

*From **Poverty** to **Prosperity***

How the Rail Industry Turned Itself Around  
and  
Became a Favorite of Wall Street

*A personal perspective: 1970 – 2012*

Tom Murray

June 2012

Friends of the Santa Maria Valley Railroad

*1970-1973: I didn't plan to make a career in railroading*

But somehow I ended up working for my hometown railroad, the Boston & Maine,  
after college



*Even as a novice in the railroad business,  
I could see that some services didn't pay for themselves*

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Some branch-line trains operated with a four-person crew and just one or two cars



*Deferred maintenance was part of the survival strategy*

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Run 'em until they fail was a way of life, and not just on the B&M



*The early 1970s were a tough time for the Northeastern railroads*

Three weeks after I started with the B&M, Penn Central went bankrupt



*Soon other Northeastern railroads found themselves out of cash*

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There was something very wrong here...



## *1973: Go west, young man*

Soo Line wasn't the most modern railroad in the Midwest, but it did make money



# *1974-1978: Soo Line's Schiller Park Terminal near O'Hare Airport*

Four years in Chicago was a great education



*But other railroads in the Midwest were not so healthy*

Radiating from Chicago were several “corridors of excess capacity” with too many railroads and too little traffic



*By the late 1970s, bankruptcy was not just a northeastern dilemma*

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1975: Rock Island



1977: Milwaukee Road



*From 1978 to 1986, I worked in Washington, D.C.*

One of the best things about living in northern Virginia was having the Southern Railway at my doorstep – it was a class act in every way



*1978-1979: U.S. Railway Association, Conrail's government banker*

Washington gave me a new window on the rail industry



## *Conrail fixed some problems*

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But it had a rough start, and in its early years it lost \$1 million a day



*1979-1986: Consulting expanded my horizons*



Client: L.A. Dept. of Water & Power  
(Intermountain Power Project)

Railroad: Utah Railway



Client:

Railroad:  
Ry.

## *1986-1990: CSX Marketing Department*

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It took CSX quite a while to merge the Chessie and Seaboard, and it really didn't pull itself together until almost a decade later



## *1990-1996: Southern Pacific Marketing Department*

My rail career began with one troubled carrier, B&M, and ended with another, SP



*At SP, long-term underinvestment and misplaced priorities made for poor service and poor financial results*

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Many trains ran for the convenience of the operating department: *“We’ll run a train when the departure track is full, and not until then.”*



1997-2012: Since leaving SP, one thing has led to another...

A newsletter covering railroad stocks led to consulting for the financial industry

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News, statistics and commentary on railroads and other rail industry companies whose shares are traded on U.S. stock exchanges

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**In this issue of Rail StockWatch**

