How to Value Your Regional or Short-Line Railroad Company

by Grant M. Farrell, ASA, CPA, ABV, CFF

Executive Summary

In the railroad industry, Class I public company multiples are often used to estimate the fair market value of private railroads classified as Class II or Class III. In almost every case, this method significantly misrepresents the fair market value of private railroad operations.

In this whitepaper, we explain why public company multiples can be misleading and discuss the mechanics of valuation used by professional business appraisers. We do so in order to provide you with the knowledge and vocabulary necessary to be an informed consumer of business valuation services and, more importantly, to understand the value of your regional or short-line railroad company.
This whitepaper provides an informative overview regarding the valuation of businesses operating in the regional or short-line railroad industry. Short-line and regional railroads play an important role in transporting products we consume every day. For these smaller lines, connectivity to a Class I rail—which opens access to the broader United States, Canada, and Mexico—is critical to their operations.

A lack of knowledge regarding the value of your railroad business could be very costly. Class II and Class III private rails are crucial to the transportation industry, but they are often not valued the same as their publicly traded Class I counterparts. In this whitepaper, we discuss the challenges of using public company metrics solely to value private Class II and Class III railroad companies and present valuation approaches that make sense from our experience working in the industry.

If valued incorrectly, opportunities for successful liquidity events may be missed or estate planning could be incorrectly implemented based on misunderstandings about value. In addition, understanding how Class II or Class III companies are valued may help you grow the value of your business and maximize your return when the time comes to transact.
When You Need to Know What Your Business Is Worth

Selling Out?

In the most obvious case, someone who is planning to sell their business needs to know what it is worth. Probably the hardest issue a business owner encounters is cashing-out their life's work. Beyond the myriad of emotional issues that come with such a decision, you will also face the raw economics of how you will sell your business and for how much. There are hundreds of issues that may arise in a transaction. Many of them ultimately affect the proceeds of the transaction to the seller. Knowing what you should be able to expect will let you evaluate whether or not an offer for your company is reasonable.

Selling In?

If you are planning on transferring ownership to your children or your management team, you will need to know what the interests in the business being transferred are worth. Given taxes and other issues, such as discounts, this may be much less than a pro rata interest in the total value of the business. Ignoring this issue can cost you a lot of money.

Buy-Sell Agreements: A Handshake or Arm-Wrestle?

Many business owners fail to understand the valuation implications of buy-sell agreements. If you have other shareholders in your business who are non-family, and maybe some who are, you probably have some kind of buy-sell agreement between the shareholders that describes how the business (or business interests) will be valued in the event of a shareholder dispute, death, or departure from the business (even on friendly terms).

In our experience, buy-sell agreements almost never sufficiently describe the mechanism to be used to value the business. The process looks simple when the buy-sell agreement is being drafted and a transaction is not on the table. However, when the day comes that a buy-sell agreement is invoked, you will want the process delineated very clearly.

All The Other Reasons Listed in the Ownership Transfer Matrix

Mercer Capital developed the Ownership Transfer Matrix to illustrate the universe of ownership transition scenarios.
Since most business owners are consumed with the day-to-day activities of running the business, many fail to acknowledge that life (and business) cycle events do happen to them, their partners, and their families; and these events will require that their businesses be valued.

Alternatively, some business owners use business valuation as an essential tool for creating ownership stability and assessing management performance. Mercer Capital professionals have spoken for years about the “things that happen to you” and the “things you make happen” as seen in the chart.

Our essential point is this: an understanding of the value of your business or business interest is critical in preparing yourself for any of these eventualities.

### Value Management

Maybe you are not currently contemplating a transaction in your business. You do not plan to sell in the next few years, you are not planning on transferring it to your children, you are not entering into any buy-sell agreements or shareholder agreements based on the value of the business, nor do you anticipate any of the other events listed in the Ownership Transfer Matrix. Then why do you care? Because knowing the value of your business can be a tremendously effective management tool.

