

BEFORE THE
SURFACE TRANSPORTATION BOARD

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RAILROAD COST OF CAPITAL –) EP 558 (Sub-No. 27)
2023

**REPLY STATEMENT
OF THE WESTERN COAL TRAFFIC LEAGUE**

WESTERN COAL TRAFFIC LEAGUE

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REPLY STATEMENT OF THE WESTERN COAL TRAFFIC LEAGUE

Pursuant to the notice that the Surface Transportation Board (“STB” or “Board”) served in the above-captioned proceeding on February 20, 2024, the Western Coal Traffic League (“WCTL”)¹ hereby replies to the amended opening statement that the Association of American Railroads (“AAR” or “Railroads”) submitted on April 23, 2024.

I. INTRODUCTION AND SUMMARY

For present purposes, WCTL finds no significant errors in the AAR’s mathematical calculations implementing the Board’s established cost of capital methodology. Nonetheless, the Board’s methodology continues to yield an inaccurate and substantially overstated cost of capital (“COC”) due to its miscalculation of the cost of equity (“COE”) component. The overstatement may be partially masked by the decline in the COC, and especially the cost of equity capital (“COE”), in 2023 relative to

¹ WCTL is a voluntary association, whose regular membership consists entirely of shippers of coal mined west of the Mississippi River that is transported by rail. WCTL’s members are: Ameren Missouri, Arizona Electric Power Cooperative, Inc., Austin Energy (City of Austin, Texas), CLECO Corporation, CPS Energy, Entergy Services, Inc., Evergy, Inc., Lower Colorado River Authority, MidAmerican Energy Company, Minnesota Power, Nebraska Public Power District, and Western Fuels Association, Inc.

2022, notwithstanding the increase in interest rates that bears on the cost of debt (“COD”) and the risk-free rate (“RFR”) in the Capital Asset Pricing Model (“CAPM”). Furthermore, the fact that CAPM COE exceeds the COE under the Multi-Stage Discounted Cash Flow Model (“MSDCF”) does not demonstrate the robustness or other soundness of the Board’s hybrid COE methodology. Instead, the reversed relationship reflects flaws in both components of the hybrid COE methodology, particularly an overstated historical Market-Risk Premium (“MRP”) in the CAPM, as well as flawed specifications in the MSDCF that are especially manifest in the 2023 data, as discussed further *infra*.

Furthermore, superior and more credible alternative values and calculations remain readily available, including those of Morgan Stanley (7.04% COC), those produced by the use of the AAR/STB CAPM inputs combined with the current MRP and associated 10-year RFR recommended by Professor Aswath Damodaran of the Stern School of Business of New York University (7.85% COC), and even the long-term cost of capital figure of 8% presented by CSX Corporation in its 10-K for 2023 to inform its investors of the carrier’s “economic profit,” equivalent to its surplus earnings above those needed to achieve revenue adequacy. These figures are in line with the values that CP, CN, and KCS presented in conjunction with the CP/KC merger and that the Board adopted in approving the merger, as WCTL explained in last year’s comments, which are hereby incorporated by reference.

WCTL recognizes that the Board may be under no immediate legal obligation to consider such matters in this particular proceeding. However, the Board

should always be interested in the soundness of its methods, especially for a matter as consequential as the cost of capital. In particular, the Board always has the ability to institute a proceeding on its own initiative to revisit its COC. For that reason and others, WCTL continues to compile and present a record of these alternate and more mainstream measures and associated data and to note deficiencies, data problems, and contradictions in the Board's established methodologies.

II. THE AAR'S COST OF EQUITY DEVIATES SUBSTANTIALLY FROM RESPECTED BENCHMARKS

Railroads are said to compete with firms in other industries for investor capital.² To that extent, an appropriate starting point for reviewing the railroad COE is to consider the expected return that railroads and equities generally need to offer in order to attract or retain investment.

