Lending to Small Railroads

Presented by Rob Hart
for the Northwestern University Transportation Center
Sandhouse Gang
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Deconstructing the Railroad Industry

Amtrak
Commuter Railroads
Tourist Railroads

Class I Railroads
Class II Railroads
Class III Railroads

563 Railroads*

* AAR, 2007
Deconstructing the Railroad Industry

Class I Railroads
• 7 companies (CN, CP, BNSF, UP, CSX, NS, KCS)

• Revenue: $63 bln (add $1.8 bln for FXE, KCSM)

• 90% + of revenue, carloads, employees, etc.

Class II Railroads
Class III Railroads

* AAR, 2007
Deconstructing the Railroad Industry

Class II Railroads
Class III Railroads

556 Railroads
$2.3 bln total revenue*

a/k/a “Small Railroads”

* AAR, 2007; $3 bln total revenue per ASLRRRA, 2009
### Deconstructing Small Railroads

Different Characteristics….

<table>
<thead>
<tr>
<th>Type of RR</th>
<th>No. of RRs</th>
<th>Miles Operated</th>
<th>Avg. Length</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regional</td>
<td>31</td>
<td>17,073</td>
<td>550.7 Mi</td>
</tr>
<tr>
<td>Local Line Haul</td>
<td>309</td>
<td>21,855</td>
<td>70.7 Mi</td>
</tr>
<tr>
<td>Switching &amp; Terminal</td>
<td>205</td>
<td>7,546</td>
<td>36.8 Mi</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>545</strong>*</td>
<td><strong>46,474</strong></td>
<td><strong>85.3 Mi</strong></td>
</tr>
</tbody>
</table>

*ASLRRRA, 2004*
### Deconstructing Small Railroads

#### Different Ownership....

<table>
<thead>
<tr>
<th>Type of Owner</th>
<th>No. of RRs*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shipper</td>
<td>72</td>
</tr>
<tr>
<td>Government</td>
<td>29</td>
</tr>
<tr>
<td>Class I</td>
<td>18</td>
</tr>
<tr>
<td>Private/Other</td>
<td>426</td>
</tr>
</tbody>
</table>

*ASLRRRA, 2004*

- Public Companies
- Private Holding Cos.
- “Ma & Pa”
“Private/Other” Small Railroads

Examples of “group operators” of multiple railroads:

<table>
<thead>
<tr>
<th>Genesee &amp; Wyoming (63 RRs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>RailAmerica (42)</td>
</tr>
<tr>
<td>Watco (20)</td>
</tr>
<tr>
<td>OmniTrax (17)</td>
</tr>
<tr>
<td>Gulf &amp; Ohio (8)</td>
</tr>
<tr>
<td>Pioneer Railcorp (15)</td>
</tr>
</tbody>
</table>

Sources: Company websites
Private Investors expected to make (lots of) money acquiring “unprofitable” Class I routes (“branch lines”)

- Penn Central & Conrail & Staggers & 1981–83 recession: too many miles, expensive people, railcars & not enough loads
- Class Is: Lower expenses and capital spending to improve cash flow
- ICC makes it easier to sell than abandon
- Labor protection is modified to reduce legacy costs
- Result: One man’s problem is another man’s opportunity….  
  o ICG: East Miss.; Midsouth; Paducah & Louisville, Chicago Central
  o Wisconsin Central
  o Montana RailLink
  o Iowa Interstate
  o Railtex
  o Genesee & Wyoming & many more

- Why did it (mostly) work out?
  o Lower labor costs and minimal work rules
  o Got closer to the customer to grow “the top line”
  o Surplus locomotives and railcars available to lease
  o Track and bridges were good enough
  o Two or more Class I connections
  o Supportive commercial banks
Capital Needs of Small Railroads

- Working Capital
- Maintenance of Way
- Equipment—Locomotives, Track Machinery
- Acquisitions

...capital needs not much different than large railroads ($ are smaller)
Sources of Private Sector Capital

Where do companies get outside funding?

• Equity
• Public Debt (Bonds)
• Private Placements of Debt
• Leasing
• Bank Loans
Small Railroads have Limited Access to Capital Markets—Why?

- Too small
- Inadequately capitalized
- Inadequate financial reporting and disclosure
- Don’t fit the institutional “box”
- Not profitable
Sources of Capital for Small Railroads

Public Sector:
- State Grants and Loans
- FRA/USDOT Grants and Loans (“RRIF” Program)
- Short Line Tax Credit (indirect public support)

Private Sector:
- Commercial banks!
Bank Lending from the Inside
DON’T MAKE BAD LOANS!

• Banks are depository institutions (“demand deposits”)

• Bank failures were commonplace from 1776 to 1932 and caused numerous “Panics”
• Inadequate liquidity reserves and inadequate capitalization when loans went bad

• Regulation is designed to protect depositors so each bank is reviewed
  o Assess quality of loans—every loan and every borrower has a risk rating
  o Assess quality of decision-making to lend or not—“risk analysis”
  o Assess quality of ongoing monitoring of loan portfolio

• Regulators (“bank examiners”) are risk averse

• Trend over last 10 years or so: use mathematical models to calculate a risk rating

• Why? “Transparency; Objectivity; Standardization”

• Risk rating models use historical financial results to calculate the risk rating; ratings change as the borrower’s financial performance changes.
What is Credit Risk?

