RAILROAD WEEK IN REVIEW

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"If this is going to be a street fight, then so be it." — Hunter Harrison

Bare knuckles ruled Wednesday as CP's Hunter Harrison and Pershing's Bill Ackman did yet another conference call to convince NS shareholders that the CP proposal offers the better long-term value. The argument was partially framed by Monday's response to the NS "White Paper" penned by former STB commissioners Nottingham and Mulvey. Their argument is essentially that the combination would not pass muster with the STB and shot down the Voting Trust concept: "In our expert opinions, the STB is not likely to approve CP's proposed voting trust or the CP+NS merger."

CP's Monday rebuttal holds that voting trusts are common in railroad transactions and "are crucial to the proper functioning of the market." Moreover, a voting trust "enables the target carrier's stockholders to receive consideration prior to regulatory approval and substantially reduces the target carrier's exposure to regulatory risk." CP maintains that the STB's denying the voting trust would be "intrusive," and "would represent a marked departure from STB precedent and policy, and would be inconsistent with its statutory mandate."

Repeatedly on Wednesday's call both Harrison and Ackman cited 144 successful voting trust applications with the STB. Writing for NS, Mulvey/Nottingham say "In the past, the STB routinely and informally permitted carriers to acquire controlling stakes in other carriers using a voting trust, provided that the trustee was independent." CP argues that CP will be the railroad in trust and Harrison will run NS after having completely divorced himself from CP and becoming in effect a free agent who can go anywhere.

CP is taking its case directly to NSC shareholders, offering $32.86 cash per NSC share, 0.451 shares of stock in the combined CP-NS, and 0.451 of a contingent value right (CVR), which will have a maximum value of $25. Here's where it gets interesting. CP is saying that with a 65 operating ratio, NSC shares will have an intrinsic value of $91 a share, right where they are now. CP targets $175 price for the combined CPNS by October, 2017.

The CVR is equivalent to a put spread, in which an investor owns a $175 European-style put and is short a $150 European-style put. It's essentially an insurance policy that protects investors if the share price of CPNS drops below $175 before the spread's Oct 2017 expiration. The option's intrinsic value is the difference between $175 and the CPNS share price, so as share price rises toward $175 strike price, the option value falls. (A European option may be exercised only at the expiration date of the option; American options may be exercised at any time before the expiration date. Of course, the holder can sell for cash at any time.)

The process has only two outcomes: NS continues as today on its way to a 65 OR, or the voting trust happens and Harrison moves to NS and does his thing. Using present analyst consensus estimates for CP and NS, including revenue, OR, tax rates, and capital expenditures, NS with no operational improvements will earn in 2017 $11.13 a share vs. $12.29 with operational improvements. The latter number assumes only 42 percent of the Pre-Merger Operational Improvements and zero percent of the Post-Merger combination benefits.

Using a conservative 15x multiple, CPNS shares would be worth at least $167 with no improvements and up to $221 with. Add it all up and NSC shares that have what CP says is a $79 intrinsic value today (the Gurufocus website says $77, but I'll not quibble) could hit a near-double of $140 if all goes to plan. If no STB approval, NSC holders still get $127 intrinsic value, a 60 percent increase.

The icing on the cake is the threat of a proxy fight. Though Ackman/Harrison say they would prefer a negotiated transaction, they are ready to go the proxy-fight route a la Pershing/CP, using the NS Annual Meeting to nominate a new Board in Feb, 2016. I would not be surprised to see it go this way, given the NS response thus far.

To be sure, there are a lot of IFs in the preceding. But I'm a simple soul and find a bird in the hand is worth two in the bush. As is, NS earned $5.54 a share over the past 12 months, goes for $91 a ticket, and pays a $2.36 dividend. You get an earnings yield of 6.1 percent and a dividend yield of 2.6 percent, for a total return of 8.7 percent. The discounted cash flow intrinsic value is, as noted above, $77.09, making the share price 118 percent of intrinsic value.

A share of CP will set you back $125. It earned $6.58 over the past twelve months and paid you a $1.05 dividend. Your earnings yield was 5.3 percent, the dividend paid 0.8 percent, so your total yield was 6.1 percent, equal to NSC before the dividend. The DCF intrinsic value for CP is now $73.84, making the share price 169 percent of intrinsic value.

How I see it: NSC total return of nine percent and trading at 1.2 times intrinsic value vs. CP total return of six percent and trading at 1.7 times intrinsic value. We know we have a two-percent economy, we know that NS, serving 70 percent of the US population, will grow volumes by at least that much, and we know that, with NS total annual revenue units running more than twice CP's, NS will fare better in a slow-growth environment than CP. No IFs about that.

The 45G shortline tax credit is once again down to the wire. The House says it's working on a bill to make the 45G track maintenance credit retroactive to 2015 and extend it through 2016. The previous authorizing bill expired at the end of last year and let it go at that. What some are calling the "tax-extenders package" still must pass muster with the full House and Senate.

Pulling this off is a big positive for the holding companies like Watco, OmniTrax, and GWR. If the bill becomes law, one gets to book the full 2015 tax credit in 2015. In the case of GWR, for example, Wolfe Research estimates the tax credits would boost 2016 net income by about $28 million. Across the board the 45G credits enhance net earnings and free cash flow and support higher long-term valuations.

The implications for the smaller, privately-held short lines are less clear. Many don't have any taxable income to begin with, so the $3,500 per-mile maintenance and rehab subsidy is wasted. However, a mechanism exists for short lines to assign the credit to customers who do have tax liabilities and who benefit from a better railroad.

I take the position that a short line that can't afford the conservative $5,000 per mile per year cost (ties and surfacing only, ex-bridges, weed control, road crossings, etc.) to keep Class 2 track up to spec may not have a strong business case for continued existence. Over and over, my Rule of 100 (you need 100 cars per mile per year to achieve an 85 OR) proves out on light density short lines that are in reality streaks of rust in the weeds, existing on subsidies like the 45G.

PFL Petroleum's *Railcar Report* this week says lease rates for tank cars are not where they were just a few months ago. "We are confident that this slump in lease rates is temporary, and will eventually return with any rebound in oil prices. This is simply a cycle which we see in the commodity markets regularly. In the meantime, we continue to see tank cars, last in crude service or other heavy petroleum products, being cleaned and put into various other services such as ethanol and clean oils."

But before going into active service in alternate commodities, they have to be parked someplace. Many *Week in Review* readers at short lines can provide storage space at reasonable rates as well as place/pull on demand. Let me know if you are having a hard time finding storage, repair, or cleaning locations. I'm sure we can find several places that can accommodate your needs.

The 30th annual Railway Equipment Finance conference registration is in full swing and is running ahead of last year. I'm looking at an agenda packed, as usual, with high-profile speakers, and, as usual, the chance to meet and greet the movers and shakers.

The conference runs March 6-9 at La Quinta (Palm Springs), Calif. The Monday Keynote speaker is Koch CFO Steve Feilmeier. on the role rail plays in Koch Industries and how Koch sees the rail economy heading into 2016.   On Tuesday we get Wells Fargo (First Union Leasing) economist Sarah House for insights and analysis on the US economy for 2016.

The REF website agenda is still work a Work in Progress, but if past experience is any indication (I've been going going off-and-on since they first did La Quinta twenty-plus years ago), you won't go away hungry.