Ultimately, you will get two returns from your business – what we in the valuation community call “interim cash flows” and “terminal cash flows.” Interim cash flows might be your salary, your benefits, and your dividends. You know what these are and what you can do to influence them. But your biggest cash flow may be the terminal cash flow – when you go to sell your business. Are you managing your business in a way that increases its value or not? Do you know?
The Basic Concepts That Must Be Defined in Every Valuation

Before covering specific details related to the short-line railroad industry, it is important to understand basic concepts related to the valuation analysis.

It comes as a surprise to many business owners to learn that there is not a single value for their business. Numerous factors (legal, tax or otherwise) play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

The Valuation Date

Every valuation has an “as of” date, which simply means that it is the date around which the analysis is focused. The date may be set by legal requirements related to a death or divorce, or be implicit, such as the closing date of a transaction.

The Purpose of the Valuation

The purpose of the valuation is important because it is linked to the transfer event (such as a sale, estate planning, etc.). A valuation prepared for one purpose is not necessarily useful for another.

The Standard of Value

The standard of value is an important legal concept that must be addressed in every valuation assignment. “Fair market value,” most commonly used in tax matters, is the most familiar standard of value. Other important standards of value are “investment value” (purchase and sale transactions), “statutory fair value” (corporate reorganizations), and “intrinsic value” (public securities analysis). Using the proper standard of value is crucial in obtaining an accurate determination of value. The standard of value will influence the selection of valuation methods as well as the level of value.

The Levels (Premise) of Value

Does it make a difference in value per share if you own 10% or 75% of a business? You bet it does. The former is a minority interest and does not enjoy the prerogatives of control that the latter does. How does this affect value per share? The minority owners are relegated to bearing witness to a process over which they have no control or discretion. In effect, they often play the role of silent partners. They
cannot control compensation or distributions, and they certainly cannot dictate the strategic direction or operational management of the business. Thus, the fair market value per share of a minority owner is likely worth less per share than the shares of a 75% owner.

To add further insult to injury, a minority owner of a private business likely has no ready market in which to sell their interest. Minority ownership in a publicly traded company enjoys near instantaneous liquidity given that such interests can be traded on organized and regulated exchanges. The unique uncertainties related to the timing and favorability of converting a private, minority ownership interest to cash gives rise to a valuation discount (marketability) which further distances the minority owner's value per share from that of a controlling owner's value per share.

The following chart provides perspective of the various levels of value. In most cases, a valuation is developed at one level of value and then converted to another level of value by way of a discount or premium. Knowing when to apply such adjustments and quantifying the size of these adjustments is no simple matter.

The Whole Business

Control (Strategic) Value

Value to Uniquely Compelled Investor

Control Strategic Premium

The Whole Business

Control (Financial) Value

S Election or Sale of Company

Control Financial Premium

Minority Interest Discount

Theoretical for Most Privates

Marketable Minority

Public Stocks, Appraisal Construct

Marketability Discount

Most Shareholder Planning & Transfers

Nonmarketable Minority

Private Illiquid Assets, Appraisal Conclusion

What does all this have to do with your business? A lack of basic knowledge of these concepts can leave you short of the required vocabulary and understanding needed to comprehend how the value of a business interest is developed.
Important Industry Factors

A review of the regional and short-line railroad industry is important in establishing a credible value for a business operating in this space. Such a review should consider a wide range of issues (far too many to list in full here). Below are important industry considerations.¹

- **U.S. Production.** Increased production typically means greater demand for Class II and Class III services. Production changes in the mining, manufacturing, electric, and gas sectors have an important impact on demand for rail shipments in the U.S.

- **Competitive Landscape.** Competition comes from other methods of transport, including road, ocean, and air transportation. Fuel price declines result in greater competition as less fuel-efficient and more convenient transport methods become more attractive.

