

Rails 2021: CP or CN+KSU....plus REAL-RR bidness

NARS

But I think '21's going to be a
good year/SEPTEMBER 2021



Rails Top 10 Pandemic/Recovery 21-?-

1. Covid (duh) – Delta Blues-Not done quite yet
2. The Shark’s Tooth – How RRs handled the down & the ups- and now everyone knows what a “supply chain” is!
3. Uncertainty/Visibility/(Lack of) Guidance – Getting Clearer (or is it?)
4. Accelerated (Not Altered) Trends
5. Intermodal! (see #4)
6. Zooms and (Rail) Trends (now we’re going back Live!
7. Technology – from Portals to Pulses: Tu Simple!
8. ESG
9. Ag
10. Globalization/Slowballization/De-Globalization

Recurring and Accelerating Rail Trends

(Not to be confused with RailTrends November 19-20!)

- The Mix Shift Towards Higher Levels of Service

- The Parallel Faster Decline of Coal

- The Continuation and Success of PSR

- The Continuing “Cult of the OR”

- The Continuing Fight over FCF – Share Buybacks “vs” Capex

- The Consistent “Hype” of EV & AV Highway Competition (response?)

- The Remaining Importance of Trade (and Tariffs Remain)

- Solid Financial Results/Good Cash Flow & Capital Access

- The Continued Lure of M&A in short lines/regionals

- The Continued “Hype” on the Value-Trap of Rail Consolidation

5 Enduring (?) Railroad Competitive Advantages

1 Labor Advantage

(ex: Double-stack LA-Chi – or Rupert-Toronto)¹

2 Fuel Advantage

(4:1 ton/mile; AAR)²

So 2A is Environmental Advantage (see....WMRT, Unilever, etc.)

3 Infrastructure Advantage

(after the IHS buildout; user-pay and capex to support changing logistics patterns – ex: transcon)³

4 Railroads' Excellent Financial Condition, Liquidity, Free Cash flow

5 Railroads' Historic Ability to Reduce Expenses in a Known Slowdown (2009, 2020)⁴

1. AV trucking?; 2. EV Trucking?; 3. Infrastructure Bill? (LOL); 4. Newly Added (in response to C19)

New Administration: A Return to “Normalcy”?

- **STB Impact?** *Even more relevant*
- **Infrastructure?** *Talk and Action?*
- **Crew Size!!** (FAST Act Re-auth)
- **Emissions, etc?** *Plays to RRs/ESG*
- **Ethanol?**
- **Amtrak & Passenger?**
- **Trade!!** *The only unequivocal good (?)*

Dealers' Choice? Deal-Fever in Short Lines (still)

- Many small recent deals (by OmniTRAX, RJ Corman, etc.)
- Watco-Dow deal a new prototype?
- On the market: US Steel lines, many others BTR
- Off Market & Smaller Deals (ex. SLGW)
- Spanner in the works? Problematic STB?
 - Massena Lines & lawsuits
 - *Pan Am still "Incomplete" (NEARS)*
 - *WC-Watco*
 - KSU?
- Buyers (all with different CoC, timeframes, ROI expectations):
 - Strategic (above)
 - PE (and PE/partner)
 - Infrastructure Firms
 - Class Ones as sellers (CN?) and/or Buyers (CP-CMQ, CSX-PAR?)

2020:KSU Shows Up & the Rumor Mill (Again)

- Sized right for Infrastructure Funds (partnerships) - other C1s too big – so *this*, would have not been the start of a trend (rather, the culmination of a trend in regional rails)
- *A financial deal doesn't require STB approval*, (at least not YET....) or change the competitive landscape much, if at all (except by adding capital and/or tech)
- Infra funds can provide capital (“velocity of capital” – KSU *generates* plenty of capital)
- Infra Funds remove companies from the Q-to-Q –
 - Despite “Cult of the OR”, rail investors are actually patient
 - But advantages of LT strategy are apparent in dealing with opportunities & existential threats
- The rumors this time were *specific*: Blackstone & GIP (so who leaked?) - \$20B (and maybe a second offer?)
- And then the old-C1 rumors re-emerged....

