Rail Renaissance: Returns, Capital & Capacity

AB HATCH abh18@mindspring.com
SANDHOUSE GANG/NORTHWESTERN
DECEMBER 1 2009::
Railroads at historic tipping point

- The *Railroad Renaissance* is here – *will it last?*
- Capacity issues across all modes – *or so we thought?*
- Volume increasing – *right?*
- Share, rates, service levels (yes) – and returns increasing
- *But pushback (shipper/regulator/union) also increasing!*  
- A secular, not a cyclical story – *right?*
- Capacity and infrastructure – and competitor - issues remain
- *Fully reflected in the market? Or is this just another cyclical slowdown?*

**NET/NET**-

- *The industry is poised to go up – or down – based on decisions made here & now*
Railroad Performance
Class I Railroads

Source: *Railroad Facts, AAR*   (Based on a design by R. Gallamore)
Street influence on RR$s – and Why that affects ALL stakeholders

- Battle for cash
- Management’s reactions to pressures
- Investors, competitors, regulators, politicians, labor – oh, yes, and customers
- Short term decisions/long term consequences
- *Remember 2004!* (?)
- Which “bucket” will they place their chips?
ARE ALL CONNECTED!

Virtuous Circle ('03-07) or Disinvestment?
Key Class1 Issues in Recession ‘09

- Re-regulation Bigger Threat than Ever
- Rates (versus Volumes)
- The Economy
- Service
- Green Ramifications
- Stimulus, MAP21, ATRK, “High” Speed Rail (ONERail)
New Sources of Capital – Threat or Opportunity?

- Fortress-RailAmerica/FEC (etc)
- Infrastructure Funds (Toll Roads)
- Hedge Funds & “Activists” (TCI)
- PPPs – Heartland, Nat’l Gateway, CREATE
- Share repos
- C-1 Buyouts (DM&E)
- JVs – Meridian, Patriot corridors
Threats to the Renaissance

- Cyclical vs. secular argument
- New Congress – impacting labor & shippers
- Mandated Reviews – STB, Canada
- Rereg – the MAD answer
- Execution: service
- Execution: merger
- Hedge funds?
- Liquidity?
Warren’s $44B “all-in” bet

- Advantages of going private? (capex cycle)
- Influence in DC
- “Robber Baron” vs. “Sage”
- Bets not (just) on economy – rereg, coal, western intermodal
What happened to the “end of the cycle”?  
Thinking strategically vs. tactically?  
Panic Mode?  
Passenger the new lead dog?
North – or South – of the Border

- Canada as the new model for rail regulation?
- NAFTA review?
- The “J” (& The MidAmerican, etc)
- Auto Restructuring
- Customs/Border issues
- Detroit tunnel?
- Rebirth of passenger rail?
- RR Days on the Hills
S&P 500 and Railroads
Monthly Data January 1980 – April 2007

Index Jan. 1980 = 100

Sources: MSN and CSI, Inc.
Change in U.S. Railroad Non-Intermodal Carloads

Source: AAR Weekly Railroad Traffic
Change in Canadian Railroad Non-Intermodal Carloads

Source: AAR Weekly Railroad Traffic
Change in U.S Railroad Intermodal Units

Source: AAR Weekly Railroad Traffic
Change in Canadian Railroad Intermodal Units

Source: AAR Weekly Railroad Traffic
Railroad Intermodal Revenue Growth Over 5% - Long Live the New King!

Source: Carload Waybill Statistics (includes non-Class I railroads)
Intermodal was the Top Source of U.S. Freight Rail Revenue, but Coal will be Number 1 in 2008

*Data for BNSF, CSX, KCS, NS, and UP  Source: Railroad financial reports
Source: Association of American Railroads’ *Weekly Railroad Traffic*
U.S. Railroad Intermodal Traffic
Trailers vs. Containers (millions)

Source: Association of American Railroads’ Railroad Facts
Intermodal Growth Drivers
Domestic and International

- Globalization
- Trade
- Railroad Cost Advantages
- Share Recovery From Highway
- Truckload Issues
Railroad Return on Equity
Class I Railroads

Source: Railroad Facts, AAR
RR CoC vs. ROIC – RR Stocks have done well but… they still trade at a discount to all stocks

Source: Surface Transportation Board
Note: Cost of equity estimation method changed by Board effective 2006 and 2008.
Railroad Capital Expenditures
Class I Railroads

Source: *Railroad Facts*, AAR
Class I Railroad Capital Spending vs. Net Income

(Current Dollars)

Source: Association of American Railroads
Is growth affordable? Capex up 10% in ’07, up 12% in ’08, so far only down 5-10% for 2009F.

One rail cuts, most increase capex during ’07.

What will 2010 look like? (long term growth v short term weakness)

Is additional capacity necessary? Desirable?

Can the intermodal model extend to carload?

Wall Street’s constrictive role (“fighting the last war”) – is it changing?

Is this disconnect between the Renaissance and the Street the opportunity of a lifetime?
Future Demand for Freight Transportation Will Continue to Grow

*Billions of Tons of Freight Transported in the U.S.*

- **2002**: [Bar chart showing approximately 20 billion tons of freight transported]
- **2035p**: [Bar chart showing approximately 35 billion tons of freight projected]

p – U.S. DOT projection
Future Corridor Volumes Compared to Current Corridor Capacity

2035 without improvements

- Green: Below capacity
- Yellow: Near capacity
- Orange: At capacity
- Red: Above capacity
Railroad Rates - the old story
Class I Railroads, Revenue Per Ton-Mile – another (related) New Paradigm

Cents

Constant $: Down 49% since 1980
Current $: Up 17% since 1980

Source: Railroad Facts, AAR
Rail Employment is Up for the First Time in Decades

Total Class I Employment: Jan. 2001-Nov. 2008

Source: Surface Transportation Board
Railroad Employee Productivity
Class I Railroads, Ton-Miles Per Freight Service Employee

Source: Railroad Facts, AAR
Rail Service Cycles

- Is the recent improvement in the metrics sustainable? Systemic?
- Is it a product of huge capex injection and IT?
- Or, is it merely a product of lower volumes/less stress on the network…
Rail Regulatory Risk

- Biggest Uncertainty Entering ’09
- Safety Bill done
- “Competition” Bill (“M-A-D”) vs Anti-Trust
- STB makes it 3-straight shipper “wins”
- Rocky & The Dark Star – new horror movie?
- Cost of Capital Revision shock
- Mandated STB, CTA “Reviews”
- AAR/RAC/ASLRRA have great “D” but hard to score on defense
Tax Incentives to Leverage Capacity Expansion

- 25% tax credit for projects that expand rail capacity
- Expense other infrastructure capital expenditures
- Leverage private investment
RR/Investor Issues Summary-3Rs3Cs

- Recovery?
- The Re-Set
- Re-Regulation
- Capital Needs
- Capital Cooperation
- Cash Flow
ABH Consulting
Anthony B. Hatch
155 W. 68th Street
New York, NY 10023
(212) 595-0457
ABH18@mindspring.com