- **Fuel Prices.** To mitigate fluctuations in fuel prices, industry operators often implement surcharges to customers. Recorded as revenue, these surcharges increase operators’ income despite adversely affecting profit margins. With the recent collapse of crude oil prices, and consequently diesel fuel prices, revenue from surcharges has fallen and weak signals from the industrial production index has only compounded these losses.

- **Demand.** Dependent on freight traffic for the shipment of coal, consumer goods, automobiles, and agricultural goods; when import and export trade volumes rise, demand for the industry’s services increases, positively affecting revenue.

How Does Valuation Work?

Again, it comes as a surprise to many owners to learn that there is not a single value for their business. Numerous legal factors play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose here is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

Without offering a full dissertation on business valuation, you need to understand that there are three commonly accepted approaches to value: asset-based, market, and income. Approaches refer to the basis upon which value is measured.

Each approach incorporates procedures that may enhance awareness about specific business attributes that may be relevant to determining the final value. Ultimately, the concluded valuation will reflect consideration of one or more of these approaches (and perhaps several underlying methods) as being most indicative of value for the interest under consideration.

¹ Source: IBISWorld
The Asset-Based Approach

The asset-based approach can be applied in different ways, but in general, it represents the market value of a company’s assets minus the market value of its liabilities.

Investors make investments based on perceived required rates of return and only look at assets as a source of rate of return. While an asset value consideration can be a meaningful component of the overall valuation of a Class II or a Class III railroad, it is the income generated by these assets that typically drives the value of a business. For this reason, the asset-based approach is typically not the sole (or even primary) indicator of value.

The Market Approach

The market approach utilizes market data from comparable public companies or transactions of similar companies in developing an indication of value. In many ways, this approach goes straight to the heart of value: a company is worth what someone is willing to pay for it.

In many industries, there are ample comparable public companies that can be relied on to provide meaningful market-based indications of value. Acquisition data from industry acquisitions (typically a median from a group of transactions) can be utilized as a multiple on the subject company’s performance measure(s). This will often provide a meaningful indication of value as it typically takes into account industry factors (or at least the market participants’ perception of these factors) far more directly than the asset-based approach or income-based approach.

For Class II and Class III railroad companies, we believe a market approach makes sense; however, Class I public multiples often misrepresent the fair market value of private railroad operations. We discuss this in further detail later.

The Income Approach

The income approach can be applied in several different ways. Generally, such an approach is applied through the development of an ongoing earnings or cash flow figure and the application of a multiple to those earnings based on market returns. The income approach allows for the consideration of characteristics specific to the subject business, such as its level of risk and its growth prospects relative to the market.
There Are Differences Between Public and Private Railroad Companies

The Publics

As mentioned earlier, we believe that solely comparing private Class II and Class III companies to Class I companies for valuation purposes is problematic. To know why, let’s first take a look at the public companies. As of the date of this publication, there are seven publicly traded transportation companies with significant rail operations, each of which is traded in the U.S. or Canadian equities market.\(^2\)

CSX Corporation (CSX)

CSX Corporation provides rail-based transportation services in the United States and Canada. The company offers rail services and intermodal transportation services through a network of approximately 50 terminals, transporting manufactured consumer goods in containers in the eastern United States. CSX transports agricultural and food products, fertilizers, chemicals, automobiles, metals and equipment, minerals, and forest products, and delivers coal, coke, and iron ore to electricity-generating power plants, steel manufacturers, and industrial plants. It also exports coal to deep-water port facilities. Further, CSX offers drayage services, including pickup and delivery of intermodal shipments and trucking dispatch services. It serves the automotive industry with distribution centers and storage locations and connects non-rail served customers through transferring products, including plastics and ethanol, from rail to trucks. Additionally, CSX acquires, develops, sells, leases, and manages real estate properties. The corporation owns and leases approximately 4,400 locomotives and operates approximately a 21,000 route mile rail network, serving various population centers in 23 states east of the Mississippi River, the District of Columbia, Ontario and Quebec.

