include bank and other short-term borrowings and equity capital not channeled into PPE. Note too that working capital finances the *accounts receivable turnover* – how many times the receivables portfolio has been collected in the accounting period and the higher the better. You can approximate this number by dividing total annual cash received from billable sources by average annual AR.

Better AR and AP management can increase working capital. First, look at the AR cycle and see if there are ways to shorten it, reducing accounts receivable and increasing cash. Watco, for example, has found that reducing their AR cycle to 50 days could be worth seven figures in working capital. Second, look for ways to stretch out payables that are in effect an interest-free loan. Third, see what short-term debt you can roll into LTD.

Longer term, short lines need to find ways to increase free cash flow. Start by maximizing external capex funding (grants, RRIF loans, and tax credits) and reducing dividends to shareholders. If there is any preferred stock, get rid of it by converting it to common, using the dividends avoided to increase cash on hand, retained earnings and thus current assets.

Some short lines have sold additional shares to raise cash for working capital, though dilution of shareholders' equity is a downer. It's what happens when, for example, NS grants options to its officers and then they sell these options on the open market thereby increasing the float. The current push to repurchase shares is in large measure driven by the need to reduce an inflated share count created by employee option sales. My feeling is that an equity infusion via new stock ought to be viewed only as a last resort after steps such as I've outlined above have either been implemented or positively tagged as non-starters.

To give you one example, RailAmerica in 2005 (the last full year it filed a 10-K) had a current ratio of 0.88, down from 0.94 in 2004. There had been no change in the current portion of LTD ($6.1 mm) though there was a $4 mm disc ops charge. Current liabilities increased $20 mm or 18% while current assets rose $11 mm or 11% including a disc ops credit of $3 mm, so there was a gain of $16 mm in current liabilities somewhere other than disc ops. Average AR for the year 2005 was $73.5 mm on revs of $423.7 yielding an asset turn of 5.8x or 63.3 days outstanding per receivable dollar. Debt was 98% of equity at year's end, BTW. And it was in 4Q06 that Fortress took RRA private.

Jim Bowers, one of the best numbers people in the short line space, makes a very insightful comparison with an old penny-farthing bike. He writes, "The working capital situation of the short line balance sheet is liken to an old style bicycle; only the front wheel is the smaller one and the back wheel is the big one. The rider is peddling like hell to get the smaller front wheel to turn the larger back wheel.

"Since a lot of AR is due from Class 1 carriers, this does have a tendency to turn at least every month, if not sooner. Whereas, the big wheel, representing AP and long term debt due in a year, turns slowly, about 1/12th each month. This makes working capital look rather odd for the industry. Most bankers and other financiers not familiar with the industry walk away from short lines as they have poorer looking balance sheets than one would expect. However, we are not Wal-Mart with a very heavy reliance on inventory turn to keep [the current ratio] well above one-point-oh."

And so, if after all this, you're still interested in seeing all the relationships, drop me a note and I'll send you the spreadsheet. You might find it helpful to save it to disc and insert your own numbers. I only ask that in return you share your results and conclusions (confidentially, of course). If enough short lines do, we can begin to develop a pattern that can be shared with all.