



INVESTING IN RAIL

INFRASTRUCTURE INVESTMENTS

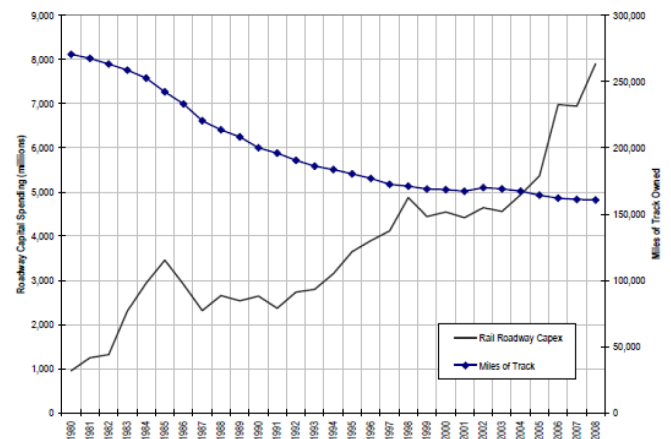
Railroads provide a basic, but critical role for any developed society – they facilitate the connection between producers and consumers of essential goods and support a large section of the economy. The North American rail industry represents one of the world's oldest and largest collections of transport infrastructure.

The US rail industry was once a global leader in rail infrastructure development and innovation, with acclaim for manufacturing world-class locomotives and carriages. In 1934 Budd Manufacturing Co. created the Zephyr, a US diesel-powered train that broke the world speed record. The locomotive travelled from Denver to Chicago at 77 miles per hour and set the US on a course to dominate global rail development. However, over time US rail had become a forsaken sector and failed to keep up with innovations seen elsewhere in Europe and Asia, with aging rolling stock that lacked efficiency compared to competing alternatives in the air and on the roads. The post-World War II era saw the economy make a structural shift away from rail and towards expansion of the US automobile industry.

From an investment perspective, returns from rail operations became uneconomical and by the 1970s, the rail industry's return on capital averaged just 2%. The majority of railroads in existence were in ruin, with bankrupt railroads accounting for more than 21% of North America's rail mileage.¹ This led to a number of players exiting the market.

The decline of the rail industry prompted US Congress to reform federal railroad regulation and in 1980, the Staggers Rail Act was established to alter rules around competition, service routes and pricing. The Act was instrumental in reviving the sector and promoting new investment into rail development to help create one of the most cost-effective and productive freight systems in the world.

US rail infrastructure spending vs. miles of track (1980 – 2008)



Source: Wolfe Research

Deregulation of the industry also resulted in a number of bankruptcies and mergers, taking the number of Class I railroads in the US from about 40 down to five, effectively creating regional duopolies. By 2004, a number of the operating challenges (e.g. labour agreements) abated for the merged entities and they were able to improve operating margins. Since 2004, there has been no real evidence of pricing wars amongst the competing rail roads.

¹Source: Chronology of America's Freight Railroads July 2023

In the last 10 years, US Class I railroads have spent more than US\$250 billion on infrastructure and equipment and have laid approximately six million tons of new rail. Over the last 15 years, freight railroads have invested, on average, US\$24.2 billion of their own capital into improving and maintaining their networks.*

Investments have been made across the sector to expand capacity, improve transportation efficiency and forge new regional connections. Some railroad operators have established intermodal links – combining rail transportation with road or shipping services to provide freight customers with single end to end solutions. Rail intermodal transport volumes have significantly expanded since the turn of the century.



THE ATTRACTIVENESS OF RAIL

The synergies between regulatory support, capital investment and operational improvements have contributed to US rail now offering attractive returns on investment. North American rail operators are large corporations that benefit from scale and network effects. One of the largest operators, Union Pacific, operates the world's largest freight rail yard. The company's Bailey Yard in North Platte, Nebraska, covers 2,850 acres and has a total length of eight miles, making it three times the size of New York's Central Park. The site is operational 24 hours a day, seven days a week and handles 14,000 rail cars each day that travel across the company's 32,000 route miles.²

From agriculture to automotive parts to chemicals and coal, railroads serve practically every industry sector and forms essential infrastructure for communities. The North American rail sector is suitably diverse with an expansive network which is vital for the conveyance of bulk goods. Indeed, about 40% of intercity freight volumes in the US are moved by rail, one of the highest for any developed country.* While the sector is capital intensive, there are a number of fundamentally attractive factors for infrastructure investors.

i) Earnings have limited sensitivity to competition

- North American railroads operate within duopoly markets and hence, face limited competitive pressures. Within each of these markets, the main operators have shown discipline in pricing which has been reflected in strong returns on capital.