<table>
<thead>
<tr>
<th>CSX Corporation (CSX)</th>
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<tbody>
<tr>
<td><strong>MVIC</strong></td>
<td><strong>LTM Revenue</strong></td>
</tr>
<tr>
<td>$61.5 billion</td>
<td>$11.5 billion</td>
</tr>
</tbody>
</table>

\(^2\) In each table, MVIC or the Market Value of Invested Capital represents the value of total capital invested in the company, including tangible assets and goodwill. LTM Revenue denotes total revenue over the last twelve months. EBITDA or Earnings Before Interest, Taxes, Depreciation, and Amortization is a measure of a company’s performance before factoring in financing, accounting decisions, or taxes.
Norfolk Southern Corporation (NSC)

Norfolk Southern Corporation engages in rail transportation of raw materials, intermediate products, and finished goods in the United States. It also transports overseas freight through various Atlantic and Gulf Coast ports. In addition, NSC is involved with the operation of scheduled passenger trains; leasing or selling rail property and equipment; development of commercial real estate; telecommunications; the acquisition, leasing, and management of coal, oil, gas, and minerals; and the transport of automotive and industrial products. It operates approximately 19,500 route miles in 22 states and the District of Columbia.

<table>
<thead>
<tr>
<th>Norfolk Southern Corporation (NSC)</th>
</tr>
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<tbody>
<tr>
<td>MVIC</td>
</tr>
<tr>
<td>$44.8 billion</td>
</tr>
</tbody>
</table>

Union Pacific Corporation (UNP)

Union Pacific Corporation operates railroads in the United States. It offers transportation services for agricultural products, including grains and commodities produced from grains; food and beverage products; automotive products, such as finished vehicles and automotive parts; and chemicals comprised of industrial chemicals, plastics, fertilizers, petroleum and liquid petroleum gases, crude oil, and soda ash. UNP also transports coal; petroleum coke; biomass; industrial products such as construction products, minerals, consumer goods, metals, lumber, paper; and intermodal import and export container traffic, among other miscellaneous products. UNPs rail network includes 32,070 route miles linking the Pacific Coast and Gulf Coast ports with the Midwest and Eastern United States gateways.

<table>
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<tr>
<th>Union Pacific Corporation (UNP)</th>
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<tbody>
<tr>
<td>MVIC</td>
</tr>
<tr>
<td>$102 billion</td>
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</table>

Kansas City Southern (KSU)

Kansas City Southern provides freight rail transportation services. KSU operates a north/south rail route between Kansas City, Missouri, and various ports along the Gulf of Mexico in Alabama, Louisiana, Mississippi, and Texas, as well as a direct rail passageway between Mexico City and Laredo, Texas, serving Mexico’s industrial cities and three of its seaports. KSU also owns a 157-mile rail line extending from Laredo, Texas to the port city of Corpus Christi, Texas and the northern half of the rail bridge at
Laredo, Texas. KSU serves the chemical and petroleum, industrial and consumer products, agriculture and minerals, energy, intermodal, and automotive markets. Its coordinated rail network includes approximately 6,600 route miles extending from the Midwest and Southeast portions of the United States into Mexico and connecting with other Class I railroads.

<table>
<thead>
<tr>
<th>Kansas City Southern (KSU)</th>
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<tbody>
<tr>
<td>MVIC</td>
</tr>
<tr>
<td>$13.5 billion</td>
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</tbody>
</table>

**Canadian National Railway Company (CNR)**

Canadian National Railway Company engages in rail and related transportation business, transporting cargo and serving exporters, importers, retailers, farmers, and manufacturers. CNR serves the cities and ports of Vancouver, Prince Rupert (British Columbia), Montreal, Halifax, New Orleans, and Mobile (Alabama), as well as the metropolitan areas of Toronto, Edmonton, Winnipeg, Calgary, Chicago, Memphis, Detroit, Duluth (Minnesota), Superior (Wisconsin), and Jackson (Mississippi) with connections to various points in North America. It operates a network of approximately 20,000 route miles of track that spans Canada and mid-America, connecting the Atlantic, the Pacific, and the Gulf of Mexico.

