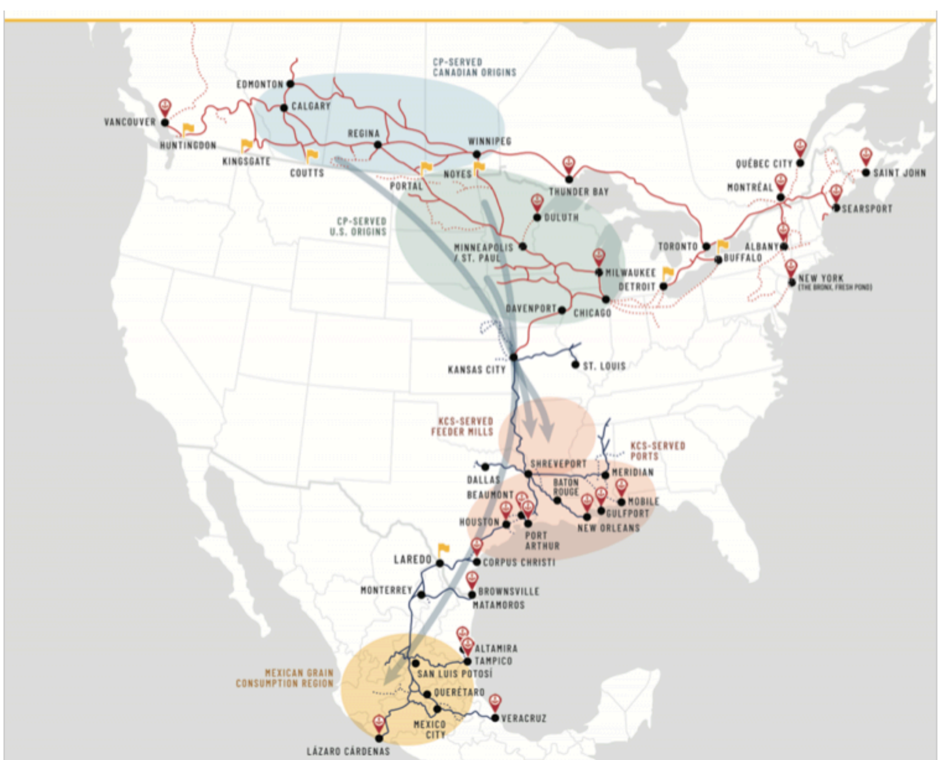
RAILROAD WEEK IN REVIEW
March 26, 2021

"Canadian Pacific Railway and Kansas City Southern have entered into a merger agreement under which CP has agreed to acquire KCS in a stock and cash transaction representing an enterprise value of approximately USD$29 billion… Following final approval from the STB, the transaction will combine the two railroads to create the first rail network connecting the U.S., Mexico, and Canada." — Canadian Pacific press release, March 21

"Joining seamlessly in Kansas City, CP and KCS together will connect customers via single-network transportation offerings… The combined network's new single-line offerings will deliver dramatically expanded market reach for customers served by CP and KCS, and provide new competitive transportation service options." — KCS press release, March 21

CP has agreed to buy KCS thereby creating a single line service from Monterrey to Montreal and from Vera Cruz to Vancouver. It's a natural fit in terms of a true NAFTA railroad, physically connecting the interiors of all three countries. How about Canadian crude and grain unit train service to Mex with finished autos and white goods coming out of Mex?

I like it. It is clean because there are no 2 to 1 concerns. It's an end to end merger allowing one waybill movements from the middle of Mexico to the Canadian core and everything in the middle in the US. *Railway Age* has the best coverage of the proposed transaction I've seen. The commodity maps are particularly helpful. Here's the grain schematic, for example.



Naturally, every time we start drawing maps of who connects to whom and where. BNSF, for one, could very well have a large dog in this fight. They are certainly well matched in the heat and eat department. Moreover, there is a lot more institutional common ground between Dallas and KC than between KC and Calgary. The $30 billion all-in figure is about 1/6 of what Berkshire says they have that's looking for a home. Imagine hooking up the Santa Fe transcon with KCS in KC. The question is which combination brings the most "durable competitive advantage" that Warren Buffett likes.

As for Norfolk Southern, I think they have their hands full right now trying to figure out what their railroad is all about. It's not clear to me what value the Meridian speedway brings to a CP/KCS combo. On the other hand the KCS/NS Meridian Speedway hits BNSF at the Alliance yard north of Fort Worth and that could be useful. See quote below.

Elsewhere, CP-KCS and NS are heavily interlaced already: Chicago - Elkhart - Detroit - Buffalo, and the CP is on NS trackage rights for their most economically sensitive segment. One of my readers who has a long history in mergers and acquisitions, writes,

> Alternatives are few should the waters turn icy and hard to navigate; revert to trackage rights on what's left of CSXT from Chicago to Detroit via Grand Rapids or go the long way around through Thunder Bay ON leaving aside US Midwest traffic. By the same token, NS reaches KCS in Kansas City from Mid-America on its own tracks and again at Shreveport LA on jointly owned (with KCS) Meridian Speedway.

