RAILROAD WEEK IN REVIEW

August 7, 2020

"A group of big buyout investors is considering a takeover bid for Kansas City Southern that could be worth more than $21 billion and mark a big bet on U.S.-Mexico trade. Blackstone Group's infrastructure arm and Global Infrastructure Partners are together exploring a potential deal and speaking to banks about financing, according to people familiar with the matter." Wall Street Journal, July 31

"Our local service compliance measure is nearly 92 percent, which reflects improved efficiencies in the handling of carload freight from the previous week as well as versus the prior month. Average car velocity held steady with the prior week. Terminal dwell was reduced but remains higher than the average level for June." — BNSF Industrial Products Network Update, July 31

"We expect industrial production will continue to rebound as the U.S. economy recovers, which will benefit manufacturing and industrial distribution companies. The housing market has been a bright spot during the pandemic. In addition to a rebounding U.S. housing market, a potential infrastructure bill would be a boon for construction-oriented industrial companies." — Morningstar Industrial Sectors Report, June 25

Kansas City Southern going private? Such would be the case if a firm such as Blackstone is the buyer. On the other hand, it has been suggested that another one of the Big Six Class Is would make a better partner, but I think it is much more likely that somebody outside the industry buys KCS, much like the deal GWR struck. Besides, the STB will have a thing or two to say if another Class I puts in a bid for KCS. Scott Group at Wolfe Research writes:

> In the US, the STB must approve all railroad mergers. We don't see any issues if Blackstone is the buyer here as the STB allowed Berkshire to buy BNSF and Brookfield to acquire GWR. However, the STB will take a close look if another railroad tries to acquire KCS. The current STB rules require any potential transaction to enhance competition for shippers. We believe the merging railroads would need to provide some form of competitive access such as reciprocal switching or trackage rights to other railroads, thus making the potential upside from such an acquisition less compelling.

Ottensmeyer and Company have done a jolly good job of making Mike Haverty's Dream come true, and its Mexico access is its Unique Selling Point, to use a marketing term. The commentary on KCS earnings calls is consistently all about creating customers. Only CSX among US railroads comes close. Norfolk, for example, is all about creating shareholder value and the customer is rarely mentioned.

Personally, I think KCS is better off remaining independent. They have the perfect management team that combines its knowledge of basic railroading with the skill to use that knowledge to increase revenue units on both sides of the border. To amplify that point, read what Cowen's Jason Seidl saith:

> The prospect of new oil drilling south of the border could prove to be a strong long-term growth driver to complement continued improvements in cross-border intermodal volume. We expect some operating leverage in the second half of 2020 and service in Mexico to continue improving, with some benefit network-wide from PSR implementation.
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> The USMCA trade agreement adds new areas of business for KCS, while the KCS intermodal franchise continues to take market share. KCS continues to be our top rail pick, as we see the benefits of the remaining cost reduction initiatives and numerous growth opportunities in Mexico and the Gulf Coast area.

Tony Hatch provides further commentary in support of a Blackstone-type transaction noting that private equity infrastructure firms have teamed up before: GWR in North America, Australia's Asciano/Pacific National, and other, smaller properties in the US — Fortress and RailAmerica, FEC, and most recently the CMQ in Maine. He adds that "infrastructure firms have some real advantages: low-cost money, a long-term outlook, reasonable return expectations, and — most of all — stability."

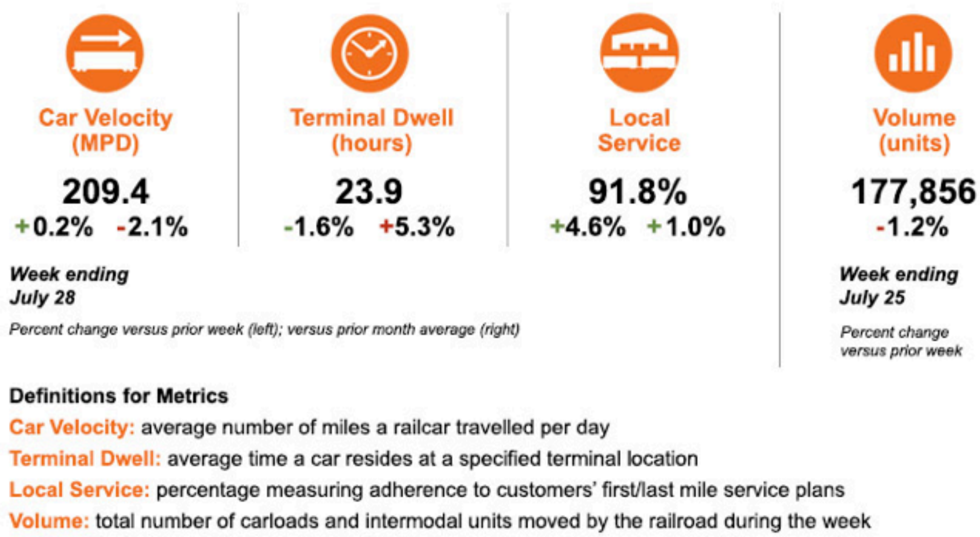
Finally, the price tag. Alison Landry of Credit Suisse writes that the Blackstone figure $21 billion implies a 20 percent premium to the "undisturbed" share price, a 13.5 multiple of trailing 12-month EBITDA, and a 15.5 multiple on the '21 consensus EBITDA. However, she adds,

> "We think KCS would require a much steeper premium, thanks to the potential upside from both PSR as well as substantial potential top line growth opportunities. It wouldn't surprise us if the intrinsic value could imply a valuation of $24 billion – or a 17x multiple on TTM EBITDA and a ~15.5x multiple on the '21 consensus. Thus we think it is fair to make the argument that the required premium would be well above this. To the extent that we are in the right ballpark, this could make a deal less palatable from an IRR perspective."

Thus I would conclude that if there is a KCS transaction it will be with a private entity, not a railroad, and the Ottensmeyer Plan can go ahead, much did the Matt Rose Plan after Uncle Warren stepped in. Waiting in the wings for Act II.

BNSF will report second quarter results Saturday as part of the Berkshire Hathaway report. Third quarter total revenue units through June 27 (Week 26) were down 12.1 percent year-over-year; merchandise carloads (all but coal and intermodal) posted a 10.0 percent decline. The third quarter is off to a good start. AAR weekly carloads through July increased four percent all-in; the year-to-date totals were again down 12 percent, with coal, autos and aggregates (includes frac sand) the largest decliners.

The BNSF website (www.bnsf.com) is chock full of useful customer-oriented tools. Take this performance tracker, for example.



For my money, Local Service performance is very helpful in planning supply chains. If you know the trip plan transit time between O-D pairs, this page shows you have odds of nine out of ten that your car will arrive according to plan. I know of no other Class I achieving TPC north of 90 (UP shows merch TPC at 76 percent). Here, July 28 TPC is 4.6 percent better than the previous week and a point better than it was a month ago.

Also of note, the BNSF Certificate of Transportation (COT) Auction Application system creates a transparent auction market for grain cars. It uses the market to allocate freight cars efficiently, thus freeing BNSF from being accused of favoring one customer over another. And, in the same way that stock market futures markets function, the trades communicate the state of current and future supply/demand for rail freight.

BNSF grain customers can get the latest COT bids and offers here. Note that there are time limits on when these auctions can be purchased, much like the strike dates on stock options. For example, the current listing shows that "August COTs, if purchased, are not guaranteed if ordered after 08/11/2020. The non-guaranteed car order deadline is 08/20/2020." This helps BNSF monitor car supply and demand while at the same time protecting customers' cars.