<table>
<thead>
<tr>
<th>Canadian National Railway Company (CNR)</th>
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<tbody>
<tr>
<td>MVIC</td>
</tr>
<tr>
<td>$69 billion</td>
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</tbody>
</table>

**Genesee & Wyoming Inc. (GWR)**

Genesee & Wyoming Inc. operates through three segments: North American Operations, Australian Operations, and U.K./European Operations. GWR transports various commodities, including agricultural products, autos and auto parts, chemicals and plastics, coal and coke, food and kindred products, lumber and forest products, metallic ores, metals, minerals and stone, petroleum products, pulp and paper, and waste. In addition, it operates deep sea maritime containers; provides bulk haulage, including coal, aggregates, cement, and infrastructure services; and provides rail, coal loading, and railcar switching services for industrial customers. It owns or leases 122 freight railroads in the United States – including 105 short line railroads and 2 regional freight railroads; 8 short line railroads located in Canada; 3 railroads located in Australia; 1 railroad located in the United Kingdom; 1 railroad in Poland and Germany; and 2 railroads in the Netherlands. GWR
owns a total of approximately 15,900 miles of track and operates 6,200 additional miles of track that is owned or leased by others.

<table>
<thead>
<tr>
<th>Genesee &amp; Wyoming Inc. (GWR)</th>
<th>MVIC</th>
<th>LTM Revenue</th>
<th>EBITDA Margin</th>
<th>Earnings Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6.6 billion</td>
<td>$2 billion</td>
<td>30%</td>
<td>7%</td>
<td></td>
</tr>
</tbody>
</table>

**Canadian Pacific Railway Limited (CP)**

Canadian Pacific Railway Limited owns and operates a transcontinental freight railway in Canada and the United States. CP transports bulk commodities, including grain, coal, potash, fertilizers, and sulfur; merchandise freight, such as finished vehicles and machinery; automotive parts; chemicals and plastics; crude; metals and minerals; forest and industrial products; and consumer products. CP also transports intermodal traffic comprised of retail goods in overseas containers that can be transported by train, ship, truck, or in domestic containers, and trailers that can be moved by train or truck. In addition, CP offers transload, leasing, and logistics services. CP offers rail and intermodal transportation services over a network of approximately 12,400 miles, serving the business centers of Canada from Montreal, Quebec to Vancouver, British Columbia; and the United States' Northeast and Midwest regions.

<table>
<thead>
<tr>
<th>Canadian Pacific Railway Limited (CP)</th>
<th>MVIC</th>
<th>LTM Revenue</th>
<th>EBITDA Margin</th>
<th>Earnings Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30 billion</td>
<td>$4.9 billion</td>
<td>51%</td>
<td>26%</td>
<td></td>
</tr>
</tbody>
</table>

**Size, Diversification, and Location Impact Valuation**

Each of the above companies is considered a Class I rail operator. As their business descriptions indicate, the operations of these seven publicly traded railroads are diverse and international. Each entity is exposed to many different industries and products, including passenger transportation, while using and maintaining between 6,000 to 33,000 miles of rail. In addition, these companies have 6,800 to 42,000 full time employees, with revenues between $2 billion and $20 billion. When utilizing these public companies as a valuation benchmark, keep in mind the above descriptive analysis when comparing your private company railroad operation and adjust for the differences.

In Chart 1 on the next page, the Market Value of Invested Capital (MVIC) is shown for the above seven companies. As of the date of this whitepaper, the average MVIC for these seven public companies was $49.5 billion.

