Railroads

Opportunities for 3Ps

January 31, 2019
Established in 1995 in Philadelphia to advise short line railroads and companies in the rail industry, SRF has advised on projects in 42 US states and Canadian provinces.

Currently advising on $1.7B in port-rail projects
- Public and private finance
- Business sales and acquisitions
- Transportation planning and policy
- Business development and site selection

Created OnTrackNorthAmerica in 2007, a 501c3 non-profit advancing sound transportation policy and collaborative, holistic growth of the rail industry.
Presentation Outline

**3P and Trade** – Two current SRF examples of Port/Railroad 3P finance

- Railroad industry as context
- Fundamentals of railroad economics
- Opportunities for 3P structures with railroads
Quotes and Notes from Yesterday...

- As a Port, “the world does not end at the gate”
- “Ocean carriers can contract for rail capacity, but cannot contract for long-term trucking”
- After “necessary disruptions” precision railroading creates value
- “Inland Ports present strategic opportunity”
- “Ports must press forward the infrastructure agenda”
Direct Financial Benefits for On-Dock Rail Development

SRF calculated 16 different value streams in a high, mid, low revenue scenarios for a Port client seeking to finance on-dock rail improvements to facilitate new business:

- Port is funding 100% of the project and will receive 8% of direct financial benefit
- Port is hesitant to levy fees on its tenants (earning 30% of the benefits)
- Port is hesitant to charge the carrier / beneficial cargo owner they seek to attract (earning 31% of the benefits)

Question: how to get railroad investment into public rail infrastructure?

### Example #1

<table>
<thead>
<tr>
<th>Port</th>
<th>Terminal</th>
<th>Railroads</th>
<th>Carrier/BCO</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>8%</td>
<td>30%</td>
<td>30%</td>
<td>31%</td>
<td>1%</td>
</tr>
</tbody>
</table>

![Pie chart showing the distribution of direct financial benefits among different stakeholders.]

- Green: Carrier/BCO: 31%
- Blue: Railroads: 30%
- Purple: Terminal: 30%
- Dark Blue: Port: 8%
- Light Blue: Others: 1%
Port, Lease, and Rail Revenues to Fund Infrastructure

SRF structured a large debt issuance backed by corporate guarantees of a lease, port fees, and rail fees to fund an infrastructure for a near-dock industrial development supporting exports of 14,000+ TEU and 0.8M T/yr bulk.

**Port-controlled rail assets provided opportunity to capture incremental revenue share from guaranteed rail activity to fund more than the rail improvements.**

Port revenues from lease and dockage and wharfage fees (all company backed) supports a complete infrastructure package on the project.
Railroad Industry Context

Opportunities created in differences between Railroad and Port economics.
Structure of the North American Rail Industry

Class I Railroads
Class II and III Railroads
Industrial Rail Shippers

7
600+
3000+
Comparison of Railroad Types

**Class I and Regional Railroads**
- Long-haul carriers
- The railroads are “public” like a utility but without price controls
- Railroads privately fund the infrastructure and locomotives
- Railroads maintain exclusive operational control over tens of thousands of route miles

**Terminal (Class III) Railroads**
- Last-mile carriers
- Typically operate a few miles of track and switching yards
- Many public, private and hybrid ownership / operation models
- Perform the blocking and interchange for Class Is and switching for customers
Fundamental Railroad Economics

To design a Private-Public-Partnership you must address the fundamental economic interests and requirements of each party.
Revenue Sources

Revenue Diversity
• Balance by sector
• Intermodal v. Carload v. Unit Trains

Revenue per Car
• Agriculture, Chemical, Industrial
• Coal / Auto have smallest per-car revenue
• Intermodal (per container ... context)

Long trains, Long hauls
• ... And the long story of short lining
Highlighting the Highlights

**Operating Ratio**
- What does it mean?
- Why does it matter so much?

**Capital RE-Investment!**
- Over half of net cash
- *These are not really “additions”*

**Leverage**
- Debt is typically 40% +/-
- NS: the undisputed long-bond champion!

**How are they using extra cash?**
- Paying for capital!
- Paying down debt
- And giving equity back!
The “Average” Class I - $13B Annual Revenue

Sources of Cash

- Operating expense: 58%
- Capital investment: 15%
- Dividends and interest: 9%
- Taxes paid: 9%
- Shares repurchased: 9%

Uses of Cash

<table>
<thead>
<tr>
<th>Source of Cash</th>
<th>2017</th>
<th>2016</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expense</td>
<td>$10,551</td>
<td>$9,888</td>
<td>$10,551</td>
</tr>
<tr>
<td>Operating expenses (loss)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td>$3,435</td>
<td>$3,074</td>
<td>$2,8</td>
</tr>
<tr>
<td>Per share - diluted</td>
<td>$1,922</td>
<td>$1,668</td>
<td>$1,5</td>
</tr>
<tr>
<td>Dividends per share</td>
<td>$2,44</td>
<td>$2,36</td>
<td>$2</td>
</tr>
<tr>
<td>Total paid</td>
<td>$12,938</td>
<td>$12,329</td>
<td>$12,169</td>
</tr>
<tr>
<td>Operating expense ratio</td>
<td>45%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Cash provided by operating activities</td>
<td>$3,253</td>
<td>$3,034</td>
<td>$2,9</td>
</tr>
<tr>
<td>Property additions</td>
<td>$1,723</td>
<td>$1,887</td>
<td>$2,3</td>
</tr>
<tr>
<td>Cash flow</td>
<td>$5,180</td>
<td>$5,287</td>
<td>$5,2</td>
</tr>
</tbody>
</table>