• The risk a lender takes that a loan (P&I) will not be repaid.

• Credit Analysis is to assess this risk.
  
  o What is the deal?
  o What is the risk?
  o Given the risks, why make the loan?
  o Is it worth it to take the risk? – Risk v. Reward
    ❑ Adequate return on the lender’s capital = adequate compensation for taking the risk

• The only “upside” for a lender is getting repaid with interest!
How does the loan get paid back?

• What is the Primary Source of Repayment?
  
  o “Free Cash Flow” is defined as:

  Net Operating Cash Flow (Profit plus Depreciation + Decreases in Working Capital Assets)*
  -- Cash Taxes
  -- Capital Expenditures
  = Cash left over for Interest, Principal Payments and Dividends

• What is the Secondary Source of Repayment?
  
  o Liquidate the Collateral

* Another conventional definition of cash flow is EBITDA: Earnings Before Interest, Taxes, Depreciation and Amortization
Problems with RR Collateral

Recovery is uncertain v. the public interest

Assuming the bank can foreclose, what then?

- Locomotives and railcars are easy to liquidate
- Working capital assets—accounts receivable; inventory
- Track structure—net liquidation value of ties, rail, OTM, ballast
- Real Estate—what is it worth laying under the track?

Value of the parts in liquidation doesn’t equal value of going concern
Borrower might not own the track!

Different Ownership of Mileage Operated...

<table>
<thead>
<tr>
<th>Type of Owner</th>
<th>Mileage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owned</td>
<td>27,730</td>
</tr>
<tr>
<td>Leased</td>
<td>3,841</td>
</tr>
<tr>
<td>Trackage Rights</td>
<td>5,026</td>
</tr>
<tr>
<td>Government</td>
<td>9,167</td>
</tr>
<tr>
<td>Other</td>
<td>710</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>46,474</strong></td>
</tr>
</tbody>
</table>
Railroad Lending is Cash Flow Lending

- There has to be enough Free Cash Flow for debt service (strong primary source of repayment)

- The Bank can’t depend on collateral recovery (weak secondary source of repayment)

- Starting point to analyze Free Cash Flow is:
  - historical financial performance
  - the 5 yr. financial forecast
We can’t predict the future…what can go wrong?

What are the risks that the Free Cash Flow won’t be large enough to repay the loan over time?

Even the best financial projections are uncertain, so what are the risks they are wrong?

- **Business Risks**
- **Financial Risks**

Risks can be mitigated by:
- Facts about the business or industry
- Terms and conditions of the loan

…but risks can’t be mitigated away completely (unless you give the Bank a cash deposit)
Business Risks for Small Railroads

Is there something about the railroad that could affect future Free Cash Flow?

• Quality and experience of management

• Diversity of commodities (how cyclical are they?)

• Number and diversity of shippers (what drives demand for their products?)

• Size

• Labor relations

• Legal and regulatory matters

• Quality/adequacy of track, bridges, signals, locomotives, railcars—Safety, 286K, etc.
Financial Risks

Is there something about the capitalization of the business that could affect Free Cash Flow?

If the small railroad has:
• Other debt obligations
• Lease payments
• Tax payments
• Dividends

  o Is there enough cash flow to meet all these obligations?
  o How do these payment obligations rank in priority compared to the Bank’s loan?
  o What claim do these obligations have on the assets (collateral)?
  o What is the relative priority of the Bank’s claim on assets?
  o Is there enough cash to get through bad times? (Liquidity)
Loans have shorter terms than other debt
Lines of credit are preferred over term loans—they are more liquid to the bank
Term loans will mature in 3–7 years and have a shorter duration
Bank loans charge interest based on floating rate benchmarks (no interest rate risk):

- “Prime Rate” set by the banks from time to time
- London Inter-bank Offered Rate (LIBOR) a Eurodollar market interest rate set daily

Railroad loans are cash flow loans, so loans are monitored with financial covenants:

- Leverage ratio: Maximum Total debt divided by EBITDA [low is better]
- Fixed charge coverage ratio: Minimum ratio of FCF/(Capex + Taxes + Debt Service) [high is better]
- Minimum Tangible Net Worth: Tangible Assets – Liabilities [more TNW is better]
Typical small railroad bank loan credit facility

**Term loan secured by all assets**
- Matures in 5–7 years
- Floating rate, Prime or LIBOR plus a spread
- Closing fee
- Purpose: equipment, track maintenance programs, acquisitions
- Fully amortizes, but sometimes a small balloon payment at maturity
- Financial Covenants monitored monthly or quarterly
- Audited financial statements required annually
- Limitations on other debt, dividends

**Secured revolving line of credit**
- Matures 2–3 yrs.
- Purpose: working capital; letters of credit
- Floating rate, Prime or LIBOR plus a spread
- Closing and Unused fee
In Conclusion:

- Defined Small Railroads
- Describe different attributes affecting creditworthiness
- Emergence of Small Railroads since 1980
- Defined credit risk and credit analysis
- Discussed capital needs and barriers in the capital markets
- Identified sources of capital
- Discussed bank regulation and why loans are the way they are
- Railroad lending is cash flow lending
- Figure out what can go wrong with the cash flow and what to do about it
- Defined a typical small railroad loan package