Chart 2 shows the implied EBITDA multiple for each of the discussed companies over the previous 24 months. Although, these seven companies are large, many private companies utilize the valuation multiples of public companies to estimate private company value.
The Differences Between Public and Private Companies

Chris Mercer, CEO of Mercer Capital, wrote extensively about the differences between public and private companies. In the footnote is a link to his article, and below a summary of the three significant differences he discussed.4

1. Visibility and Availability of a Stock Price

Minority investor valuation information is available for nearly every public company at the click of a mouse. With private companies, however, there is virtually never a market for minority shares, and while there is a market for controlling interests, this is rarely accessed by the typical business. Therefore, unlike public

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3 GWR may be an exception as they have purchased and combined many Class II and Class III railroads.
4 chrismercer.net/public-markets-provide-the-context-for-private-company-valuation/
companies, information about private companies' value is usually unavailable for non-shareholders, and often, even for shareholders. While the public markets provide ongoing information about the value of public companies, the only way to obtain credible evidence of value for private companies is to engage in an appraisal process with a qualified business appraiser.

However, many private companies never obtain a business valuation (appraisal) so little is known about their value. Value is a function of expected cash flows, the expected growth of those cash flows, and risk. This functionality works both for public and private businesses. The board and management of a public company knows: (1) its shares are being valued today based on investor expectations about its future; (2) the company’s shares will be valued tomorrow, and that dividends and share buybacks will be recorded; and (3) their performance will be judged by the returns they provide for investors.

As a result, public companies face a constant tension between reinvesting for future growth and providing returns in the form of dividends or share repurchases. If boards and management of public companies do not provide competitive returns, there is danger of shareholder apathy, declining stock prices and even takeovers. This tension provides a certain discipline regarding a focus on returns. Contrarily, private companies do not have the same instant market tension. Nevertheless, value does change over time, even if no one is watching, and returns are being provided to private company owners, even if they are not recorded.

2. Information Availability

Quarterly and annual financial reporting provides information for investors to make informed decisions regarding their investments in public companies. These public companies are also faced with many required disclosures if certain events occur. This kind of public information is readily available from the SEC, where anyone can search and obtain the various filings for a given company.

On the other hand, private companies have virtually no required public or shareholder disclosure. A bank may require that a loan client obtain an annual audit, but generally that is the extent of their required financial disclosure. Investors in most private companies (sometimes even significant owners) often lack good information about the performance and value of their company.

When applying the guideline public company method, this kind of publicly available information is used by business appraisers. They attempt to identify public companies that are sufficiently similar in nature, business, size, and other comparative features to the subject private company. Upon finding similar publics, they can derive valuation multiples that are potentially applicable to their private company. As such, the public securities markets provide active and ongoing evidence regarding the value of private companies.

3. Third Party Testing

Public companies face scrutiny from many sources: (1) buy-side analysts working for institutions; (2) sell-side analysts working for investment banking and brokerage companies; (3) analysts at thousands of asset management firms who are scouring the markets for investment opportunities; (4) technical
analysts; and (5) millions of individual investors. This instills an inherent sense of discipline for managements and boards to report their financial results and prospects and to run their companies for the benefit of their shareholders. Private companies, on the other hand, have no analysts following them, except perhaps a lending bank analyst who will look at the financial performance from a bank’s viewpoint, not the shareholders’ one.

What Valuation Approaches Make Sense for Class II and Class III Railroad Companies?

Guideline Public Company Method Can Be Helpful But Not as a Stand-Alone Method

No matter the reason for the valuation, a credentialed appraiser should consider utilizing the market approach, and therefore the guideline public company method. Making the judgment that the guideline public company method is appropriate or not appropriate can be simple or quite complex. While using publicly traded railroad companies to assess the value of a Class II or Class III can provide a general context for private company valuation, this process should not begin and end at public company valuation multiples applied to private company performance levels. To put it bluntly, the above seven publicly traded railroad companies are not comparable to most Class II and Class III railroads. As such utilizing Class I railroads to value privately held ones requires various adjustments to be made. It is not an “apples to apples” comparison. To explain further, let’s consider a couple of major differences.

