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How to Value Your Regional or Short-Line Railroad Company

Class II & III Railroads – Rethinking the Guideline Public Company Method

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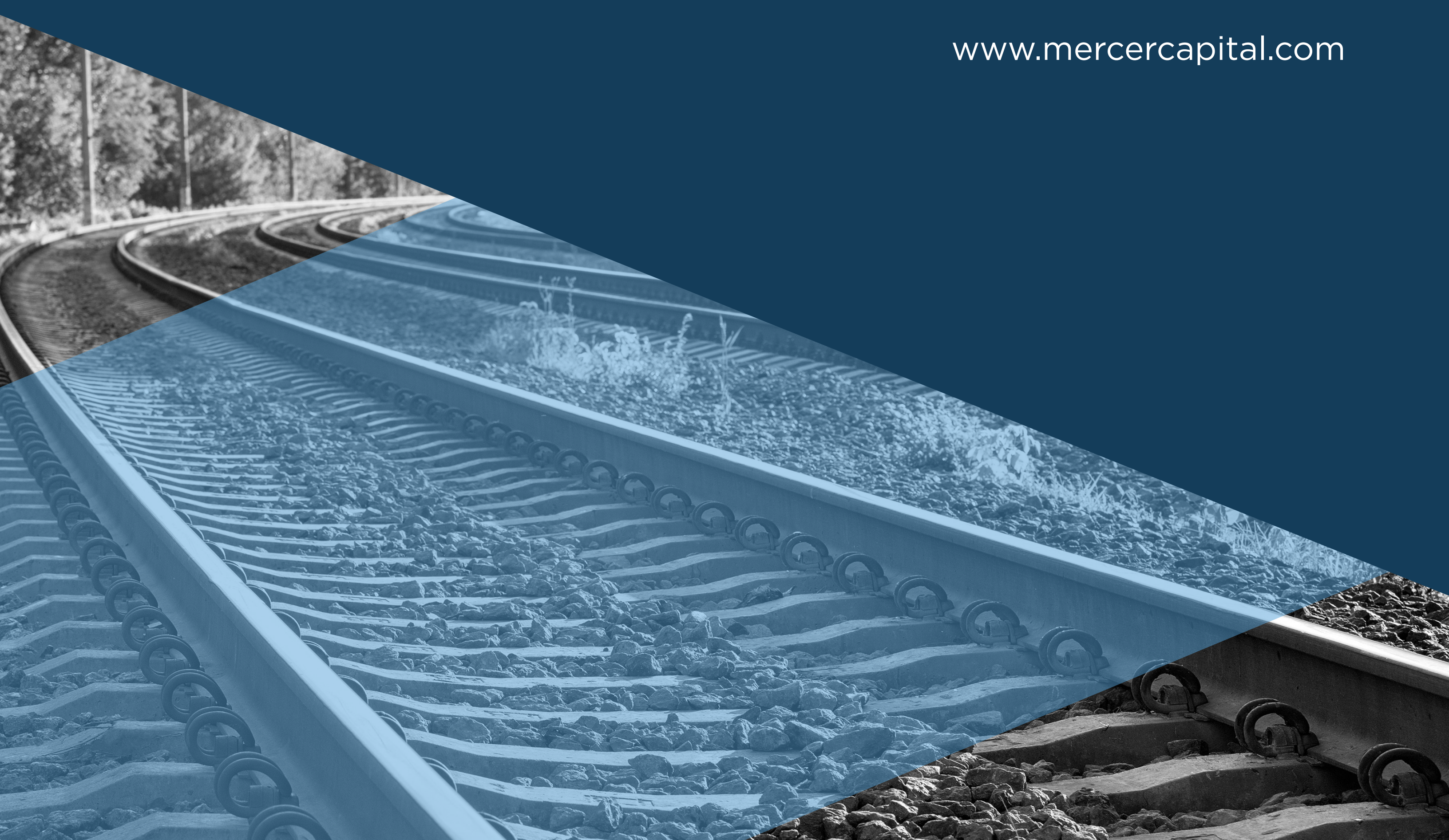


Executive Summary

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.

All companies should scrutinize performance and value creation. Although not mandated for private companies, this process helps (1) communicates shareholder returns, (2) provides context for management compensation and merger & acquisition decisions, and (3) manages expectations.