In particular, Morgan Stanley continues to present weighted average cost of capital values for individual railroads. The most timely and relevant for purposes of the 2023 COC are those from its *4Q23 Preview: How Many Ways Can You Say "A Tale of*

² In fact, the railroads in the composite sample have not needed to raise outside equity capital for many years, and instead rely on revenues extracted from customers. The railroads respond that those revenues are not "excess," but needed to fund dividends, buybacks, and capital expenditures, and suppressing their COE will cause funds needed for operations to be diverted to non-railroad purposes. That outcome seems unlikely. Most railroad rates are not regulated (the same reason that "circularity" in the MSDCF growth estimates is supposedly not a concern). The extraordinary returns that the railroads continue to extract provide more than ample incentive for the railroads not to kill their "golden goose." For example, UP's return on equity in 2023 exceeded 47%. UP Annual Report for 2023 at 32, https://www.up.com/cs/groups/public/@uprr/@investor/documents/investordocuments/pdf_up_10k_02092024.pdf.

Two Halves”? (Jan. 8, 2024, before the railroads disclosed their results for 4Q23).

Relevant excerpts from the report are attached as Exhibit A. The following table presents the figures and then applies the AAR’s weighting of the carriers in the composite sample by equity market capitalization:

Table 1			
Morgan Stanley COC Values for Year-End 2023			
Carrier	MS COC	Weight	Weighted
CSX	7.30%	25.22%	1.94%
NS	7.10%	19.67%	1.40%
UP	6.90%	55.11%	3.80%
All		100.00%	7.04%

The calculation is presented at WCTL’s e-workpaper at tab “Table 1.”³ The Morgan Stanley values are virtually the same as for 2022, 2021, and prior years that WCTL has previously presented, showing stability in the cost of capital as perceived by the financial and investment community, notwithstanding recent changes in such items as interest rates and inflation.

The Morgan Stanley values are particularly probative since the Morgan Stanley estimates were relied upon by CP, CN, KCS, and the Board itself in the contest between CP and CN for control of KCS and the Board itself in finding that the CP/KCS merger was fair to the stockholders of both entities. *E.g.*, FD 36500, *CP/KCS Merger* (STB served March 15, 2023), at 150.

³ The Morgan Stanley figures may possibly reflect a tax shield for debt. If so, the effect is very modest, as the shield is calculated as weight of debt (18.29%) times cost of debt (5.34%) times tax rate (21%), which equals approximately 0.2% (0.00205104).

Furthermore, the Morgan Stanley average COC can be closely approximated using readily available and very credible data. For this purpose, the appropriate methodology is the CAPM, which is generally used by investors. *E.g.*, Jonathan B. Berk and Jules H. van Binsbergen, “*How Do Investors Compute the Discount Rate? They Use the CAPM*,” *Financial Analysts Journal*, Vol. 73, No. 2, Second Quarter 2017, 25-32. To apply the CAPM, WCTL has utilized the AAR’s capital (debt/equity), structure, cost of debt, and beta, but in conjunction with the MRP and RFR recommended by Professor Damodaran as of 2023 in *Equity Risk Premiums (ERP): Determinants, Estimation, and Implications – The 2024 Edition* (March 8, 2024), https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID4751941_code20838.pdf?abstractid=4751941&mirid=1. His paper discusses at great length and in great detail the pitfalls of relying on a long-term historical MRP to measure current investor expectations and explains how the implied MRP (4.60%) provides more accurate, reliable, and appropriate results. Because his MRP (4.60%) is developed using a 10-year Treasury yield (3.88%), *id.* at 155, it is appropriate to utilize this RFR together with the associated MRP. The resulting cost of capital is 7.85% as follows:

Table 2				
Derivation of Cost of Capital for Industry Composite Sample Using Damodaran MRP and RFR (10-year) and AAR RFR, Beta, Capital Structure, and Cost of Debt				
CAPM Cost of Equity		Industry Cost of Capital		
Risk-Free Rate	3.88%	Component	Weight	Cost
Market-Risk Premium	4.60%	Debt	18.39%	0.98%
Beta (Composite Sample)	0.9858	Equity	81.61%	6.87%
Cost of Equity	8.41%	Average COC		7.85%

The calculation is presented at WCTL's e-workpaper at tab "Table 2."