• **Size.** Not one publicly traded company listed above has less than $2 billion in revenue. When comparing public companies to private companies, there is a general “rule of 10,” which says if a subject company is 10x larger or smaller than the public company compared to it, the growth and risk factors are so different that it is very difficult to adjust. According to this “rule of 10,” any short-line or regional railroad with revenues of less than $200 million violates the general comparability rule in reference to one of the seven Class I rails. This is just a general rule and it is not an absolute, but it makes sense to keep in mind, especially in light of the next difference, diversification.

• **Diversification.** Each of the above public companies generate revenues from multiple sources of services, customers, industries, and multiple locations (many internationally). Every business owner understands that diversification minimizes risk and promotes growth; both are value enhancers for a business. However, many short-line and regional railroads are tied to a certain area or region. In addition, many short-line railroads have one or two significant customers located on the rail which presents significant customer risk due to lack of diversification. This fact pattern changes the risk profile significantly, making comparison between smaller, private railroads to the publics unsupportable.

Additionally, for companies of larger and more diversified business models, the cost of debt and equity capital is significantly cheaper. Larger, seemingly less risky businesses have access to more sources of capital compared to smaller, more risky businesses (all other things being equal). Each of these
differences (and more) must be considered in performing a valuation utilizing public companies. Since many short-line and regional railroads are significantly smaller and less diverse than the public railroads (most of which are not even 10% the size of the smallest publicly traded railroad), it would be wise to utilize other, more appropriate and supportable valuation methods such as an income approach and a guideline transaction method. Let's discuss each in turn.

The Income Approach

The income approach is a general way of determining an indication of value of a business, business ownership interest, security or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.

Valuation methods under the income approach include those methods that provide for the direct capitalization of earnings estimates, as well as valuation methods calling for the forecasting of future benefits (earnings or cash flows) and then discounting those benefits to the present at an appropriate discount rate.

By utilizing an income approach, the actual cash generated by the railroad would be the primary driver of value with an appropriate discount rate. The discount rate would be selected by incorporating specific company risk factors unique to the subject company. Examples include (1) product diversification, (2) customer diversification, (3) industry concentration, (4) key man issues, etc. Typically, this is performed using a discounted cash flow method or a single period capitalization method.

The Market Transaction Approach

Market transactions of privately held companies in the same or similar business may provide a reasonable basis for valuation of the subject company. Such companies provide controlling interest valuation data. Market transactions are used to develop valuation indications under the presumption that a similar market exists for the subject company and the comparable companies.

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Ideal guideline companies are in the same business as the company being valued. However, if there is insufficient transaction evidence, it may be necessary to consider companies with an underlying similarity of relevant investment characteristics such as markets, products, growth, cyclical variability, and other salient factors.

**Previous Market Transactions**

When considering the available transaction data for regional and short-line rails, Genesee & Wyoming (GWR) has been very active. While they do not disclose income statement or book value data to derive transaction metrics, we can track the enterprise value of assets purchased and track miles acquired.

Using the only transaction data available, we observe the following multiples reflected in Table 1. On the next page, Table 2 provides the same multiple for the publics.

Although these are not direct financial indicators, it is interesting to observe the relatively tight range of GWR's acquisitions in contrast to the public company multiples. While this is not a primary valuation indication, it can be a consideration for reasonableness if the fact pattern is right.