Rails Summer 2021 – Realities & Perceptions

- RR investing themes (managers & investors) move from *“Cult of the OR”* (alone) to
 - Growth
 - Technology
 - ESG
 - COMPARISONS – mostly useless *and* about to get harder in H2/21
 - Rails modestly trail the market H1/21
- Rails get unofficial “B+” for H2/20 Recovery (both operationally & financially)- and by ASCE
- Rail Q2/21 EPS – 4 “wins” 2 “losses” (mild – but CN & KSU, interestingly)
- But....Today it’s a “C” as Rail Service is an issue (again) – perception & reality
 - ACC and other Shipper groups
 - House T&I Committee
 - STB commentary
 - Churchill: *“never let a good crisis go unused!”*
 - Rail metrics improving by the end of the quarter into summer – *but NOT (YOY) RR traffic*
- As Supply Chain “fragility” tests globalization, sparks inflation
 - A truly worl-wide issue – ocean, ports, rails & trucks, warehouses, shippers
 - JIT to JIC actually benefits rails
 - Near-shoring?
 - Front page news!
- Add Consolidation to the mix....giving the STB an opportunity?....
- Add the White House to the mix....

Executive Order (& Leak) Sows Confusion

- Biden's EO against power consolidation/BIG business includes rail
- Clearly a late addition
- Leaked as "part 2" to the WSJ, the scoop send sends RRs stocks down
- So....2 paragraphs/page 9 (*"Is That All There Is?"*) – *only an Encouragement (STB is "very, very independent")*
 - *Advises freight rail to work with Amtrak (remember the POTUS nickname)*
 - *Suggests "fairness"*
 - *NO mention of current M&A (KSU); almost definitely coincidental*
 - *DOES provide "cover" for the STB opposition to the merger (if....)*
 - *DOES support the consistently public statements by the STB/Chairman that RRs have too much power and are:*
 - *Monopolistic (EO suggested Duopoly)*
 - *Overly focused on cost - & headcount – reduction*
 - *"In bed with Wall Street", in thrall with PSR*
 - *So consistent with existing STB viewpoints*
- *Most likely outcome: HEARINGS!*

Rail Mergers Since Staggers

- *SFSP – in trust, rejected*
- *Short line creation “golden age”*
- *UNP – CNW then SP – disaster averted, barely*
- *BN+SF*
- *CRR split between NSC & CSX – Lights out*
- *CN bucks the trend – IC, BCR, WC, GLT – and the J*
- *So CN+BNSF leads to....**Moratorium!***
- *KSU exemption*
- *Moratorium expires, M&A still on hiatus*
 - *Shipper Anger/STB “switched sides”*
 - *Gains overwhelmed by “conditions”*
 - *“Railroad renaissance” & Pricing Power & technology & PSR*

Rail Merger Attempts 21st C

- CP's attempts at CSX and NSC are *radically different* from C?+KSU
 - Anticipated value creation was EHH/PSR in a US carrier NOT the combination
 - Rejection was obvious, no formal filing (not relevant in trust discussions)
 - ALL stakeholder groups opposed (remember the "J"!) except one – investors
 - By delinking EHH & CP, Mantle Ridge won proxy fight at CSX by pleasing the only stakeholder group that matters in that case (no STB, though they were..."concerned")
- PSR sweeps the industry; no baseline year to truly show the pivot to growth (though CP and KSU lead the industry) – *THIS IS A GOOD THING – let me explain....*
- Class Ones sell lines (CSX, CN) then turn to buying them (CSX, CP)
- Infra attempt(s) at KSU – *"flushes out an interested party"*?*