In that regard, the 7.17% MRP utilized by the AAR under the Board's methodology is problematic in several respects. It stems from 1926 and thus covers nearly a hundred years, rendering it largely insensitive to recent trends and developments, including changes in interest rates, inflation, market returns, and investor expectations. The AAR combines the 4.26% RFR (based on the yield on 20-year U.S. Treasury bonds, AAR Appendix H) with a 7.17% MRP to yield a standard return for equities of 11.43%, which MRP is then adjusted downwards slightly by the 0.9858 railroad beta for the composite sample to yield a CAPM COPE of 11.33%. The Board uses a MRP that reflects the arithmetic average of the historical S&P 500 equity returns above the RFR since 1926, nearly a hundred years ago, rather than a MRP based on more current investor expectations.

In that regard, it is significant that the AAR's reported MRP was 7.17% for both 2022 and 2023, even though the performance of the market as a whole (meaning the S&P 500) was very different in those two years, with a decline in 2022 and a hefty gain in 2023. The inevitable conclusion is that the 1926-based MRP has achieved a degree of stability such that it is not likely to change significantly going forward. The Board's MRP reflects historical returns, not the expected returns that drive investor decisions and valuations and the opportunity cost of capital. The Board's approach is as if a home buyer expected to obtain a mortgage based on historical rates averaged over an extended period, rather than the rates prevailing in the current market.

The historical or expected returns incorporated into the Board's version of the CAPM vastly overstate what investors can reasonably expected to achieve at this time. The AAR identifies a MRP of 7.17% based on a RFR of 4.26%. Consequently, the expected return for an equity with a beta of 1.0, or the market as a whole, is 11.43% (7.17% + 4.26%).

The Board's posited return is substantially greater than the returns for U.S. equity projected by mainstream and well-respected investment firms. In particular, Morningstar reported, on January 5, 2024, estimated equity returns of over the next 7-10 years of 5.2% from BlackRock, 7.0% from J.P. Morgan, 4.6% from Vanguard, and 4.0% from Morningstar itself. See <https://www.morningstar.com/portfolios/experts-forecast-stock-bond-returns-2024-edition> (Jan 5, 2024).⁴ The Board's use of the 1926-based MRP and associated RFR results in an expected return under the CAPM for equities that is substantially greater than what mainstream investors can reasonably expect to obtain. In particular, the Board's return is nearly triple that identified by firms such as Vanguard and Morningstar. That level of deviation, which also explains why the CAPM COE exceeds the MSDCF COE for 2023, should not be ignored.

Further confirmation of the unreasonableness of the AAR's COC for 2023 (and also 2022) can be found by considering the 10-K for 2023 of one of its Class I members and a member of the composite sample, CSX,

⁴ Morningstar's estimate was from October 2023, and the others were from September 2023.

https://s2.q4cdn.com/859568992/files/doc_financials/2023/q4/913a6f6f-7cbe-4481-9873-39ab722ebec0.pdf. In its 2023 report, CSX introduced the non-GAAP concept of

“economic profit” to address return in excess of its long-term cost of capital of 8%, similar to how the Board measures return above the level needed to achieve revenue adequacy:

Management believes Economic Profit (CSX Cash Earnings or CCE) provides additional perspective to investors **about financial returns generated by the business by representing a profit generated over and above the cost of capital used by the business to generate that profit.** Economic Profit is designed to incentivize strategic **investments that earn more than the required return.** Increases in Economic Profit indicate that the Company is effectively allocating capital and rewarding shareholders by **generating growth in excess of the incremental cost of capital associated with reinvestment in the business.** This measure should be considered in addition to, rather than a substitute for, net income. This measure is defined by the Company as gross cash **earnings minus the capital charge on gross operating assets.** Gross cash earnings is calculated as Adjusted Earnings before Interest, Taxes, Depreciation and Amortization (“Adjusted EBITDA”), less an assumed 15% cash tax. **The capital charge uses a long-term average cost of capital of 8%** multiplied by the gross operating assets. CSX’s gross operating assets include gross properties and other non-cash assets, net of non-interest bearing liabilities.

CSX 10-K for 2023 at 33 (emphasis added).⁵

The fact that CSX would identify a long-term average cost of capital for use by its investors for assessing its 2022 and 2023 financial performance of 8% makes

⁵ CSX does not appear to adjust its gross operating assets for deferred tax liabilities, thus understating its economic profit.

even more suspect the Board's use of a cost of capital of 10.58% for 2022 and 9.87% for 2023. Indeed, the 8% can be, as demonstrated *supra*, nearly replicated by using the CAPM in conjunction with Professor Damodaran's MRP and RFR, and the 8% is far closer to the Morgan Stanley cost of capital figures than the Board's values.