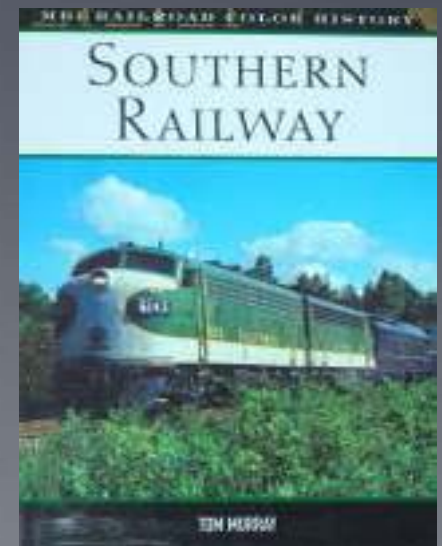
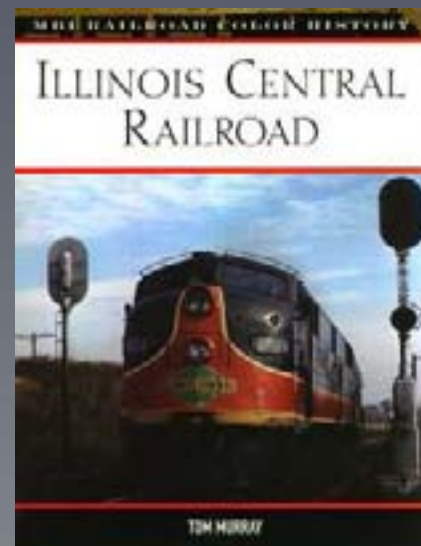
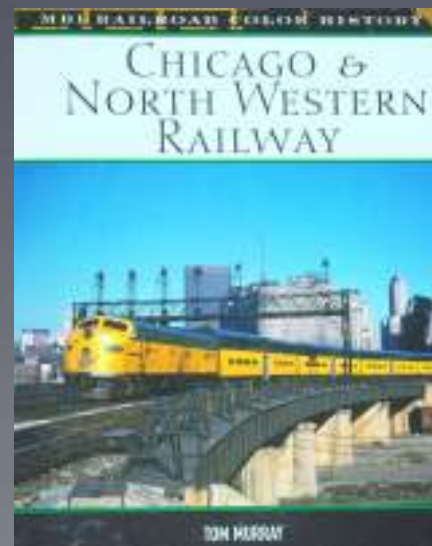
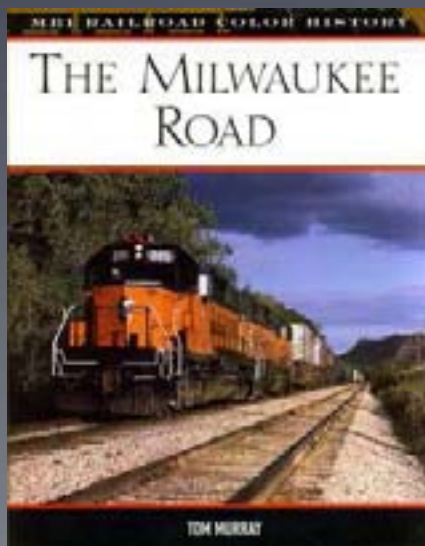
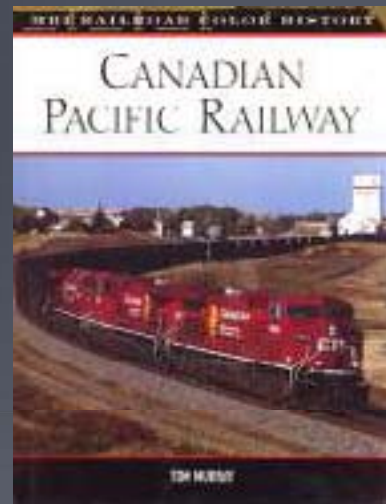
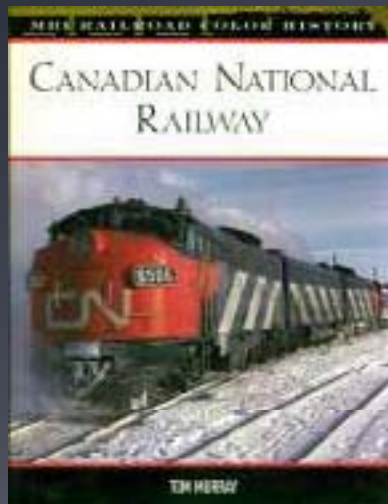
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Volumes are weakening, the weather's been awful in parts of the U.S. and Canada, the STB has decided to regulate the railroads' fuel surcharges, and the Federal Reserve has left the door open to "additional firming" of interest rates, depending on how the economy behaves. None of this seemed to matter much to investors in rail stocks. Although there were some down days, and even down weeks, for rail stocks in January, by month's end they had finished well into positive territory. The Dow Jones U.S. Railroads Index turned in a gain of 6.38% for the month, well ahead of the S&P 500's 1.41% increase.

Of course, more than half of the month's 25-point increase in the Dow Rail index came on the last day of the month, following an announcement by Union Pacific that it would increase its dividend and start a share repurchase program. UNP became the third major railroad to boost its dividend in January (the others were CNI and NSC). For many years free cash flow was unknown in the rail industry, but now railroads are generating enough cash to allow them to boost both their capital spending programs and their payouts to shareholders. And it isn't just the railroads themselves that are sharing the wealth with their owners: in recent days, FreightCar America announced a share buyback and GATX both a buyback and an increase in its dividend.