**at least I hedged myself*

Some RR (KSU) Consolidation Thoughts/FALL 2020

- RR Consolidation – by which I mean FINAL rail consolidation, involving the US “Big 4” - isn’t simple (see IT/operational/cultural integration)
- RR Consolidation history isn’t pretty – but there would be no **Railroad Renaissance** without the mergers
- **Full RR Consolidation will be opposed** – FOLLOW-ON EFFECTS - shippers, unions, regulators
 - See the aborted CP-NSC effort (and CP-CSX)
 - See active STB on CSX-CN “Massena Lines”
 - See Newly-Active Mexican regulator; AMLO
 - Doesn’t meet the “Matt Rose” provisions – failing/flailing railway, shipper need for capacity
- Risks – Access, other deal-breaking provisions (“Approved BUT....”)
- Mexican Risks – AMLO, PEMEX, near-shoring “hype”

CP+KSU = ?

- INITIALLY \$275 (FACE PRICE) 20%+ above last (published PE) offer; closing price
- Carries **OLD-RULES** regulatory risk but also has upside
- **Can be seen as a *stabilizing force* for the industry**
 - Keith Creel locked up
 - Two smallest C1RRs combine (to form the smallest C1 but, still....)
 - KSU, always seen as the (Sumter 1861/Sarejevo 1914) *flashpoint*
 - North/South in an East/West (US) world
- This is a very different deal than the foundational post-Staggers deals
 - **End-to-end, no 2:1 points**
 - Value creation is driven by *synergies not economies* - thus
 - *Integration risks much lower than in the past*; technology is better (KSU a leader)

Risks & Reactions?

- **STB wants a vehicle to intervene (IMHO)** – but this (THAT isn't it
- Mexico is always a wildcard (starting with AMLO see KSU history) but
 - there isn't a *valid* reason to intervene;
 - cross border shippers have been frustrated with Mexican service and can see CP as an operational
- Canadian authorities and shipper orgs seem ecstatic – CBR, Ag
- April 1 (Fools Day) is key date for opposition – some may be created simply opportunistically
 - **The expected “line around the block” looking for handouts; “backing for bucks”**
 - Most negotiations will be private (see PAR – CSX+GWR+NSC)
 - What will impacted rails (UNP, BNSF, CNI) do? Seek delay by asking for exemption removal?
 - What will CP/KSU offer? See Robbstown, etc
 - KCSM still needs UNP, BNSF

ABH *Original* Bottom Line – CP+KSU

- There will be a trust (check)
- This will pass, with or without exemption (Exempt!)
- There will be concessions and not all of the long-haul, “looks good on the map” opportunities will pan out (see Iowa and a 10mph rail)
- Nonetheless the synergies level from the webcast will prove conservative (see CMQ example), although of course we await details
- Mexico and cross border/near shoring represents both the greatest long term risk – and opportunity
- This is not the “flashpoint” for rail consoli-meggedon
 - Injuries to other C1 RRs relatively minor and recoverable
 - The rail system is still by far an East/West network
 - *Any Big 4 combination will trigger massive shipper, congress & STB reaction*
 - *Conditions imposed very likely outweigh benefits (that PSR – and technology can come close to solving, anyway)*
 - *No failing carrier on the horizon; no systemic shortage of capacity (PTC, etc)*

Uh Oh – Enter CN!

- CN surprises CP, KSU, shippers, me....HOW?
- Big increase in price (+\$5B) - \$325 FACE PRICE
- (Voluntarily) Non-Exempt (new rules)
- Approvable Deal – with some challenges
 - Overlap of CN's Illinois Central & the KCS in MS/LA
 - Brings in (petro) chemical shippers, strong lobbyists
 - Better opportunity for long haul N/S intermodal
 - CN had argued for KSU losing "exempt" status
 - Much more *destabilizing* for the industry, leaving CP & KC twisting in the wind
- STB back in play and in a Big Way
 - Not Happy about Wall Street
 - Not Happy about PSR
 - Not happy about future Mergers

What's Next? Wait for the STB....