Year End

- Total assets                        | $35,711  | $34,892  | $34,129  |
- Total debt                          | $9,836   | $10,212  | $10,000  |
- Total shareholders’ equity          | $16,359  | $12,409  | $12,100  |
- Shares outstanding                  | 284.2    | 290.4    | 29        |
- Total shareholders’ equity per share| $57.57   | $42.73   | $40.35   |

Financial Ratios

- Operating ratio                      | 67.4%    | 68.9%    | 70.2%    |
- Interest coverage ratio              | 37.5%    | 45.1%    | 49.2%    |
The “Average” Class I - $13B Annual Revenue

Sources of Cash

- 58% Operating expense
- 15% Capital investment
- 9% Dividends and interest
- 9% Taxes paid
- 9% Shares repurchased

Uses of Cash

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2016</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total operating revenue</td>
<td>$10,551</td>
<td>$9,888</td>
<td>$10,800</td>
</tr>
<tr>
<td>Income</td>
<td>$3,435</td>
<td>$3,074</td>
<td>$2,850</td>
</tr>
<tr>
<td>Dividends and interest</td>
<td>$1,522</td>
<td>$1,522</td>
<td>$1,522</td>
</tr>
<tr>
<td>Taxes paid</td>
<td>$1,723</td>
<td>$1,887</td>
<td>$2,300</td>
</tr>
<tr>
<td>Shares repurchased</td>
<td>$1,530</td>
<td>$1,147</td>
<td>$500</td>
</tr>
</tbody>
</table>

What is this??

AAPA Trade Conference, Tampa FL  
Strategic Rail Finance  
January 31, 2019 – Page 15
Reinvestment vs. Returning Capital

Q At what point is it worth building something new?!

A When you can get a 10 or 12 month payback!!
3P Structure Opportunities

> Revenue Sharing
> Cost of Capital and Programmatic Returns on Investment
> Asset Ownership, Operations, and Lease Structures
Revenue Sharing via “Carload Credits”

Keeping it simple

Recoup a small (six-figure) investment with a “carload credit” acknowledging $2.5M/yr of new rail revenue

> Warehouse owner invests in dock and doors
> Transload tenant pays “improvement rent”
> Railroad credits the tenant $100 per car on new rail traffic for three years
> Railroad benefit: spot four more box cars on every switch (960 cars per year) with no increase in op ex and no cap ex
> Port benefit: transloader ships an extra 2900 export containers of paper, generating $0.7M/yr in new wharfage revenue
Menus for Hybrid Ownership / Operations

Ownership
- Land
- Repair facilities
- Locomotives
- Mainline and yard tracks
- Structures
- Industrial tracks
- Rolling stock
- Leasing options

Operations
- Train operations
- Signals and dispatching
- Track maintenance
- Overhead rights
- Trackage rights
- Level of service

Pricing
- Tariff rate setting
- Interchange agreements
- Utility easements
- Land leases
- Industrial switch agreements
- Storage rates
Menus for Hybrid Ownership / Operations

### Ownership
- Land
- Repair facilities
- Locomotives
- Mainline and yard tracks
- Structures
- Industrial tracks
- Rolling stock
- Leasing options

### Operations
- Train operations
- Signals and dispatching
- Track maintenance
- Overhead rights
- Trackage rights
- Level of service

### Pricing
- Tariff rate setting
- Interchange agreements
- Utility easements
- Land leases
- Industrial switch agreements
- Storage rates

Business Development
Cost of Capital, Hurtle Rate, and Programmatic ROI

Two forms of Return on Investment
1. Financial returns
2. Programmatic returns

Private entities focus on #1 - Public on #2

Port Hurtle Rate: 6% to 8%
Railroad Hurtle Rate: 25% +

A Port’s access to capital AND ability to balance financial returns with programmatic returns provides a low financial hurtle rate

Examples of Programmatic Returns on Investment
- Job creation
- Tax base
- Increasing exports
- Infrastructure development
- Foreign direct investment
- Congestion reduction
- Air and water quality
Summary Points

• Simplify
• Know the economics
• Manage risk allocation
• Develop business for the railroad
• Leverage your low hurdle rates and access to capital
• Consider all the operation / lease alternatives
• Own the rail assets
Thank You!

John Elliott, Senior Vice President
jelliott@strategicrail.com

1700 Sansom Street, Suite 500
Philadelphia, PA 19103
(215) 564-3122
strategicrail.com