Furthermore, the 8% does not stand alone, but should be considered with the still lower values used by CN, CP, KCS, and the Board itself in the CP/KCS merger proceeding.

The deviation between the cost of capital values adduced under the Board's methodology and those utilized by investors, the railroads, and the Board itself in other contexts is more than worthy of a Board-initiated rulemaking proceeding. At a minimum, the Board should require CSX to identify the basis, assumptions, and data for its 8% figure.

III. THE 2023 INPUTS REVEAL ADDITIONAL DEFECTS AND CONTRADICTIONS IN THE MSDCF

The fact that the MSDCF COE for 2023 is lower than the CAPM COE is not cause for celebration. Review of the MSDCF calculation and underlying data, or lack thereof, reveals additional cause for concern and also contradictions in the intended application of the model to the 2023 data.

The primary cause for the relatively low MSDCF figure is the low growth rates, which are sharply below those in previous years. Indeed, the growth rate for NS is 2.8%, less than even the current rate of inflation. Furthermore, the Stage Two average composite growth rate, 5.020%, presented by the AAR is actually lower than the Stage Three growth rate based on the general economy as a whole of 5.530%. As explained

infra, the relationship of these figures contradicts the basic specification of the MSDCF, particularly the redefinition of cashflow in Stage Three to equal income before extraordinary items, without adjustment for depreciation, deferred taxes, and capital expenditures, based on the assumption that the others items will offset each other as income and cashflow grow at the rate of the general economy.

In understanding the substantial decline in growth rates from those used in the 2022 MSDCF, it would be very useful to review the analyst forecasts themselves. That review might show, among other things, whether the decrease was due to projected reductions in total earnings or instead to changes in projected stock buybacks.⁶ Review would also show whether the reductions relate to the future or to historical data, particularly historical data that is captured elsewhere within the initial cashflow calculation component of the MSDCF, thus creating a double-count of the low or negative growth in the initial years, which not only lowers the 2023 values. The same double-count would overstate growth in higher-growth years, resulting in the demonstrated instability in the MSDCF results from year-to-year. These matters were

⁶ WCTL's review of the Credit Suisse analyst reports for the 2022 MSDCF showed that as much as 45% of the forecasted EPS growth was attributable to buybacks.

implicated in the analyst projections for CSX, NS, and UP from the Credit Suisse analyst used in the 2022 MSDCF, as WCTL explained in the comments it submitted last year.⁷

Unfortunately, the three analysts that provided EPS forecasts qualifying for inclusion in the 2023 MSDCF, or their firms, elected to conceal their identity.

Accordingly, it is not possible for the WCTL to obtain the underlying reports or review them for the types of issues present in the 2022 reports from Credit Suisse. In that regard, WCTL notes that Credit Suisse was acquired by UBS, which may explain why no separate Credit Suisse report is identified in the AAR's materials. Those materials also do not identify any UBS reports.

However, there is good reason to think that the railroads in the composite sample do enjoy access to those reports. Standard practice is for analysts to provide copies of their reports to the subject companies that they review.⁸ The railroads thus likely possess the unnamed analyst reports and could easily locate and produce the reports utilized in the MSDCF calculations. The Board's reliance on data that is uniquely available to railroads and not shippers creates an unlevel playing field and is another reason not to continue to rely on a methodology, however established, especially one

⁷ Review of the materials would also bear on the issue of whether the financial investment community views or treats operating leases as debt for purposes of the capital structure (debt/equity ratio). Ignoring debt has the effect of overstating the overall cost of capital since the cost of debt is lower than the cost of equity.

⁸ In that regard, Supplementary Note .05 to FINRA Rule 2241 addresses conditions under which portions of the analyst draft report may be shared with the subject company and the analyst may then modify the report based on information received from the subject company. See [2241. Research Analysts and Research Reports | FINRA.org](#).

implemented as a “black box,” that provides one side with a systematic advantage. At a minimum, the Board should require the AAR to include the underlying reports as part of its opening submission.