Then there is UP. KCS has grain rights from Omaha to KC. The UP line segment between Rosenberg and Victoria was improved with KCS funds. The UP and KCS (Tex-Mex) cohabitate at Laredo TX where UP uses the Tex Mex bridge — improved in 2005 with a $50 million RRIF loan with covenants relating to UP — to reach KCS de Mexico. There are joint access agreements with Ferro-Mex, 26 percent owned by UP in Guanajuato State (autos) and at Tampico to reach the Altamira Port.

There is also an intriguing shortline twist. KCS also has a marketing agreement with the CN to reach Mobile, AL via the Mississippi Export Railroad and its Alabama Export Railroad subsidiary. As noted in WIR for 12/18/2020, "Canadian National has selected Alabama Export Railroad, and Ray-Mont Logistics for launching a new, innovative, high-tech logistics park in Mobile, Alabama."

And as if that isn't enough, Loop Capital Markets railroad analyst Rick Paterson notes that the STB has two sets of railroad merger rules. In the first set, "the less onerous structure that existed 1980-2000," KCS was granted an exception to operate under the old rules, not the new. How fortunate. The new rules "raise the bar" by requiring proposed mergers "to enhance competition." (The STB settled this Tuesday, writing that "Under the Board's statutes and regulations, this proposed transaction would be classified as 'Major' and would be the first major transaction to seek Board approval in more than two decades.)

Since the Canadian Loonie is only worth 80 cents US, it's useful to show the combined properties in constant US dollars —see spreadsheet on the next page. While I was at it, I wanted to see what one's return would be if one bought KCS for the $25 billion pre-debt purchase amount.

Average KCS net annual income 2018-2012 was $596 mm. By way of comparison, KCS net income increased at a CAGR of 2.4% over the last 5 years, making the projected 2021 net $611, and providing a railroad value of $32 million ten years out, assuming the original $25 billion continues to yield that 2.4 percent return.

The CSX/Pan Am Southern saga continues to play out with CSX finding fault with the several objections filed in opposition to the transaction. CSX starts by pointing out it has received 58 letters of support from customers and local government entities. This is a "minor" proceeding in that it is pro-competitive and in the public interest, being an "end-to-end extension of the CSX network." As to the selection of the GWR subsidiary to operate Pan Am Southern, CSX assures the board there will be no two-to-one loss of competitive access.

Further, the Vermont Rail interests "have not raised any competitive issues that would justify re-classifying the transaction." GWR's Berkshire & Eastern subsidiary will run PAS on a contract basis, thus protecting all previous commercial and operating arrangements with PAS. Furthermore, if there should be any perceived loss of competition, the transaction's public benefits "far outweigh any potential competitive concerns."

CSX concludes that the Board should extend the 30-day filing period for objections and comments and that "the Board should reject requests to re-classify the Transaction as 'significant' [inasmuch as] issues raised by commenting parties can be addressed" without making this a "significant" transaction.

The STB disagrees, decreeing Thursday that it will not treat this as a "minor" transaction. The February 25 application will now be considered a "prefiling notification," desiring that CSX submit by April 1 a proposed procedural schedule for a "significant" transaction. The application for the significant transaction must be filed between April 25 and June 25, 2021.

CP + KCS Carload Revenue Analysis				
Full Year ending	12/31/20			
			Year-to-Date	
	CP	**CP**	**KCS**	**Combined**
Revs $ mm	C$	US$	US$	US$
All Carload	$ 5,412	$ 4,330	$ 2,027	$ 6,357
Coal	$ 566	$ 453	$ 147	$ 600
Intermodal	$ 1,563	$ 1,250	$ 319	$ 1,569
Check totals	$ 7,541	$ 6,033	**$ 2,493**	$ 8,526
Units (000)	units		units	units
All carload	1,398.0		1,050.0	$ 2,448
Coal	260.0		179.0	$ 439
Intermodal	1,050.0		925.0	$ 1,975
Rev Units	2,708.0		2,154.0	$ 4,862
RPU	C$	US$	US$	US$
All Carload	$ 3,871	$ 3,097	$ 1,930	$ 2,597
Coal	$ 2,177	$ 1,742	$ 821	$ 1,366
Intermodal	$ 1,489	$ 1,191	$ 345	$ 795
System RPU	$ 2,785	$ 2,228	**$ 1,157**	**$ 1,754**
Income Statement				
Total Revenue	$ 7,710	$ 6,168	$ 2,633	$ 10,343
Operating Expense	$ 4,399	$ 3,519	$ 1,630	$ 6,029
Ops Income	$ 2,444	$ 1,955	$ 1,003	$ 3,447
Net Income	$ 2,444	$ 1,955	$ 619	$ 3,063