M&A ACTIVITY IN THE RAILWAY INDUSTRY: WHAT'S COMING DOWN THE TRACK?

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OVERVIEW

- Railroad Acquisition/Investment Trends
- Regulatory Review of Transactions
- Implications for Stakeholders of Recent Activities

I. Railroad Acquisition/Investment Trends

Class I's

- 1980: Over 40 Class I railroads
- Today: 7 remaining Class I railroads (UP/BNSF/CSXT/NS/CP/CN/KCS)

Prior/Recent Activities

- Wave of major mergers concluded with UP/SP (1996), Conrail (NS/CSX) (1998)
- STB issues Moratorium (2000) to block BNSF-CN; then Policy Statement (2001) to significantly increase burden of proof on merger applicants
  - Some increased "alliances" (e.g., NS/KCS "Meridian Speedway" project, NS/Pan Am "Patriot Corridor" project)
  - U.S. Carriers acquire stakes in Mexican railroads (UP–FMX; KCS-TFM)
  - Some Class I's continue to spin off shortlines (e.g., 2018 CSX announces sale of ~ 650 miles of separate, non-contiguous branch/feeder lines)
  - Recently, other Class I's seek to acquire shortlines
    - » E.g., CN/BL&E acquires CSXT's Massena line (STB reconsideration pending)
    - » E.g., CP acquires Central Maine & Quebec Ry. (STB authorization, 2020)

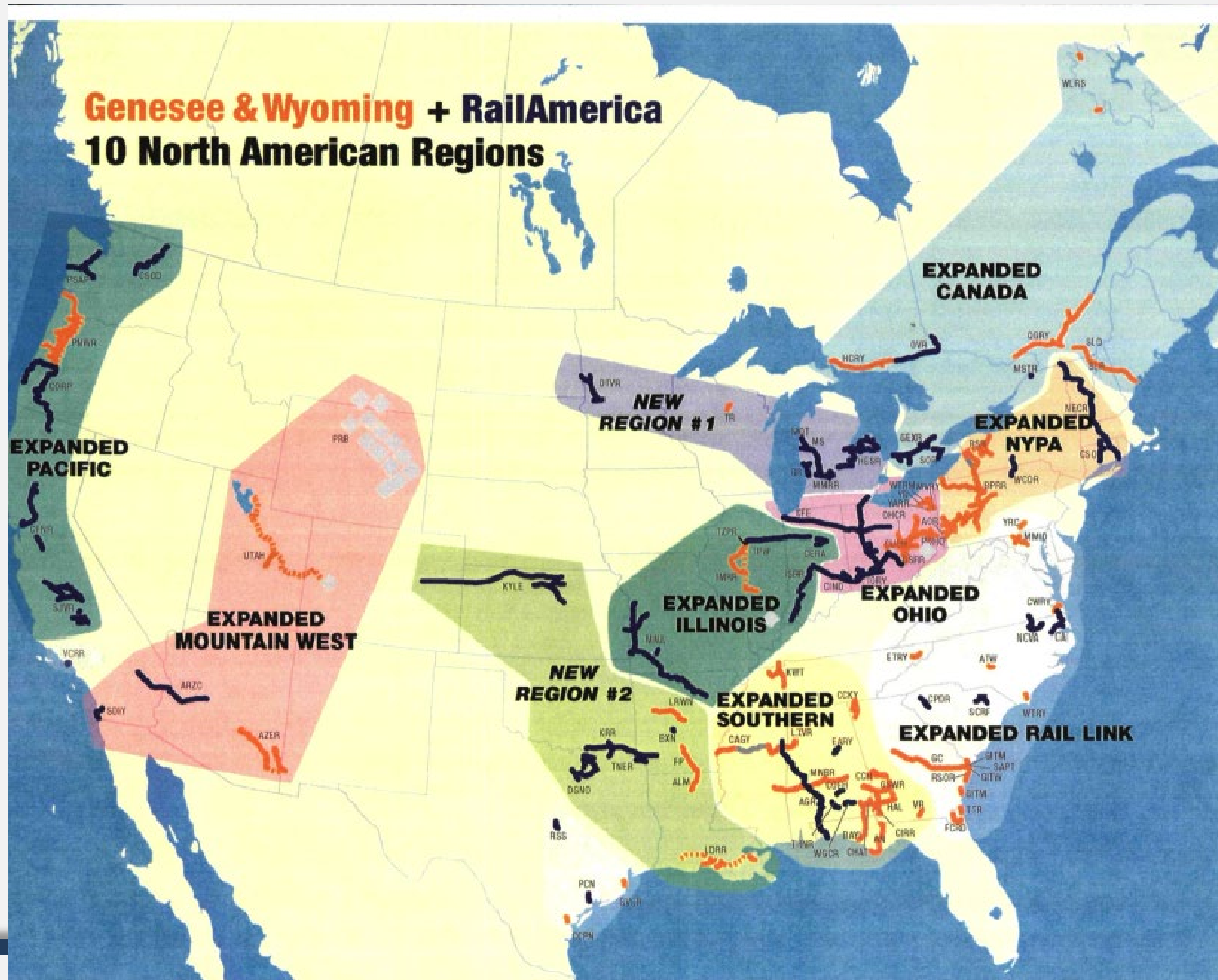
I. Railroad Acquisition/Investment Trends

Class I's (continued)