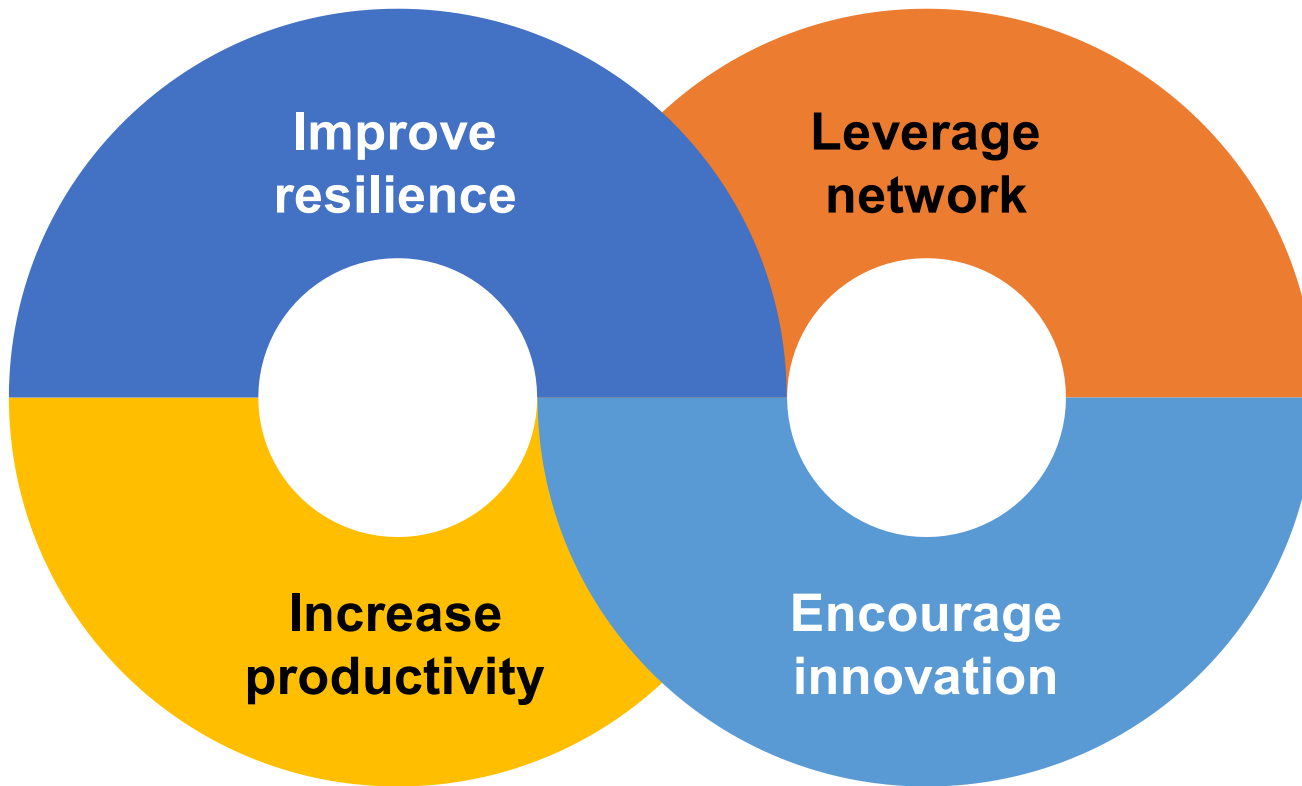
- CP has synergy “wobble room” (*yep!*) – but holds to no bidding war – *NOPE!*
- CP utilizes political strategy – *still*
 - Wins exemption
 - Fights a “fantasy bid”?
 - Suggests MAD (Dorgan, Keith, etc)
 - Plays underdog’s hand quite well; adjusts to changing perceptions (“stakeholders” etc)
- War of the Words – and it has gotten personal
 - Battle by press release – now over – or, *it is supposed to be!*
 - Virtue Signaling – Gates, ESG
 - Shipper vs Stakeholder Support
 - CN sues the STB! (Over the Massena Lines)
 - CN puts LA trackage up for sale (lots of buyers) – enough?
- Changing STB – **THIS is critical**
 - *Wants RR power reduced, Street influence diminished, PSR abolished!*
 - 2 Sets of rules? YES
 - Outside Influence? (shippers, Defazio, Durbin, etc) How independent? How public?
 - **Key – will CN get a VT – and when? Or is this how STB stops further/final consolidation?**