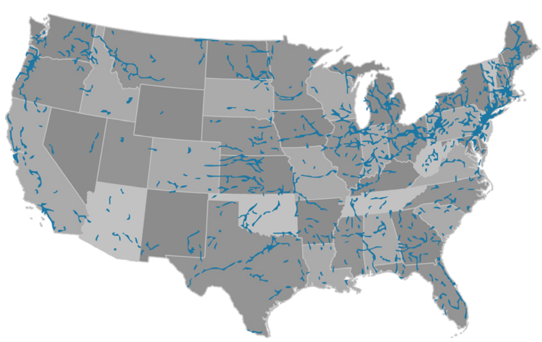
In this whitepaper, we explain why public company multiples are misleading and examine alternative valuation methods.

Introduction

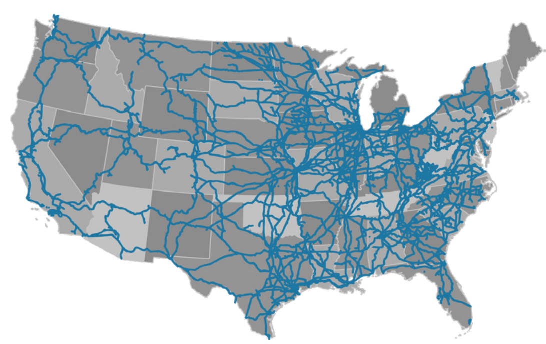
Short-line and regional railroads play an important role in transporting products we consume every day. However, unlike their larger counterparts, short-line and regional railroads rely on the operations of other rail lines. Connectivity to a Class I rail, which opens access to the broader United States, Canada, and Mexico, is critical to the operations of these smaller lines. Class II and Class III private rails are crucial to our transportation industry. So it raises an important question - are they valued the same as their publicly traded Class I counterparts?

Many owners and investors in short-line and regional railroads use the publicly traded Class I railroads to estimate the value of their business or investment. While under specific conditions this method may be suitable, in our experience, using public markets is rarely appropriate when valuing private rails – this whitepaper discusses the primary reasons why. To do so, we must begin by understanding each of the publicly traded Class I railroads and assess their comparability with regional and short-line railroads.

Class II and III U.S. Railroads



Class I U.S. Railroads



Source: Freight Rail Works

The Publics

As of the date of this publication, there are five publicly traded transportation companies with significant rail operations, each of which is traded in the U.S. or Canadian equities market. These five companies are:

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 30 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 connect 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 3,500 locomotives and operates approximately a 20,000 route miles rail network, serving various population centers in 26 states east of the Mississippi River, the District of Columbia, Ontario and Quebec

CSX Corporation (CSX)			
Enterprise Value	**LTM Revenue**	**EBITDA Margin**	**Route Miles**
$86.2 billion	$14.7 billion	50%	19,671

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 and has intermodal operations. NSC primarily transports intermodal containers for a wide range of industries, including agriculture, beverages, chemicals, construction materials, automotive, and coal. NSC operates approximately 19,100 route miles in 22 states and the District of Columbia.

Norfolk Southern Corporation (NSC)			
Enterprise Value	**LTM Revenue**	**EBITDA Margin**	**Route Miles**
$69 billion	$12.2 billion	47%	19,137

UNION PACIFIC CORPORATION (UNP)

Union Pacific Corporation operates railroads in the United States and provides transportation services for products in a variety of industries including agriculture, food and beverage, automotive, chemical, and energy. UNPs rail network includes 32,070 route miles in 23 states west of Chicago and New Orleans. Most of UNP's track links the Pacific Coast and Gulf Coast ports with the Midwest and Eastern United States gateways and shares a duopoly with privately owned Class 1 BNSF in the Western states. UNP operates 8,300 locomotives.

Union Pacific Corporation (UNP)			
Enterprise Value	**LTM Revenue**	**EBITDA Margin**	**Route Miles**
$183.4 billion	$24.1 billion	49%	32,693

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.

Canadian National Railway Company (CNR)			
Enterprise Value	**LTM Revenue**	**EBITDA Margin**	**Route Miles**
$95.3 billion	$12.7 billion	54%	18,800

CANADIAN PACIFIC KANSAS CITY LIMITED (CP)

Canadian Pacific Kansas City Limited owns and operates a transcontinental freight railway and is the only one of the Class I railroads to have track spanning Canada, the United States, and Mexico. CP transports bulk commodities, merchandise freight, and intermodal containers. In addition, CP offers trans-load, leasing, and logistics services. CP offers rail and intermodal transportation services over a network of approximately 20,000 miles.