### Table 1: GWR Acquisition Data

<table>
<thead>
<tr>
<th>Target Name</th>
<th>Transaction Date</th>
<th>Transaction Implied MVIC ($millions)</th>
<th>Route Miles</th>
<th>MVIC / Route Mile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Providence &amp; Worcester Railroad Company</td>
<td>8/15/16</td>
<td>$122</td>
<td>154</td>
<td>792,403x</td>
</tr>
<tr>
<td>Arkansas Midland Railroad Company Inc.</td>
<td>11/19/14</td>
<td>$40</td>
<td>121</td>
<td>330,579x</td>
</tr>
<tr>
<td>Dakota, Minnesota &amp; Eastern Railroad Corporation, West End Operations</td>
<td>1/2/14</td>
<td>$210</td>
<td>671</td>
<td>312,966x</td>
</tr>
<tr>
<td>RailAmerica, Inc.</td>
<td>10/1/12</td>
<td>$1,995</td>
<td>5,557</td>
<td>358,958x</td>
</tr>
<tr>
<td>Arizona Eastern Railway Company</td>
<td>8/1/11</td>
<td>$90</td>
<td>200</td>
<td>450,500x</td>
</tr>
<tr>
<td>Georgia Southwestern Railroad, Inc.</td>
<td>10/1/08</td>
<td>$22</td>
<td>231</td>
<td>95,671x</td>
</tr>
<tr>
<td>Summit View, Inc.</td>
<td>8/4/08</td>
<td>$236</td>
<td>408</td>
<td>579,093x</td>
</tr>
<tr>
<td>CAGY Industries, Inc.</td>
<td>5/30/08</td>
<td>$91</td>
<td>185</td>
<td>489,189x</td>
</tr>
<tr>
<td>Maryland Midland Railway, Inc.</td>
<td>10/23/07</td>
<td>$22</td>
<td>70</td>
<td>317,143x</td>
</tr>
</tbody>
</table>

Source: GWR Public Filings
A Word of Caution for Owners of Short-Line or Regional Railroads

Although we have outlined why the guideline public company method should not be used in valuing Class II and Class III railroads, like with most practices in valuation, there are certain cases where the opposite holds true. In the railroad industry, the guideline public company method should be rejected until a supportable rationale can be provided for why it is appropriate for Class II and Class III.

If the differences between the Class I and Class II/III can be reconciled, then the guideline public company method may be suitable. The problem with the industry now is that most owners and investors accept public companies as indications of value and there is very little to no consideration given to the significant differences between the two. While the guideline public company method may be suitable, this is often not the case, and the income and market transaction approach tend to provide more supportable results.
Conclusion

Mercer Capital has experience valuing businesses in the regional and short-line railroad industry. We hope this information, which admittedly only scratches the surface, helps you better shop for business valuation services and understand valuation mechanics.

We encourage you to extend your business planning to include valuation, because sooner or later, a valuation is going to happen. Proactive planning and valuation services can alleviate the potential for a negative surprise that could complicate an already stressful time in your personal and business life.

When selecting a business valuation firm, choose a credentialed appraiser (ASA, ABV, or CFA) and one that has experience in your industry. Some owners opt to have their businesses valued annually or semi-annually in order to:

- Be more focused on shareholder returns and shareholder disclosure
- Create a basis to engage in appropriate transactions
- Manage the expectations of their owners regarding performance and value

Whether your valuation needs are for on-going planning purposes or are in reaction to a specific corporate event, Mercer Capital can help.

For more information or to discuss a valuation or transaction issue in confidence, do not hesitate to contact us.

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Mercer Capital has experience providing corporate valuation and financial advisory services to companies in the regional and short-line railroad industry.

Mercer Capital is a national business valuation and financial advisory firm. Offering a broad range of services, we have provided thousands of valuations, which are well-reasoned and thoroughly documented.

We understand the unique position of regional lines as well as the broader transportation industry. Whether in reaction to an event or for strategic planning purposes, Mercer Capital can help capture the value of your line.

Services Provided

- Valuation of transportation companies
- Transaction advisory for acquisitions and divestitures
- Valuations for purchase accounting and impairment testing
- Fairness and solvency opinions
- Litigation support for economic damages and valuation and shareholder disputes

Contact a Mercer Capital professional to discuss your needs in confidence.

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