RAILROAD WEEK IN REVIEW

August 13, 2021

"The original bidder for Kansas City Southern has returned with a $27 billion offer to challenge rival Canadian National. While the price is lower and changing railroads mid-journey for a second time isn't free, reduced regulatory risk makes it a better deal for KCS shareholders." — John Foley, Reuters Breakingviews, August 10

"Kansas City Southern today announced that it has received an unsolicited proposal from Canadian Pacific Railway Limited to acquire KCS in a transaction whereby shareholders of KCS would receive 2.884 CP common shares and $90 in cash for each share of KCS common stock held." — KCS Press Release, August 10

"This decision denies a motion to dismiss filed by CSX Transportation, Inc., and Norfolk Southern Railway Company, denies as moot a request for an interim order regarding track access by the National Passenger Railroad Corporation, establishes a procedural schedule, and appoints an administrative law judge to resolve all discovery disputes." — STB Decision in FD 36496, August 6

Twelve North Carolina short lines will divvy up more than $10 million in matching grant funds being awarded as part of the NCDOT Freight Rail and Rail Crossing Safety Improvement program (FRRCSI) that exists to insure rail infrastructure health, safety, and performance throughout the state.

According to *Railway Track & Structure*s, "The program enables NCDOT to partner with rail companies on improvement projects to move freight more effectively. This partnership helps railroads meet customer needs efficiently and in cost-effective ways while preparing them for growing service demands and partnerships with new businesses and industries."

Awards go to the Aberdeen and Rockfish for $390,000 to cover a bridge project; the Alexander Railroad gets $750,000 for track, crossings and a transload; Atlantic & Western will see $430,000 for track upgrades; and Watco's Blue Ridge Southern Railroad gets $4.5 million for track and bridges.

Carolina Coastal gets $2.2 million to upgrade track (the wording of the press release makes me think the cash infusion gets them to at least FRA Class 2 track) and bridges; and GWR's Chesapeake & Albermarle wins $1.9 million for track, bridges and a transload.

I'm especially pleased to see track upgrades — assuming they get the railroad away from 10 mph FRA Class 1 or Excepted track to 25 mph FRA Class 2 track. Doing so cuts the transit time between customers in half and lets crews do the work before their time expires. The transloads tell me these short lines are looking beyond trackside to create new customers.

Canadian Pacific upped the ante for KCS. After market close Monday CP offered around $300 a share, or about $27 billion not including assumed debt. This on the heels of the Institutional Shareholder Services (ISS) proxy services outfit recommendation that KCS shareholders vote FOR the CN offer at their August 19 meeting. Their rationale:

- "The premium, valuation, and strategic rationale for the transaction are compelling."
- "While CP is soliciting votes against the transaction, it has not provided KSU shareholders with any actionable alternative, let alone one that bridges the divide between its initial offer and CNI's offer."
- "In voting to approve the transaction, shareholders would lock in the break fee. They would also advance the deal one step closer to completion."

A reader who is watching this action closely opines, "ISS puts a different light on things in this way -- STB could ignore them as they are regarded as institutional advisors. But once institutions are locked (sort of) into this guidance they will start to 'inform' their DC representatives of the desired outcome. We will soon see how much pull, if any, the Blackstones and Morgans of the world have with this administration -- assuming the messaging can get through the WH at all to the STB."

The way I see it, CN already has the competitive advantage of being the only NA railroad that reaches the Atlantic Coast, the Pacific Coast, and the Gulf Coast. CP has begun to level this playing field with its CMQ acquisition to access Saint John on the Atlantic. Buying KCS gets them to the Gulf Coast AND into Mexico.

For its part, CN restated its position in a brief press release: "CP has made another inferior proposal to acquire KCS… CN and KCS' agreed transaction remains superior and the best option for both companies' stakeholders to deliver on a combination that will enhance competition and provide new servicing options for customers." I mean, what else could CN say?

If CN prevails, CP becomes the smallest NA Class I, and who knows where that will eventually go. I'm not offering any odds — too many variables. Will the STB approve the CN Voting Trust? If aye or nay will we know before the Aug 19[1] KCS shareholder meeting? How will KCS owners vote in either event? And so on.

Keep in mind that institutional ownership of shares of each of the three railroads exceeds 50 percent. This would seem to suggest that shareholder interest will be more focused on the

[1] The KCS Board of Directors has determined, with the concurrence of CN, that if the STB has not released a public decision by August 17, 2021, at 6:00 p.m., Central Time, the Special Meeting will be adjourned to give all shareholders and the Board time to receive and consider the STB decision. If the meeting is adjourned, the Board will announce the date on which it will reconvene the meeting. — KCS press release

financial considerations than on what the combined railroads would look like in terms of customer benefit.

Consider, for example, the $700 million breakup fee KCS has paid to CP and will be reimbursed by CN. To name one financial interest, The Children's Investment Fund (TCI) of activist Chris Hohn owns about three percent of CNI shares worth some $2.8 billion and has asked CN to drop the Voting Trust scheme as "the risk of its not being approved is too great." (Recall TCI had a part in the CSX transaction that brought the Hunter Harrison team to town.)

Then there's the possibility that CP could literally break the bank doing this. And KCS could well be wary of CP now that they have been adversaries. In any event, the CP deal will generate considerable debt issuance and seems a very risky deal for all parties. There's an additional potential complexity: the STB may just be more concerned about loss of a competitive environment in some markets. What is good for the shareholders may not necessarily be in the public interest. Just a thought.

BNSF reported Q2 results last Saturday, closing out the Class I earnings reports for the quarter. Revenue increased 26 percent to $5.5 billion on 25 percent more revenue units, 2.6 million. Revenue per unit was essentially flat at $2,086, though coal jumped eight percent on mix and ag increased five percent. Intermodal dominates the revenue-unit count at 56 percent of the total. Coal is down to 14 percent of total, industrial products was 19 percent and grain was nine percent, making the merch carload sector 28 percent of total units.

Consumer Products (auto, intermodal) revenues increased on more units and higher RPU in Q2. Industrial Products revenue increased though RPU came down; YTD vols increased in 12 of 18 commodity groups reporting. The best volume gains were in grain, metallic ores, STCC 24 lumber, scrap iron, and metallic ores. The only significant decline was in crude oil.

Operating income was $2.2 billion, up 28 percent, even as operating expenses increased 25 percent to revenue's 26 percent. The OR improved six tenths of a point to a very respectable 61.8. Net income jumped 34 percent to $1.5 billion and free cash flow after capex increased ten percent to $2.5 billion.

BNSF's 2.6 million revenue unit count beat out all other North American Class Is but freight revenue increased 26 percent vs. larger gains at the US Class Is. Only UP beat BNSF in merchandise carload revenue, $3.6 billion to $2.6 billion. Makes sense since UP's system RPU was $2,600 to BNSF's $2,100. I'm not surprised. Katy Farmer, CEO at BNSF, said early on she wants to create an environment where getting to YES with the customer is a regular event AND margins are respectable. Gets my vote.