Be that as it may, the presence of a Stage Three growth rate in the MSDCF that is higher than the composite Stage Two growth rate, and almost double the Stage One growth rate for NS, contradicts the basic theory of the MSDCF and the basis on which the Board adopted it. The theory is that growth rates were to be higher in the first two stages, linked to and conditioned on the railroads’ investing in that growth through net capital expenditure outflows in excess of depreciation and deferred taxes. In contrast, growth in Stage Three is reduced to that of the general economy (real economic growth plus inflation), and cashflow is redefined to equal income before extraordinary items because the railroads are no longer making the additional investments required to drive above-average growth, causing capital expenditures to be offset by depreciation and deferred taxes as the railroads enter a steady state. Verified Statement of AAR Witness Ghayad at 38, 62 (no growth capital); *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry’s Cost of Capital*, EP 664 (Sub-No. 1) (STB served Jan. 28, 2009), at 13.⁹

The AAR’s MSDCF for 2023 turns those principles on their head since (1) growth is increased, not reduced, in Stage Three, even as (2) cashflow is also increased in

⁹ WCTL has previously explained that the model’s theory ignores the effects of inflation: new assets cost more than replaced assets, and capital expenditures (in new dollars) exceed the effects of depreciation and expiring deferred taxes (in old dollars).

Stage Three by being defined to equal income without the effect of capital expenditures. The railroads are deemed to achieve (a) increased earnings and cashflow growth, (b) increased cashflow as a percentage of revenues, and (c) reduced capital expenditures as a percentage of revenues. The railroads truly have their cake and eat it, too, by enjoying increased earnings, increased cashflow, and reduced capital investment simultaneously. The free lunch of Increased growth with diminished investment defies the MSDCF's theory, the Board's stated defense of the model, and economic common sense.

Even if the 2023 data fit within the prior pattern, there would still be ample reason to discard the Stage Three assumption that railroads can grow at the rate of the general economy without increasing their capital expenditures. Specifically, Warren Buffet, in his letter to Berkshire Hathaway stockholders dated February 24, 2024, available at <https://www.berkshirehathaway.com/letters/2023ltr.pdf>, explained that "the [railroad] industry's capital needs will always be huge," and that "compared to most American businesses, railroads eat capital," such that "BNSF must annually spend more than its depreciation charge to simply maintain its present level of business," which requires "outlays [that is, capital expenditures] in excess of GAAP depreciation charges." *Id.* at 12.

Mr. Buffett describes, with specificity, a financial reality that a railroad's capital expenditure must exceed depreciation, including deferred tax benefits, in order for the railroad simply to maintain its existing level of business, much less be able to achieve growth in line with that of the general economy. Mr. Buffet's perspective, that of the presumptive single largest Class I railroad investor, contradicts the key assumption in

Stage Three of the MSDCF that railroads will achieve earnings growth in line with the general economy when capital expenditures are offset by depreciation and associated deferred tax benefits. That contradiction is even more substantial in 2023, when the MSDCF posits that growth in Stage Three will actually outstrip the average growth in Stage Two. The MSDCF understates the capital expenditures in the third stage required to achieve the posited growth.

The Board should not be using a COE methodology when the model's methodology does not conform to the basic financial realities of the railroad industry.

IV. CONCLUSION

The AAR's adherence to the Board's established methodology is not sufficient to establish that the resulting COE and COC values for 2023 are accurate or even plausible. To the contrary, the CAPM values rest on an assumed return for the market as a whole that vastly overstates the equity returns that investors can reasonably expect to achieve or demand. The relationship of the MSDCF inputs contradicts the basic assumptions of the model and cannot be reconciled with the recent statements of Mr. Buffett. Moreover, the railroads themselves and their investors have demonstrated that they rely on substantially lower cost of capital values with those presented by WCTL for 2023 and prior years.

These matters are important, consequential, and more than worthy of Board review.

Respectfully submitted,

WESTERN COAL TRAFFIC LEAGUE

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Dated: May 14, 2024

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CERTIFICATE OF SERVICE

I hereby certify that on this 14th day of May 2024, I have caused true and accurate copies of the foregoing Reply Statement of the Western Coal Traffic League to be served upon all parties on the service list in EP 558 (Sub-No. 27) by first class mail, postage prepaid, or by more expeditious means.

