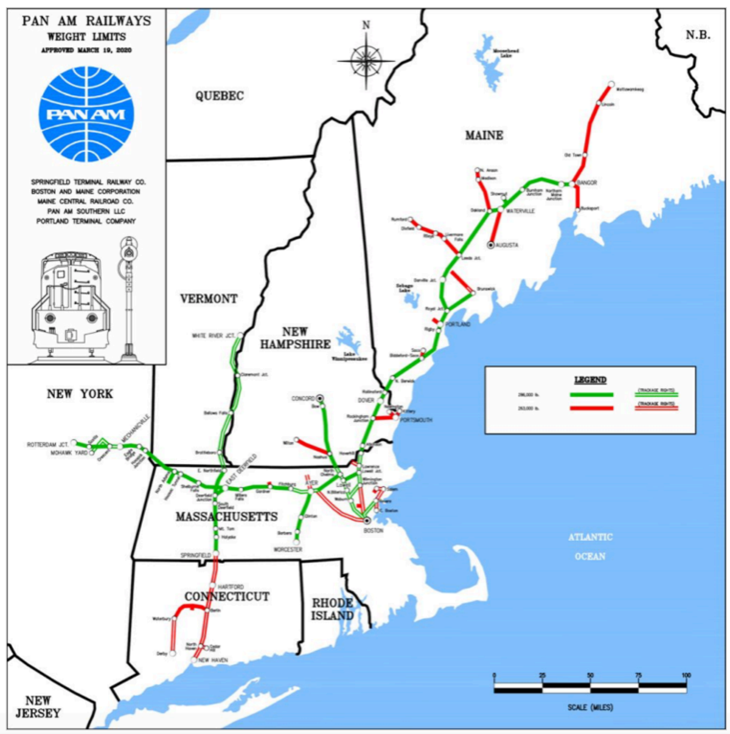
RAILROAD WEEK IN REVIEW

July 3, 2020

Pan Am Railways is for sale. At 1,700 total route-miles, it is the the largest regional railroad in North America, extending from the soon-to-be CP interchange at Mattawamkeag, Maine, to the CSX interchange at Rotterdam Jct., New York, plus branch lines. There is an east end CSX interchange at Ayer, Massachusetts, and there is a west end CP interchange on the old D&H at Mohawk Jct, NY, between Albany and Saratoga Springs. The NS interchange is at Mechanicville, New York. CN is accessed through a pair of GWR short lines.

In essence, PAR is the combination of the former Boston & Maine and Maine Central, and has been a fixture of New England railroading where, over the past 30-plus years, the NE lines have undergone numerous ownership changes. PAR is one of a handful of regional railroads with significant intermodal and finished vehicle automotive traffic (Iowa Interstate and Florida East Coast being two others.



The Pan Am Southern partnership with Norfolk Southern opens the Boston market to the latter, where CSX had been the sole provider.

Primary commodities include grain, coal, sand and gravel, food products, lumber, paper and pulp, chemicals and plastics, petroleum, processed minerals, metals, scrap metal, finished automobiles and intermodal trailers and containers.

If there were to be a sale, my preference would to be a railroad holding company such as MidRail or Brookfield Infrastructure Partners, recent purchaser of the Genesee & Wyoming properties. Railroad President David Fink has assembled a superb management team that has developed new lines of business, created a joint venture with Norfolk Southern for the mainline across Massachusetts, shared infrastructure with the Massachusetts Bay Transit Authority, added Boston-Portland Amtrak service, upgraded rolling stock, and brought on six-axle power to handle the growing traffic base.

As for valuation, *Trains* correspondent Bill Stephens writes

> Before the pandemic, interest in short line and regional railroads had been increasing as financial firms — including global infrastructure funds — joined traditional shortline holding companies in bidding for railroads that have gone on the block. And that has translated into higher valuations for railroads as investors seek long-lasting infrastructure that can offer a combination of stability and growth.

And that's what worries me. We're in an environment where the Fed is lending money to marginal companies in the name of liquidity so they can keep going. Trouble is, adding liquidity adds to the debt load and if cash flow from operations falls short of the loan covenants, the borrowing company will face a solvency issue.

How much cash flow? Investopedia provides a *solvency ratio* that measures "an enterprise's ability to meet its short-and long-term liabilities. The lower a company's solvency ratio, the greater the probability that it will default on its debt obligations." As a general rule, total debt should not exceed five times operating cash flow, and where it does you get what the financial press is calling "zombie companies." My sense is there are already too many of these among the non-class I railroads.

Finally, the usual connect-the-dots exercise does not offer up any logical players to pick up PAR in one piece. GWR already has three New England railroads, all of which touch PAR at some point, but I suspect GWR is in a cut, not add, mode when it comes to railroad names, and the Pan Am Southern relationship further complicates matters. I can't see any benefit for either NS or CSX to be a sole acquirer, nor do I see either Canadians adding PAR.

In any event, bidders will be lining up at the door — existing short lines, private equity firms, family offices, private equity firms. There may be LBO attempts, but given the "zombie company" risk (see above), I can't see any such offer succeeding. Thus I get back to my original first choice: a deep-pockets buyer that keeps present management in place.

Class I railroads have reported their Week 26 traffic data to the AAR, closing out the second quarter of 2020. The AAR's John Gray says,

> June was a month in which the slow recovery process that began in early May, began to accelerate. By the end of June, freight loadings had improved by about 60,000 revenue units weekly over where they had been in late April. The reopening of automotive plants that began in early June has regrown that business from as little as 2,000 weekly loads to over 13,000 by the end of the month.

> This also contributed to stabilization for loadings of products that support auto production such as metals, glass and plastics. However, leading the way upward was the intermodal business which, over the last two months, grew to match volumes last seen around the first of February. While all of these results are encouraging they will be much more robust if the current trend continues in the weeks following the July 4th holiday."

Looking strictly at the non-Class I railroad community, I prefer to back out commodity groups that are not primary concerns to your typical short line. The table below is encouraging because it shows merchandise carloads four points less worse off than the Class Is as a whole.

Within the broad merchandise commodity group, chemicals and grain saw just five percent declines. Forest products fell only nine percent with paper for packaging from Amazon boxes to frozen food boxes in an uptrend (BNSF EVP Marketing Steve Bobb said as much on his recent podcast with *Railway Age* editor Bill Vantuono.) Metallic Ores & Metals and Petroleum Products including LPG and asphalt dipped 11 and 13 percent respectively.

AAR NA Class Is	2020	2019	Change	2020 Pct Tot
Total Traffic	16,174,394	18,115,321	(12.0%)	100.00%
Intermodal	8,252,930	9,061,717	(9.8%)	51.02%
Total Carloads	7,921,464	9,046,312	(14.2%)	48.98%
Auto	430,304	593,389	(37.9%)	2.66%
Coal	1,645,323	2,076,398	(26.2%)	10.17%
Merch Carloads	5,845,837	6,376,525	(8.3%)	36.14%
Source: AAR thru June 27				

The recent Cowen & Co. shipper panel revealed a consensus that railroad operations are improving but customer service has suffered. The report cites customers shipping chemicals and paper in particular with chemicals constant, and paper for masks, packaging up (see above AAR commentary). A supporting report from Susquehanna Financial says that industrial merchandise car counts are "beginning to stabilize."

Back at Cowen, some customers complained about "inexperienced railroad customer service reps," questioning whether staffs have been cut too far. Yet another customer says he can rely on regular Class I sales calls inquiring about new business opportunities. Railroad over-the road service consistency is improving; first-mile last-mile not so much. Could be. I'm hearing that short lines see interchange frequency cuts adding days to transit times. Not good.