*... and articles for Trains Magazine led to writing books*



Now that I've told you about my education in railroading, let's go back and look at how this very troubled industry changed direction over the last three decades

First there was the 3R Act, then the 4R Act, and then, the Staggers Rail Act of 1980

**STAGGERS RAIL ACT OF 1980**  
Public Law 96-448; 96th Congress

AN ACT To reform the economic regulation of railroads, and for other purposes.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

**SHORT TITLE**

**SECTION 1.** This Act may be cited as the "Staggers Rail Act of 1980".

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**FINDINGS**

**Sec. 2.** The Congress hereby finds that--

- (1) historically, railroads were the essential factor in the national transportation system;
- (2) the enactment of the Interstate Commerce Act was essential to prevent an abuse of monopoly power by railroads and to establish and maintain a national railroad network;
- (3) today, most transportation within the United States is competitive;
- (4) many of the Government regulations affecting railroads have become unnecessary and inefficient;
- (5) nearly two-thirds of the Nation's intercity freight is transported by modes of transportation other than railroads;
- (6) earnings by the railroad industry are the lowest of any transportation mode and are insufficient to generate funds for necessary capital improvements;
- (7) by 1985, there will be a capital shortfall within the railroad industry of between \$16,000,000,000 and \$20,000,000,000;
- (8) failure to achieve increased earnings within the railroad industry will result in either further deterioration of the rail system or the necessity for additional Federal subsidy; and
- (9) modernization of economic regulation for the railroad industry with a greater reliance on the marketplace is essential

*The 3R and 4R Acts, and then the Staggers Act, encouraged:*

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- Rates based on market demand
  - Confidential contracts with shippers
  - Exemption of certain categories of rail traffic from regulation
  - Faster processing of merger applications
  - Sales of rail lines to new short line railroads, or abandonment where sales were not feasible
-

## *Railroads spent the 1980s consolidating (and pruning)...*

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- 1980 Chessie System + Seaboard = CSX
  - 1980 BN absorbs SLSF
  - 1982 N&W + Southern = Norfolk Southern
  - 1982 UP absorbs MP and WP
  - 1985 Soo Line absorbs Milwaukee Road core lines
  - 1988 UP absorbs MKT
  - 1988 Rio Grande acquires Southern Pacific
-

*... and then did more of the same in the 1990s*

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- 1995 UP absorbs C&NW; service problems follow
  - 1995 BN + ATSF = BNSF
  - 1996 KCS wins Mexico concession
  - 1996 UP absorbs SP; meltdown follows
  - 1998 CN, privatized in 1995, acquires IC, and with it, Hunter Harrison
  - 1999 CN and BNSF propose merger, but give up under shipper pressure
  - 1999 Conrail, privatized in 1987, is split between CSX and NS; problems follow
-

*Meanwhile, exciting things were happening in two key markets...*

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- Coal
    - 1979 BN opens Orin line into Powder River Basin
    - 1984 C&NW begins service into PRB from the south
  - Intermodal
    - 1981 SP debuts doublestack cars
    - 1984 Regular doublestack service begins
    - 1989 J.B. Hunt becomes first major trucker to make large-scale use of intermodal service
-

*... and railroads were making some big investments*

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- 1980 UP opens new westbound Bailey Yard at North Platte, Nebraska
  - 1995 CN opens new St. Clair Tunnel between Ontario and Michigan
  - 1997 BNSF completes reconstruction of Argentine Yard in Kansas City
  - 1999 UP completes third main track across Nebraska
-

*Still, in the 1990s, Wall Street didn't have much love for the railroad business*

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- Railroads still weren't earning their cost of capital
  - The industry survived through property sales and other short-term measures
  - Because most available cash was reinvested, this left little or nothing for shareholders
  - One major transportation mutual fund in late 1990s had airline and trucking stocks, but no rails; fund manager's explanation: *"No free cash flow"*
-

## *Wall Street's negativity about the railroad business showed up in stock prices*

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- Between June 1992 and June 2002:
    - Dow Jones Industrials gained 196%
    - Standard & Poor's 500 increased 159%
  - Meanwhile:
    - Union Pacific stock gained only 30%
    - CSX was up 14%
    - Norfolk Southern increased a mere 6%
-