* Association of American Railroads - Facts and Figures August 2023

² Union Pacific <https://www.up.com/index.htm>

- Capital intensity, network effects and right-of-ways create immense barriers to new entrants.
- Rails are typically the only economical solution for shippers, particularly for long haul movements of low value heavy goods such as coal and grains. Trucks are competitive as they can provide time-sensitive delivery services for more high-value goods being transported over short-and-medium haul distances. However, their competitive advantage declines in periods of strong cost inflation given the relatively greater impact on truck relative to rail. Issues that drive inflation for trucking companies include rising labour costs, driver shortages, possible limitations on hours of service and growing costs associated with truck safety compliance regulations. Trucking companies have also been less successful in passing through rises in fuel costs.

ii) Earnings are immune from commodity price movements

- Fuel costs represent a material component of rail operating costs. Class I railroads have been successful in passing on changes in fuel cost through to customers via a contractual fuel surcharge mechanism.

iii) Rail operators benefit from an effective regulatory regime

- Railroad regulation is somewhat light-handed and constructive. Economic regulation of railroad operators is primarily conducted through the United States Surface Transportation Board and in Canada, the Canadian Transport Agency. For US operators, the Staggers Rail Act effectively diluted the regulatory structure. Since the Act was passed in 1980, average rail rates (adjusted for inflation) have fallen 40%. This means the average rail shipper can move more freight than before for the same price paid more than 40 years ago.*

iv) Increased margins through implementation of precision scheduled railroading (PSR)

- PSR is a railroad operating model pioneered by the late Hunter Harrison. Mr Harrison first implemented PSR at Illinois Central Railroad in 1993 and went on to implement PSR at several other class one railroads including Canadian National in 1998, Canadian Pacific in 2014 and CSX in 2017.
- The core objective of PSR is to reduce the average time it takes to move a customer's rail car from origin to destination. PSR increases the reliability of rail as a transportation method; i.e., the goods arrive at the scheduled time. The proportion of CSX trains that arrived on time increased from 51% in 2015 (prior to PSR implementation) to 75% in 2018 (post implementation of PSR).
- PSR is also beneficial for shareholders given railroads can move the same amount of goods with fewer people and assets. This has resulted in a material increase in margins for railroads. For example, CSX's adjusted operating margin increased from approximately 30% in 2015 to 40% in 2018.

DEMAND CONSIDERATIONS

Rail operators are also well placed to manage capacity as demand changes. An improved focus on operating efficiencies has partly mitigated the effects of the recent volume downturn. But when volumes stabilise and subsequently increase, rail operators have the flexibility to meet the upturn in demand, primarily through adding cars and lengthening trains. Further gains from technological innovation and future automation provide avenues for additional operational leverage.

AN ATTRACTIVE SECTOR IN A DEPENDABLE MARKET

In the prevailing environment, the US economy is continuing to exhibit signs of sustainable recovery and growth in exports, which bodes well for the freight sector. Even in a low growth environment, rail operators have shown the ability to grow earnings. Following a period of increased investment to support intermodal volume growth, improve network performance and meet regulatory requirements, capital investment for rail operators can be expected to ease going forward. Considered together with improved service offerings, this should contribute to strong and stable free cash flow growth, making the sector attractive to infrastructure investors. At current valuations we have seen an attractive entry point to the North American rail sector and will be closely monitoring opportunities in this market.

EXAMPLES OF LISTED RAIL ASSETS

Listed Rail Company	Location
Union Pacific	Operates North America's premier railroad franchise, covering 23 states in the western two-thirds of the United States.
CSX Corporation	Based in Jacksonville, Florida and operates in the eastern United States and the Canadian provinces of Ontario and Quebec.
Norfolk Southern	Based in Atlanta, Georgia and operates in the eastern United States.
Canadian National	Spanning Canada and Mid-America as well as connecting ports on three coasts - the Atlantic, the Pacific and the Gulf of Mexico.
Canadian Pacific	Headquartered in Calgary, Alberta, and operates in seven provinces of Canada and into the United States, stretching from Montreal to Vancouver, and as far north as Edmonton.



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