RAILROAD WEEK IN REVIEW

December 11, 2015

"We will remove paper barriers for both privately-owned and leased short lines." — Jim Clements, VP Strategic Planning at CP

The gloves came off Monday as CP addressed Norfolk Southern's response to its latest offer. The call started 0900 Monday with five speakers taking an hour to cover 47 slides chock full of numbers and percents. Speaking were CP CEO Hunter Harrison, CFO Mark Erceg, Special Council Paul Guthrie, VP Strategic Planning Jim Clements, COO Keith Creel, and Bill Ackman, Pershing Square CEO. At the close of the prepared remarks, Harrison said the lines would stay open for Q&A for as long was needed. It took another 90 minutes.

Whereas Norfolk Southern CEO Jim Squires spoke in general terms last Friday — revise operating model, improve network performance, rationalize non-core facilities, e.g. — there were no numbers attached. Which was strange because NS has always been a data-driven organization. Yet here comes CP saying right up front they see $1.8 billion in "value creation," with numbers assigned to specific categories: fuel, train ops, loco utilization, crew deployment, enhanced revenue and in support functions.

I'm not alone in this opinion about data-driven discussion. CP in its slide set attributes this December 4 observation to Citi Bank: "Norfolk's stand-alone case lacks detail on the upside. While we credit NS for diverging from its tradition of not issuing financial guidance, we think its OR and EPS growth targets lack the necessary detail or upside to convince shareholders that further overtures from CP would be worth ignoring." Moreover, Harrison himself has said many times that you can say anything looking three or four years out. "Many things will change and you will have plenty of time to correct the record."

CP wants to use a voting trust to put Harrison in as CEO at NS, where the most changes are needed, and put CP in trust with Creel as CEO, where both he and the railroad are known quantities, and shows how "the public interest" is served, rebutting Squires' argument to the contrary. Ackman does a great flow chart showing the alternatives: NS stands alone or goes with CP; if ok with CP scheme, go for the voting trust. If approved, Harrison becomes CEO at NS. If not approved, NS is back to stand-alone.

Then comes the STB deliberation. If the merger is approved, CP and NS become one company; if not approved, the trust spins off NS or CP to shareholders. Here Ackman follows the money.

NS by itself could be worth \$90 per share[1] by mid-2016, when the trust would close. If NS agrees to the voting trust, and Harrison starts running the railroad, and then the STB says no, the sides retire to their corners, but with NS worth \$125 a share; if the STB says yes, shares in the new company will be worth \$140, a near-double for today's NS holders.

When CP first mentioned its access plans, I wondered how they'd deal with short lines. Monday's session left little doubt: see Jim Clements quote in italics at the top of page 1. To me, the bottleneck proposal looks like a potential winner. The devil is in the details, of course, but getting a responsible rate from a carrier controlling a bottleneck A-B will allow an efficient competitive C to B carrier to quote on the traffic.

If not usually, then frequently, there is a sufficiently efficient C to B carrier but the shipper/receiver is separated by a paper or physical barrier. Power company build-outs in Illinois and chemical plants in Louisiana demonstrate this but it requires building a physical connection. The unanswered question is whether it will be reciprocal: CP/NS getting onto the other guys' lines when the tables are turned. My concern is that this *should* be reciprocal -- I am not sure that has been thought through for the US -- and I'm not sure NS understands it. This is pretty new stuff for the present crop of railroad managers .

As part of the access discussion CP needs to say what they'd do with the Shared Asset Areas (SAAs) jointly owned by CSX and NS. If you rely on trackage rights all over, especially into key, busy terminals and you lose the SAAs, that's a net loss to competition. It's a fact that trackage rights and/or reciprocal switching is not nearly as good competitively as what the SAAs provide – a neutral, independent switching entity with the sole goal of maximizing efficient direct service.

In the traditional model, the railroad coming in on rights is at the complete mercy of the owner railroad's dispatching, etc. This is why in many instances so few have used trackage rights effectively, while others have frequently given up on them, and negotiated a haulage arrangement instead. to avoid having to operate at all. Haulage arrangements can be a very expensive alternative — and perhaps even noncompetitive. Plus, if you're trying to handle any real volumes in haulage, those haulage trains may suffer the same fate as a second class tenant trackage rights train.

My recommendation to short lines: Start looking for places you can add tonnage if NS weren't in the way via paper barriers, non-competitive pricing, or operating restrictions. Ask customers what it will take to put more of their supply chain on the rails. Squires says NS wants to grow the merch carload franchise; it follows the market managers have their marching orders.

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[1] "Based on our math, NS' target for a sub-65% OR in 2020 was largely priced into valuation prior to CP's proposal. Assuming 4% revenue growth, a 65% 2020 OR and further buyback activity of \$750 million to \$1 billion annually, we see 2020 EPS of roughly \$9. Assigning a 14x multiple and 10% discount rate implies a mid-\$80s to mid-\$90s valuation, in line with the current merger-affected stock price and up modestly from the ~\$80 price pre-offer." - Citi, Dec 2015

The dynamics of the CP threat are such that NS has no alternative but to show signs of better cost control, growing vols (even at low RVC multiples), and increasing ops income at double-digit rates in the next threes months. Voting trusts and share prices aside, if the CP threat forces NS to do what CP says IT would do, and assign numbers to the results, a merger won't be necessary and shortline numbers will be up in the bargain.

The CP presentation slides and Q&A comments make it very clear Bill Ackman has thought this through and, most importantly from the perspective of the NS shareholder, it now appears the regulatory risk is down to the trust issue and this ends in 90 days. Seems to me a no-brainer for shareholders. And, as HH said during the Q&A, "CP management is going to do everything it can to get this to the shareholders, and if that calls for a proxy, so be it."

CSX will change its listing to the NASDAQ from the NYSE effective after the market close December 21. The note at csx.com says simply, "Moving to the NASDAQ *Global Select Market* provides new opportunities and synergies for CSX, and more closely aligns with the platform where most of our trading activity already takes place. This decision is consistent with our commitment to reduce costs and uphold consistently high standards of corporate governance. The company's common stock will continue to trade under its existing "CSX" symbol.

The NASDAQ Global Select Market is one of four Listing categories. Going from most restrictive to least, they are Global Select Market, Global Market, Capital Market and Other. As a Global Select Market member, CSX will be keeping some pretty distinguished company: AAPL, AMGN, BIIB, KOSS, GOOG, and MAR, to name a few.

Moreover, it is my understanding that with the advent of electronic trading, more than half the daily CSX trades are already on the NASDAQ and another 30 percent are on other exchanges, thus leaving the NYSE with about a fifth of the volume. Makes it tough to justify the $500,000 annual membership fee for the NYSE vs. $155,000 for the NASDAQ. An excellent move, CSX, and I applaud you for it.

Genesee & Wyoming November carloads for North America drifted south by 13 percent from what they were a year ago. The 124,220 car total includes 2,061 carloads from new railroads open less than a year, bringing the same-store number down 14 percent. Of the commodity groups comprising 80 percent of vols, coal/coke was off 45 percent and metals slipped 28 percent; these two are a quarter of NA carloads. "Other," chiefly Class I overhead moves, dropped by a third. I have to say that, if GWR revenue units in North America are a proxy for the non-class I group as a whole, the shortline and regional railroad prognosis is not good.