



A familiar refrain throughout the industrial landscape, hedge fund investors take a position, is now impacting American railroads. In this case, one of a half dozen leading US “Class 1” railroads, CSX Corporation, has been notified that UK based Childrens Investment Fund (TCI) intends to invest. TCI, a big holder of ABN Amro shares, is linked to the ongoing high stakes acquisition battle, and has suggested that the CEO resign. The financial muscle of “Activist” hedge funds such as TCI afford them such power.

Only several weeks earlier, Private Equity investor Berkshire Hathaway (Warren Buffet) had invested in another Class 1 road- Burlington Northern Sante Fe (BNSF). In a recent TV interview, Buffet suggested that he had positions in two additional roads (later revealed to be Norfolk Southern and Union Pacific). The management team at Atticus Capital, a hedge fund that has invested and forced change in several high profile business combinations (including the ousting the chairman of the German Stock Exchange- alongside TCI, after an abortive run at the London bourse), includes a Rothschild scion. Recently, it too has taken positions in US railroads. This should not be a surprise- in the first quarter 2007, “Surface Transportation Operating Income” registered \$469 Million- up from \$204 Million just three years prior.

Railroads are in demand now because high operating leverage is translating into the huge free cash flows that investors crave. For CSX, cash flow is plentiful- the dividend was increased as well. As traditional borrowers from banks and capital markets, the railroads also strive to maintain “investment grade” credit ratings. In fact, in a recent CSX press release, it stated: “CSX remains committed to an investment grade credit profile to preserve its ability to invest...”

Within days of TCI’s recent foray, CSX, the target company, announced efforts to increase its value, not through investment in revenue producing projects but rather, a repurchase of shares. Indeed, CSX, with railroad and trucking operations in the Eastern part of the U.S. authorized up to \$1 Billion for common stock repurchases. In a broader context, the recent re-purchase authorization is actually part of a \$3.5 Billion share purchase program over 2006 – 2008, not insignificant in comparison with CSX’s book value of approximately \$9 Billion in the 1Q 2007. In contrast to its share buybacks, CSX

said that it expects to make investment \$1.5 billion in 2007, \$1.6 billion in both 2008 and 2009, and \$1.7 billion in 2010 in capital improvements- including expenditures for purchasing locomotives.

Share repurchases are sometimes a prelude to other corporate combinations. One point of comparison, a shipping companies that engaged in a repurchase programme, is OMI Corporation. The tanker specialist put itself in play, arranging to be acquired by Teekay/Torm, for \$1.8 Billion (equity) - a hefty premium to its market pricing. OMI had bought back 30% percent of its stock over the preceding three years.

Lisa Jenkins, the Standard & Poors railroad analyst, said: "CSX's increased, debt-financed share repurchase program indicated a somewhat more aggressive financial policy, and contrasts with a focus on debt reduction in prior years. The cumulative share buyback program is equal to about one-third of CSX's book equity and will depress credit measures somewhat." Indeed, following CSX's announcement of the increased buybacks, S&P lowered the company's long-term corporate credit ratings to 'BBB-', still within the "Investment Grade" tier, from 'BBB.'

Moodys Investor Services had a similar take, putting the credit under review, though not downgrading it, with Bob Jankowitz at Moodys saying: "CSX's plan now marks the most aggressive increase in debt for shareholder enhancement programs among the major railroads, and comes at a time when softer economic conditions could further weaken demand for railroad transportation services". On the other hand, earlier this year, Moody's offered glowing words about BNSF, another Class 1 railroad, also engaging in share buybacks, saying "Moody's anticipates that future share repurchases will be managed to preserve financial metrics within a range consistent with the current ratings."

The recent round of fund investment activity comes at time that railroad car-loadings are actually down from a year earlier, according to the American Association of Railroads' statistics; the decline in freight movements is consistent with a slow U.S. economy. The soft economy may have created a softer share pricing environment than might be the case otherwise, while cash flow is more than adequate. But, a re-fashioned investment tax credit on railroad investments may be looming, if the recently introduced "Freight Rail Infrastructure Act" (Bill HR 2116 and S 1125) makes headway in Congress.

In the wording of the bill, which could take effect at the beginning of 2008, capital allowances of 25 percent of the cost of qualified investments (new locomotives, expanded tracks and tunnels) would be possible in the first year, with qualified assets included locomotives financed under leases. In the proposed wording, sale/ leasebacks would be permitted within three months of the railroad taking delivery of qualified equipment. In the U.S., the larger railroads have spun off unprofitable segments that have re-emerged as "short line" roads. For US leasing companies, short lines provide opportunities.

A look at recent results reveals that CSX has to staved off the taxman through deferred taxes, with some \$5.8 Billion out of \$15.8 Billion of total liabilities (on a \$26 Billion



balance sheet), at the end of 1Q 2007. Such liabilities have built up through the excess of accelerated depreciation (capital allowances for tax purposes), greatly exceeding the depreciation on the company accounts. Over time, such liabilities reverse, as more tax becomes due, unless the liability is fueled by fresh investment. Were the new investment tax credit enacted, it would feed the beast of tax deferral if carried forward, or substantially reduce taxes if utilized immediately. A cursory calculation suggests that a 25% credit of \$400 Million in 2008, based on intended capex of \$1.6 Billion. CSX paid \$531 Million of taxes in 2006 with \$458 Million at the Federal level.