Canadian Pacific Kansas City Limited (CP)			
Enterprise Value	**LTM Revenue**	**EBITDA Margin**	**Route Miles**
$92.4 billion	$9.5 billion	41%	19,178

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 five publicly traded railroads are diverse and international. Each entity is exposed to many different industries and products, while using and maintaining between 19,000 to 33,000 miles of rail. In addition, these companies have 20,000 to 43,000 full time employees and report revenues between $9.5 billion and $24 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 Figure 1, the Market Value of Invested Capital (MVIC) is shown for the above five companies. As of the date of this whitepaper, the average enterprise value for these five public companies was $105.3 billion.

Figure 1 - Enterprise Value :: Semi Annual Trend

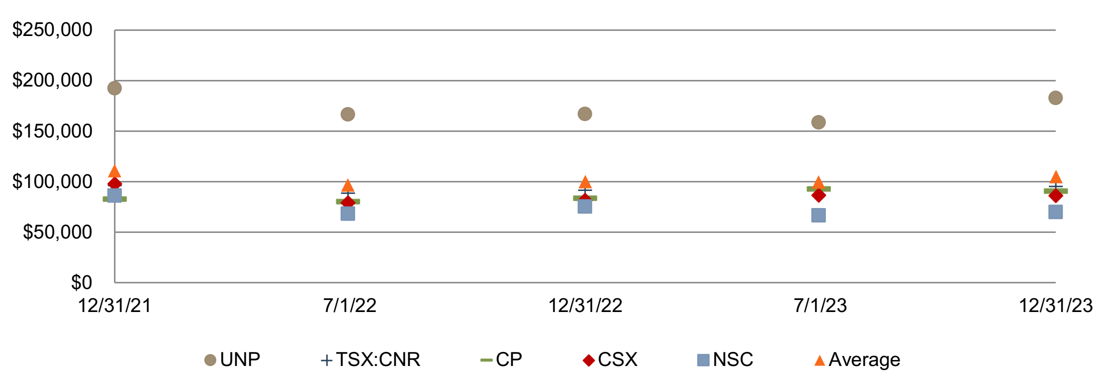
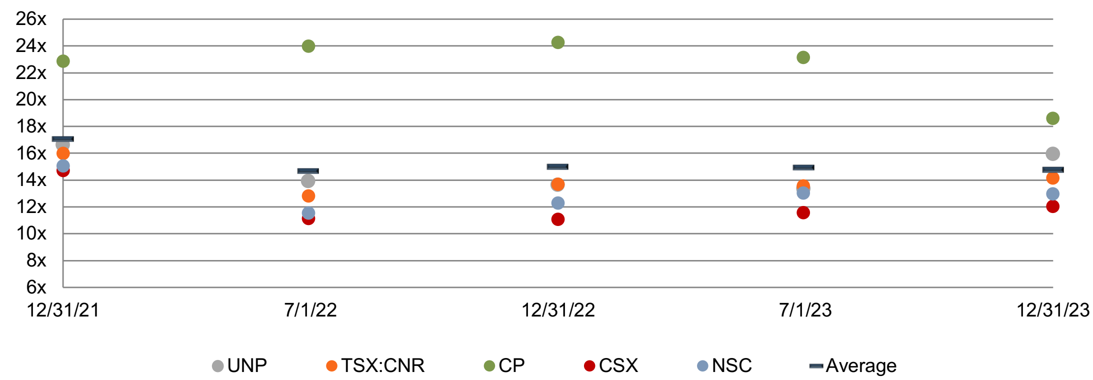


Figure 2 shows the implied EBITDA multiple for each of the discussed companies over the previous 24 months. Although, these five companies are large, many private companies utilize the valuation multiples of public companies to estimate private company value.

Figure 2 - EBITDA Multiple :: Semi Annual Trend



The Differences

Chris Mercer, Chairman of Mercer Capital, wrote extensively about the **differences** between public and private companies. Below is a summary of the three significant differences he discussed.

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 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. On the other hand, 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.

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, the publicly available information about traded companies 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. 3RD PARTY TESTING

Public companies face scrutiny from many sources, including buy-side analysts working for institutions, sell-side analysts working for investment banking and brokerage companies, analysts at thousands of asset management firms who are scouring the markets for investment opportunities, and 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, as opposed to a shareholders' perspective.