/s/ Robert D. Rosenberg

EXHIBIT A

Excerpts from Morgan Stanley's Report
on the Transportation Industry dated January 8, 2024

January 8, 2024 06:02 AM GMT

Freight Transportation | North America

4Q23 Preview: How Many Ways Can You Say “A Tale of Two Halves”?

After several muted quarters, we expect a seq. uptick in 4Q results across both Trucking & Rail. As we await the upturn, we expect mgmt. teams to sound cautiously optimistic but kick the recovery can down to 2H24. We expect an acceleration of rotation out of idiosyncratic stories to cycle winners.

A better quarter for Transports after prolonged pain. A modest seasonal uptick (after showing virtually no seasonality for several quarters) and a pickup in Rail volumes off the bottom should deliver the best (relative) quarter of 2023 for the Transport names in 4Q. We expect 10 beats, 7 misses and 5 in-line prints this quarter (following several quarters of expecting virtually all misses across the board). However, it is too soon to pop the proverbial champagne as datapoints still remain very muted coming into 2024 (though comfortably off their 2023 bottoms, in most cases). As such, **the entire industry (and market) remains on cycle watch.** Unlike most years, where 4Q results have little relevance and the street is looking ahead to FY guidance, this year could be the reverse. **Any large (or even modest) beats will be viewed as a signal that it is safe to buy the upcycle for those names (or even sub-sectors) and misses may be given a pass that their time will come.** We also expect FY guidance to have little weight given the lack of visibility on timing of the turn as well as mgmt. teams’ reluctance to stick out their neck to try and call it. As such, **we expect to hear that “2024 will be a tale of two halves” in several different ways across this earnings season, with mgmt. teams safely kicking the upturn can to 2H** (though they are likely to sound reasonably constructive/confident on 2H, given [stirring behind the curtain](#)). **The big focus will be on the big idiosyncratic winners of 2022/23 that are reporting this time** (CP, LTLs specifically SAIA, XPO and ODFL) who perhaps cannot afford to kick the can down the road and will need to lay out a much more bullish outlook for next year or risk falling short of the high bar (esp. after what [we saw with FDX a few weeks ago](#)).

Our thoughts into the prints by vertical:

1. **Rails/IMCs.** After several quarters of gloom, Rail traffic saw a noticeable pickup in 4Q (Class 1 traffic up ~4% y/y and ~1% on a two-year stack vs. down nearly 5% 1-3Q y/y) led by IM but with many verticals participating. **While this may have been enough to kick off the 2024 mean reversion trade, 4Q results and FY guidance will be key to determine (a)** how sustainable the volume bounce will be **(b)** whether the higher volumes are coming at the cost of price **(c)** what do mgmt. teams think of resource levels into higher volumes and **(d)** what is initial incremental margin like. **If the Rails do not have good 4Q**

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FREIGHT TRANSPORTATION		
North America		
Industry View		In-Line
WHAT'S CHANGED		
RXO Inc (RXO.N)	From	To
Price Target	\$18.00	\$19.00
ArcBest Corp (ARCB.O)	From	To
Price Target	\$145.00	\$155.00
XPO Logistics, Inc. (XPO.N)	From	To
Price Target	\$70.00	\$75.00
Werner Enterprises (WERN.O)	From	To
Price Target	\$61.00	\$60.00
Heartland Express Inc. (HTLD.O)	From	To
Price Target	\$16.00	\$15.00
Landstar System Inc (LSTR.O)	From	To
Price Target	\$145.00	\$148.00
Saia, Inc. (SAIA.O)	From	To
Price Target	\$270.00	\$272.00
CSX Corporation (CSX.O)	From	To
Price Target	\$25.00	\$30.00
Norfolk Southern Corp. (NSC.N)	From	To
Price Target	\$170.00	\$185.00
Union Pacific Corp. (UNPN)	From	To
Price Target	\$182.00	\$200.00
Hub Group Inc (HUBG.O)	From	To
Price Target	\$80.00	\$85.00
TFI International Inc (TFII.N)	From	To
Price Target	\$164.00	\$169.00

Morgan Stanley does and seeks to do business with companies covered in Morgan Stanley Research. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of Morgan Stanley Research. Investors should consider Morgan Stanley Research as only a single factor in making their investment decision.