KSU Update – The Waiting is the Hardest Part

- STB, ignoring investors, states it can (will?) take till 8/31 to decide on CN's VT
- Proxy advisors decide "yes" on CN proposal, then reverse to "abstain"
- Prior, CP reverses longstanding position and *raises* (face-price) bid for \$275 to \$300 (vs f/p \$325 from CN) – an "*actionable alternative*"
- (In response) KSU postpones 8/19 shareholder vote
- Reminder – *old rules (CP's proposal) vs new rules (CN's)*
- If CN's bid passes "public interest" (undefined) test, and is approved – *game over* (though still requiring approval)
- If CN's VT is rejected, then "*it depends*"
 - An ill-defined rejection (perhaps to hold off on court appeals) – CN may proceed with merger attempt (but CP could....)
 - A sharply (negatively) defined rejection (from a so-far very *wordy* STB) and they may walk away – leaving a) CP alone on the playing field or maybe even b) no merger at all

STB says “NYET” to CN’s VT; TCI gets Active

- The STB *unanimously* turns down the VT application, with nods to “Downstream Effects”
- I expect that’s game over for CN proposal
- I expect that’s game over for future consolidation (on *this* I agree with Marty!)
- KSU pivots back to CP – their deadline for their \$300 (F/P) bid is September 12 (expect a decision at midnight)
- Succession issues remain
- TCI (remember them?) owns 5% of CN (and shades of Jay Gould, 8% of CP!) and issues a challenge:
 - Jim Vena to replace JJ
 - OR “gap” must be closed, pivot *away from* growth!
 - Letter seems rushed (typos) & inaccurate (in OR accounting)
 - But activists, including TCI-CSX, are 3-0 in the modern era



Response Has Been Muted – at first

- PTC completed (almost) – provides the potential “backbone for the digital railway”
- Offense or Defense?
- Many successes on the Operations side – *defensive* measures like Car/Track inspection
 - which does lead to lower costs/greater consistency/more capacity – all of which can be sold “offensively”
 - Most CIOs report to the COO
- Chief *Innovation* Officer – KSU
- Efforts on Fuel (thus Emissions) Efficiency (ESG tactics)

To meet coming “existential threats”, Rail Tech/Innovation is Accelerating (T10)

1. Inspection Portals (from CN to the world)
2. Track Inspection Cars (at speed) and other preventive MoW)
3. New loco power (BN-WAB, PHL, **CP!**)
4. Rail Pulse – a game-changer (and other EODB efforts)
5. Moving Blacks/Quasi-moving Blocks (BNSF) – unlocking PTC
6. Outside Investments – CN/UP+Tu Simple; KSU (etc?)
7. Big New Hires at CN (WAB) and UNP (WMRT)
8. Simulation (UP’s “Train Builder”)
9. Remote meetings, virtual crew offices, zoom (sigh)
10. AVR – the “Holy Grail”, change the RR strategy? Terminals.....