USING PUBLIC COMPANY DATA

Now that we understand the general differences between public and private companies, how can we utilize the public markets to value a private company and is it always appropriate? The public securities market provides valuation evidence and a focus on shareholder returns that can be helpful for private companies in several ways. The value of private companies, like public companies, is based on future expectations of cash flow, growth and risk. Accordingly, value changes over time for both public and private companies, and these value changes can be based on both external and internal conditions.

Private Company Valuation

Private companies tend to obtain independent valuations in three different circumstances:

1. **External Requirement to Obtain a Valuation:** A business owner may be told by his accountant, tax attorney, or business attorney that an appraisal will be required to close a particular transaction. These appraisals are compliance-oriented in the tax arena and transitionally oriented otherwise.

2. **Internal Requirement to Obtain a Valuation:** Buy-sell agreements or other contractual agreements require an ongoing supply of valuation information that is valuable for examining shareholder returns and benchmarking the status of the business. In this case, the appraiser may also point out risks that, if addressed, can enhance value over time.

3. **Desire to Obtain a Valuation:** Occasionally, business owners will be sufficiently curious or motivated by external events to obtain an independent appraisal. We have several new clients each year who, when approached by a potential buyer, decide (or are asked by an adviser) to obtain an appraisal "just to be sure" when an offer comes along.

HOW WOULD WE INCORPORATE A PUBLIC COMPANY METHOD?

No matter which reason for the valuation, a credentialed appraiser should always if consider if using the market approach (including the guideline public company method) is appropriate for the valuation in question. 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 five publicly traded railroad companies are not comparable to most Class II and Class III railroads. Therefore, using Class I railroads to value privately held ones requires various adjustments to be made. It is not an apples to apples comparison. To illustrate, let's consider a couple of major differences.

- **Size:** Not one publicly traded company listed above has less than $9 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 $900 million violates the general comparability rule in reference to one of the five public rail companies. 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. By their very description, their location is not diversified. In addition, customers can also be focused. 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.

- **Access to Capital Markets.** For larger and more diversified companies, the cost of debt and equity capital is significantly cheaper. Larger, seemingly less risky businesses have access to many more sources of capital compared to a smaller, more risky business (all other things being equal).

These are just a few of the qualitative factors that 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.

Income Approach

The income approach is a general way of determining a value indication 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. In this respect, the old adage of "Cash is King" would be the primary driver of value. 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 utilizing a discounted cash flow method or a single period capitalization method.

Market Transaction Method

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.

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

Previous Market Transactions

There have been a limited number of railroad acquisitions in the last several years. While most companies 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 transaction data available, we observe the following multiples:

Target Name	Acquirer	Transaction Date	Implied MVIC (millions)	Route Miles	MVIC per Route Mile
Pan Am Systemc, Inc.	CSX	6/1/22	$600	1,200	500,000x
Central Maine & Quebec Railway	CP	12/30/19	$174	481	361,746x
Iowa Northern Railway	CNR	12/6/23	$230	275	836,364x

Note: Pan Am acquisition also includes joint interest in additional 600 miles.

Here is the same multiple for the publics:

Company Name	Ticker	Enterprise Value	Route Miles	EV / Route Mile
Union Pacific Corp (UNP)	UNP	$183,446	32,693	5,611,181x
Canadian National Railway Co (CNR)	TSX:CNR	$95,303	18,800	5,069,331x
Canadian Pacific Kansas City Ltd (CP)	CP	$92,379	19,178	4,816,941x
CSX Corp (CSX)	CSX	$86,185	19,671	4,381,346x
Norfolk Southern Corp (NSC)	NSC	$68,973	19,137	3,604,169x

Although these are not direct financial indicators, it is interesting to observe the relatively tight range for the acquisitions of small private rail lines 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.

HOW DOES YOUR RAILROAD APPRAISE?

Although we've just outlined why the GPC 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, GPC should be rejected until you can provide a supportable rationale for why it is appropriate for Class II and Class III. If you can reconcile the differences between the Class I and Class II/III, then the GPC may be suitable. The problem with the industry now is that most owners and investors accept public companies as indications of value – there is very little to no consideration given to the significant differences between the two. While GPC may be suitable, this is often not the case, and the income and market transaction approach tend to provide more supportable results."

For a useful and helpful valuation that will provide "the why" behind the value, engage a certified business appraiser on a regular basis. In our firm's experience, companies that engage in a regular valuation process tend to:

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

Mercer Capital serves many clients by performing annual valuations of private and closely held companies. Contact us today to discuss your needs in confidence.

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

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