CSX funding has included both the public markets for corporate debt, in the form of commercial paper and for traded notes, backed up, as need, by bank debt. An end 2006 balance sheet shows total debt of nearly \$6 Billion, of which \$5.4 Billion extended out beyond a year. \$4.9 Billion of the debt is corporate paper (“notes”), including \$400 Million 6 % notes with a 30 year term- maturing in 2006. Debt also includes \$473 Million of 20 year zero coupon debt (issued in 2001), with the principal amount varying each year (“accreting”) as the paper move closer to maturity. In mid 2006, CSX put a \$1.25 Billion five year credit facility in place with an 18 bank syndicate led by JP Morgan, Citibank and Bank of Nova Scotia, which was barely touched at end 2006. CSX, along with another railroad, Norfolk Southern, are both leasing equipment from Conrail, a jointly owned railroad acquired jointly in 1997. In 2006, Conrail’s rental expenses for Conrail equipment totaled \$514 Million. Under a deal unique to the railroad industry, locomotives are first leased (with maintenance provided), then purchased. Payments under this program totaled \$183 Million in 2006. With a fresh round of orders, payments were expected to rise to \$380 Million and \$441 Million in 2007 and 2008. CSX’s fleet of 3900 locomotives was being bolstered by fresh deliveries from “EMD” (sold by General Motors to private equity players Greenbrier and Berkshire Partners).

With a heavy reliance on rated corporate debt, maintenance of an investment grade rating is paramount. Nearly \$1.6 Billion of debt was set to come due in 2007 – 2008; this must be refinanced. Conversion of the zero coupon debentures into shares can also be triggered with deleterious ratings downgrades. The bank debt is also sensitive to the credit rating; at the new S&P rating of BBB-, the margin has increased to 47.5 points (versus 35 points with the BBB rating). One rating agency S & P’s concerns was that CSX’s share buybacks could be supported by debt.

By way of lease guarantees, CSX still finds itself in the maritime business. Shipping veterans will remember CSX as the owner of SeaLand Corporation from the late 1980s through 1999, when the foreign component was dealt to AP Moller (Maersk). CSX had de-accessioned the U.S. flag component of its Sea Land subsidiary to private equity investor Carlyle Group in early 2003, which renamed it Horizon Lines, being paid out during 2003 and 2004. CSX is still in the middle of operating leases on vessels that are chartered onward to Horizon Lines until 2017, with the profit on the leases recognized over time. For 2007 and 2008, such lease commitments are \$252 Million and \$174 Million.



Though the foreign fleet has been in Danish hands for eight years, and Horizon passed to another private equity investor (Castle Harlan ) who then launched a Horizon's IPO, in 2006, CSX was still on the hook for \$13 Million of lease related debt assumed by AP Moller, and was similarly contingently liable for \$8 Million of debt taken over by Horizon.

What now for the hedge funds? In the hands of a smart lawyer, the Horizon lease guarantees may keep CSX independent, if a non U.S. investor attempt to swoop in. Protection against take-over by non US entities are one reason, according to analysts, why transportation companies hold US flag transportation assets (where ownership is restricted to entities passing a 75% US citizenship requirement). Additionally, like port facilities, the railroads may be deemed a vital part of the US infrastructure, and acquires would face rigid scrutiny. So, it is more likely that "activism", if it plays out, would likely involve stretching the allowable ratios driving both credit ratings and loan covenants to their maximum.

Given the important role of railroads in the U.S. infrastructure, and the criticality of commodities transported, an outright take-over by a fund investor, particularly a non-U.S. entity, would seem unlikely. However, an activist investor could force a "special dividend" for example. Alternatively, it could lobby for share buybacks, which would drive up earnings (unaffected overall) per share (reduced number of shares).

In the case of CSX, with a healthy \$937 Million of cash/ equivalents/ short term investments at the end of 1Q 2007, its ability to generate cash flow is a keen attraction. Moody's in evaluating the CSX credit, looks for Debt/ EBITDA around 3x, with a lower number being better. It also looks for EBIT / Interest near 4x and "Retained Cash Flow" to debt of 20%- with higher cash flow to debt related items being more desirable. Were the unused and very tempting \$1.25 Billion bank line (that can be expanded to \$1.75 Billion, as needed) used to increase payouts (in the form of dividends) or for buybacks, financial measures would deviate from these measures. In rough numbers, the 1Q 2007 EBITDA of around \$700 Million, works back to \$2.8 Billion annualized- compared with consolidated debt and other long term liabilities of \$6.6 Billion.

Assumption of significant additional debt could have a deleterious impact on its credit metrics and ultimately its rating. Rating agency Fitch (which also downgraded CSX debt) put it succinctly: "... activist shareholders' recent calls for more aggressive action from the company increase the risk that CSX could undertake additional debt-financed share repurchases in the event that free cash flow is sufficient to cover the current program."

And if free cash flow were not sufficient, ie CSX chooses to incur debt in order to fund payments that will keep the activists at bay? If cash used for dividends (or treasury share purchases), were to crowd out needed capital spending at CSX and the other large roads, calls for infrastructure tax credits would likely go unheard.