## *But the hard work began to pay off after 2000*

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- Mergers had eliminated much of the inter-railroad competition that once existed
  - Capacity on key corridors started to fill up
  - Starting in 2003, railroads were shocked to find that they could make annual price increases of 5% and more stick
  - Railroads didn't hesitate to shed marginal business
  - *“Our strategy has been to ensure that every piece of business that moves on our railroad is re-investable.”* (Jack Koraleski, Union Pacific, April 2012)
-

## *Milestones in the railroads' resurgence as an investment vehicle*

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- 2003: Bill Gates starts to acquire Canadian National stock, and by 2006 is CN's biggest shareholder
  - 2007:
    - Canadian Pacific rejects a takeover proposal by Brookfield Asset Management
    - Hedge fund TCI stages a proxy battle to gain seats on the CSX board (but then sells its shares)
    - Warren Buffett invests in several railroads, then in 2009 buys BNSF (*"What was a terrible business 30 years ago is a better business now"*)
  - 2012: Activist investor Bill Ackman unseats CP's CEO, chairman, and several directors; proposes to install former CN executive Hunter Harrison as CEO (stay tuned)
-

## *Railroads were once again growing their business*

- Class I railroads: revenue ton-miles (billions)

1970: 765

1980: 919

1990: 1,034

2000: 1,466

2011: 1,729



- Intermodal trailers & containers (thousands)

1970: 2,363

1980: 3,059

1990: 6,207

2000: 9,177

2011: 11,890



*Source: Association of American Railroads*

## *But on a much smaller network*

### Class I railroads: miles of road operated

1970: 196,479

1980: 164,822

1990: 119,758

2000: 99,250

2011: 95,514

*Source: U.S. Dept. of Transportation, Bureau of Transportation Statistics; Association of American Railroads*



## *Railroads have become more efficient, and more profitable*

- Class I railroads: operating ratio

1970: 95.7%

1980: 93.3%

1990: 86.9%

2000: 85.2%

2011: 73.1%

- Return on equity

1970: 0.43%

1980: 6.01%

1990: 8.18%

2000: 7.95%

2011: 11.13%



*Source: Association of American Railroads*

*After decades of hard work, rail stock returns outpaced the rest of the market*

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Between June 2002 and June 2012:

Norfolk Southern stock gained 222%



Union Pacific was up 267%

And CSX almost quadrupled in price, gaining 295%

Meanwhile:

***Both the Dow Jones Industrials and the S&P 500 increased just over 30%***

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## *The road ahead is promising, but we can't be complacent*

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- Positives for rail industry over the coming decades
    - Fuel efficiency
    - Highway congestion will drive more business off the roads and onto the rails
    - Tight rail capacity supports continued pricing power
  - Still, there's room for improvement
    - Equipment utilization remains shockingly poor, particularly for loose-car business
    - The “scheduled railroad” is still more talk than reality
    - Service quality has improved but local service remains a weak spot
-

## *There are plenty of challenges ahead*

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- Internal
    - Make better use of existing capacity in the network (use Europe as a model)
    - Use partners where necessary to move traffic the “last mile” (e.g., SMVRR)
    - Don’t overreach on pricing; minimize regulatory involvement
    - Meet the PTC challenge
  - External
    - Respond to a dynamic world economy that affects how and where traffic moves
    - Manage community impacts as railroad footprint expands at key nodes in network
    - Attract smart, capable people to an industry that still has image problems
    - Panama Canal expansion is a wild card
-

## *What We've Lost*

The friendly local railroader



## *What We've Lost*

The fallen flags... too many to list



*Love 'em or hate 'em, sometimes big railroads make sense*

---

Did it make sense to run a coal train from Utah to southern California over Donner Pass? Maybe for SP it did, but not for the customer.



*And we still have diversity...*

Short lines and regional railroads are healthier than ever



*Railroading has a bright future*

Much brighter than it looked in 1970



## Acknowledgments

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- Rob Himoto and the Friends of the Santa Maria Valley Railroad, for the invitation to be here today
  - The many professional railroads who mentored me during my career
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  - My father for introducing me to railroads
  - My wife Marcia for encouraging me to follow this path
-

# Questions?

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