For analyst certification and other important disclosures, refer to the Disclosure Section, located at the end of this report.

Risk Reward – CSX Corporation (CSX.O)

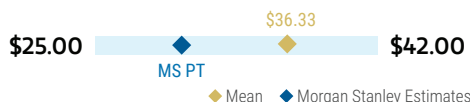
New Opportunities Meet Structural Risks

PRICE TARGET \$30.00

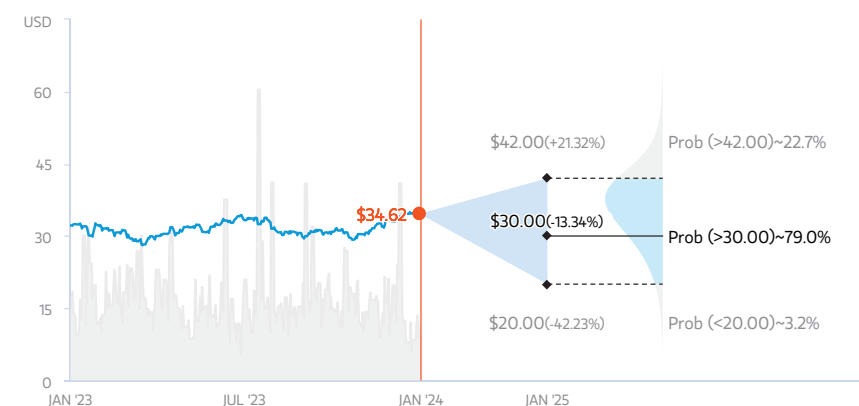
We use a 10-year DCF assuming 7.3% WACC and terminal cash flow perpetual growth rate of 1.5%. Our DCF valuation implies a fwd P/E of ~16x, which is modestly below CSX's historical average. We believe US rails deserve to trade at discounts to historical valuation due to structural growth and pricing headwinds relative to history.

Consensus Price Target Distribution

Source: Refinitiv, Morgan Stanley Research



RISK REWARD CHART AND OPTIONS IMPLIED PROBABILITIES (12M)



Source: Refinitiv, Morgan Stanley Research, Morgan Stanley Institutional Equities Division. The probabilities of our Bull, Base, and Bear case scenarios playing out were estimated with implied volatility data from the options market as of 05 Jan, 2024. All figures are approximate risk-neutral probabilities of the stock reaching beyond the scenario price in either three-months' or one-years' time. View explanation of Options Probabilities methodology [here](#)

Source: Refinitiv, Morgan Stanley Research, Morgan Stanley Institutional Equities Division. The probabilities of our Bull, Base, and Bear case scenarios playing out were estimated with implied volatility data from the options market as of 05 Jan, 2024. All figures are approximate risk-neutral probabilities of the stock reaching beyond the scenario price in either three-months' or one-years' time. View explanation of Options Probabilities methodology [here](#)

BULL CASE

\$42.00

19x Bull Case on NTM EPS

Economic recovery accelerates. The broader economy accelerates driving a sharper and higher freight upcycle. Volumes see broad upside and IM is able to better compete against IM even with a sharp upcycle. Pricing accelerates some and cost inflation moderates more materially at least on a per carload basis as CSX delivers operating leverage.

BASE CASE

\$30.00

16x Base Case on NTM EPS

A Restock Upcycle. The economy continues to chug along in 2024 and a restock drives a freight upcycle. Revenues grow LSD% y/y as yield manages to stay positive (though just so) and volume growth continues after inflecting positively in 4Q. Cost inflation moderates some but not as much as hoped and operating leverage proves elusive with EBIT growing only modestly y/y.

BEAR CASE

\$20.00

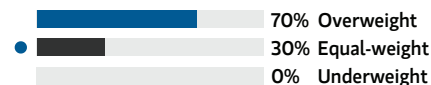
12x Bear Case on NTM EPS

From Recovery to Recession. The economy tips into a recession pushing out any cycle inflection and industrial /bulk commodity end markets are hit the most while IM suffers from even more competition with truck as pricing fails to inflect materially higher. CSX falls short of revenue and EBIT expectations given volume softness and higher than anticipated cost inflation.