- Increased interest in acquisitions by private equity/shareholders
  - Berkshire Hathaway acquires BNSF in 2010
    - Transaction involved an $8.1 billion "acquisition premium"
  - In 2012, Pershing Square Capital Management, L.P. engaged in a successful proxy contest to replace certain CP Board of Directors
    - Beginning in 2014 CP aggressively sought to first merge with CSX, then NS, with the eastern carriers strongly resisting
      - » In 2016, CP sought to implement a "voting trust" arrangement whereby CP's CEO would depart CP and become the CEO of NS before a CP/NS merger application was filed
      - » As part of its merger overture, CP voluntarily proposed to extend terminal trackage rights and reciprocal switching, and other bottleneck relief to its United States operations
      - » CP terminated its acquisition plans on April 11, 2016
    - Other Class I carriers state that they will not be left out of any additional industry consolidation should it occur

I. Railroad Acquisition/Investment Trends

Shortlines



I. Railroad Acquisition/Investment Trends

Shortlines

- A similar wave of consolidation in the short line industry
- Large holding companies now own/control a substantial portion of short lines in the U.S.
  - G&W controls ~ 108 short lines
  - Watco controls ~ 89 short lines
  - OmniTrax controls ~ 19 short lines
  - Patriot Rail controls ~ 13 short lines
- New entrants include “non-traditional” players/investment funds
  - Brookfield Asset Management, Inc. and DJP XX, LLC acquired G&W (2019)
    - Formerly, Fortress Investment Group acquired RailAmerica (2006); G&W acquired RailAmerica from Fortress (2012)
  - OmniTrax is a subsidiary of the Broe Group
  - Patriot Rail was acquired by SteelRiver Infrastructure Partners LP in 2012
  - Grupo Mexico Transportes (controls Ferroxmex) acquires Florida East Coast Railway in 2017 ($2.1B)
  - Pan Am (formerly Guilford, now owned by Tim Mellon) recently announced sale

II. Regulatory Review of Transactions

Railroad Mergers/Line Sales

- Major mergers subject to STB approval and are reviewed under a broad "public interest" standard
  - Standard examines the transaction's competitive impacts, its impact on the adequacy of transportation to the public and on other carriers, and employee impacts. (49 U.S.C. §§ 11323-11324)
- The STB has authority to impose conditions to its approval of such transactions that are designed to mitigate competitive or other adverse impacts
- STB's rules now require pro-competitive showing for Major transactions
- Line sales are also subject to STB regulatory review (49 U.S.C. § 10901)
  - Board generally authorizes line acquisitions unless there is a showing that the transaction is "inconsistent with the public convenience and necessity" and the Board can also impose conditions on approval.

II. Regulatory Review of Transactions

Exemptions

- Most transactions are exempt from STB approval requirements
  - Exemptions are authorized where the Board finds that the transaction is (i) not necessary to carry out the national rail transportation policy and (ii) limited in scope/regulation is not needed to protect shippers from the abuse of market power (49 U.S.C. § 10502)
- Broad "class exemptions" adopted in the mid-1980s cover most – but not all – of the day-to-day short line railroad/rail line acquisition and operation cases processed by the STB
- Generally, such transactions, including those involving holding companies, involve public notice, filing of an exemption notice, with the exemption going into effect 30-45 days after it is filed, unless the STB otherwise directs

Opposition to Exempt Transactions

- Generally, three options: (1) ask the Board to "reject" the exemption (2) ask the Board to "stay" the effective date of the exemption pending further Board review; or (3) ask the Board to "revoke" the exemption after it goes into effect
- In addition, the STB has issued some new procedural rules involving public notice of the contents of any "paper barriers" included in the transaction

III. Implications for Stakeholders

- Class I mega-mergers are occasionally discussed, but no major transcontinental transaction has been proposed
  - If so, how will the applicants address, and how will the STB's "pro-competition" merger rules address/affect?
- Might there be increasing interest by private equity/shareholders in mega-acquisitions, and if so, how will the STB respond?
  - Might investors' short-term return objectives affect infrastructure investments, service, staffing, and general railroad common-carrier obligations?
- If KCS were a target, would the STB's "Major" consolidation rules be applied, and might that transaction trigger additional merger proposals?
  - *See Major Rail Consol. Procedures*, EP 582 (Sub-No. 1) ("for a merger proposal involving KCS and another Class I railroad, we will waive application of the new rules and apply the rules previously in effect unless we are persuaded otherwise")

III. Implications for Stakeholders

- A wave of consolidations is now occurring in the shortline industry. Mega-holding companies now own/control a substantial portion of shortlines
  - Will the short line merger wave continue, and if so, what are the impacts?
  - Does the growth in holding companies signal the beginning of the end of the locally owned/controlled short line? Is "bigger" necessarily "better"?
  - Will short line holding companies attempt to leverage size/seek to be more aggressive on handling carrier rates with connecting Class I's and, if so, what will the impact be on customers? (*see, e.g., BNSF v. PNR*, No. 16-01061 (N.D. Tex) (breach of contract/handling carrier agreement)
  - Will there be a future need for the STB to take a closer look at short line consolidation issues? *See, e.g., Brookfield Asset Management, Inc. et al. – Control Exemption – Genesee & Wyoming, Inc., et al.* (served July 22, 2019) (STB postpones the effective date of exemption allowing public to submit comments on "the issues presented here, including whether the class exemption is appropriate for this transaction")

Thank You!

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