Coal Continues to Slide

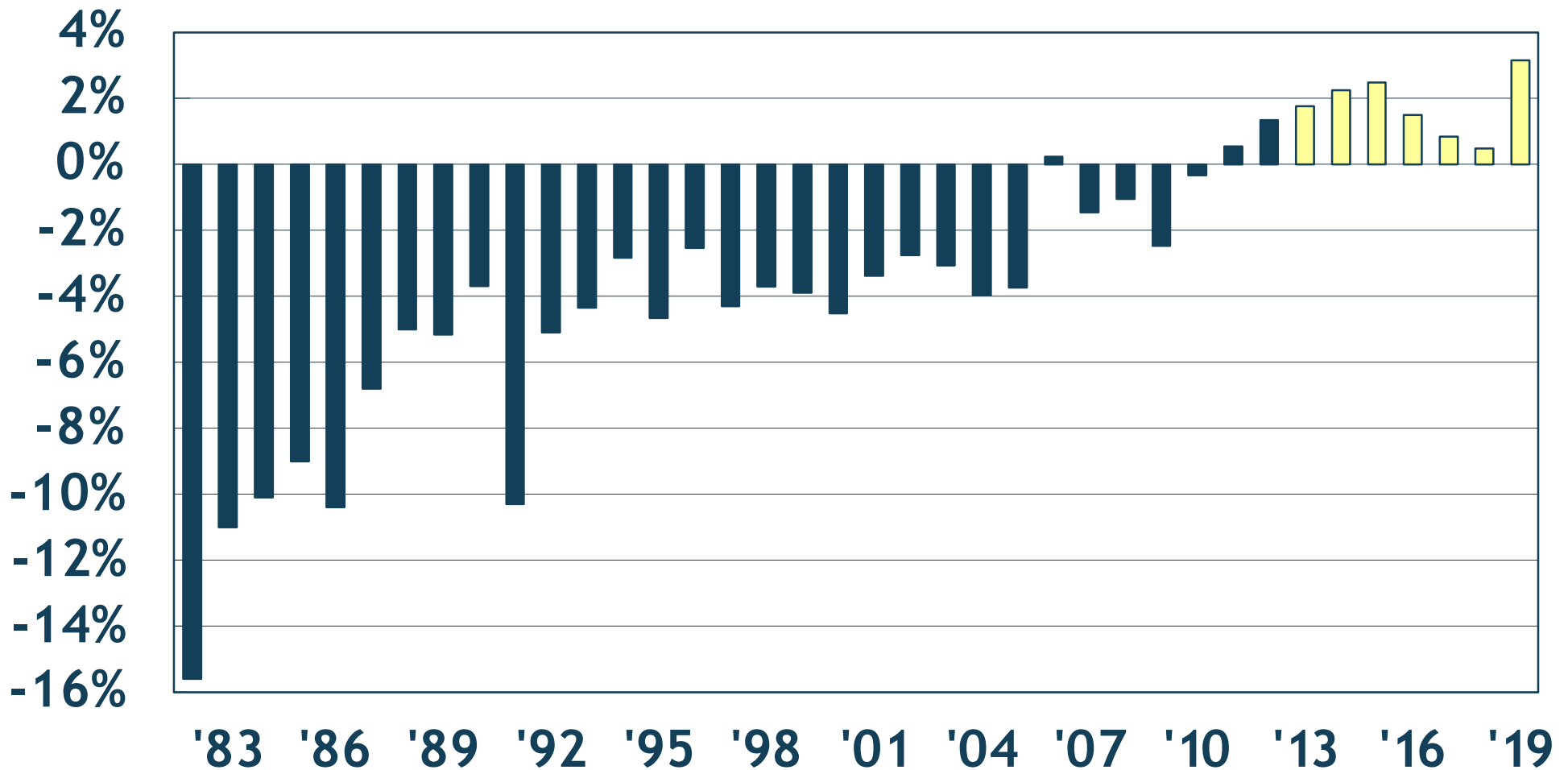


% Share U.S. Electricity Generation

	2000	2005	2010	2015	2019	2020*
Coal	52%	50%	45%	33%	23%	19%
Natural Gas	16%	19%	24%	33%	38%	41%
Nuclear	20%	19%	20%	20%	20%	20%
Renewables	2%	2%	4%	7%	11%	12%
Hydro	7%	7%	6%	6%	7%	7%

*Jan-Oct Source: EIA

Spread Between Rail Industry's Return on Investment and Cost of Capital



*In 2006, the Surface Transportation Board significantly changed the method by which it calculates the rail industry cost of capital. Source: STB

Person of the Year

NARS recognizes
Tony Hatch
with the
NARS 2019 Person of the Year Award
for his steadfast support of NARS and its regional associations.

*Thank you Tony for your guidance, dedication and service
to NARS and its regional association!*





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