EQUAL-WEIGHT THESIS

2024 will also be a pivotal year for CSX as the new team of CEO Heinrichs and COO Cory tackle their first upcycle going for growth. Not unlike other US Rail peers, the key question is whether this growth can come at the right price/mix. If it can, CSX would have achieved something the US Rails have struggled to do for roughly a decade and the market will reward the multiple. If they cannot, the mgmt. team will want the market to be more patient with the growth pivot while tackling inflation, regulatory and comp headwinds. **However, also like US Rails peers, the stock has underperformed the sector for 2 years and valuation is closer to fair value in our opinion.**

Consensus Rating Distribution



● MS Rating

Source: Refinitiv, Morgan Stanley Research

Risk Reward Themes

Contrarian: *Negative*

Secular Growth: *Negative*

View descriptions of Risk Rewards Themes [here](#)

Risk Reward – Norfolk Southern Corp. (NSC.N)

Structural and Regulatory Risk Balanced by Tempered Expectations

PRICE TARGET \$185.00

We use a 10-year DCF assuming 7.1% WACC and terminal cash flow perpetual growth rate of 1.5%. Our DCF valuation implies a fwd P/E of ~14.0x, which is below NSC's historical avg. given our cautious outlook on rails. We believe US rails deserve to trade at discounts to historical valuation due to structural growth and pricing headwinds relative to history.

Consensus Price Target Distribution



RISK REWARD CHART AND OPTIONS IMPLIED PROBABILITIES (12M)

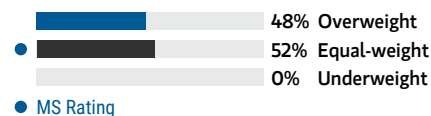


Source: Refinitiv, Morgan Stanley Research, Morgan Stanley Institutional Equities Division. The probabilities of our Bull, Base, and Bear case scenarios playing out were estimated with implied volatility data from the options market as of 05 Jan, 2024. All figures are approximate risk-neutral probabilities of the stock reaching beyond the scenario price in either three-months' or one-years' time. View explanation of Options Probabilities methodology [here](#).

EQUAL-WEIGHT THESIS

We believe NSC continues to face secular headwinds given end market exposure. While the company has executed on PSR, coal gains are likely to be transitory in nature and the rail continues to face the threat of share gain from truck. Safety/regulatory scrutiny and cost overhang from the Ohio accident could last for a while. However, valuation has come in recently to be closer to fair value though there continues to be risk to consensus numbers in the out-years.

Consensus Rating Distribution



Risk Reward Themes

Secular Growth: *Negative*
Contrarian: *Negative*

View descriptions of Risk Rewards Themes [here](#)

BULL CASE

\$290.00

19x Bull Case on NTM EPS

Economic recovery accelerates. The broader economy accelerates driving a sharper and higher freight upcycle and Industrial/bulk commodity end markets keep up while IM competition eases as the truck market tightens. Inflation and service issues moderate materially and operative leverage is more robust as less resourcing is needed for the volumes than we anticipate driving EBIT +HSD% y/y.

BASE CASE

\$185.00

14x Base Case on NTM EPS

A Restock Upcycle. The economy continues to chug along in 2024 and a restock drives a freight upcycle. Revenues grow LSD% as volumes remain positive through 2024 after inflecting in 4Q23. This is led in particular by IM given the easy comp (esp. on two year stack). Yield stays positive though just so and may disappoint expectations. Inflation and service issues moderate but operating leverage is harder to come by than hoped and OR improves only ~1pt despite an easy comp.

BEAR CASE

\$125.00

11.0x Bear Case on NTM EPS

From Recovery to Recession. The economy tips into a recession pushing out any cycle inflection. Weak economic activity weighs on Industrial/bulk commodity end markets. IM suffers from even more competition with truck as rates fall to inflect positively and coal tailwinds reverse sharply. Inflation proves more persistent and OR deteriorates y/y once again.

Risk Reward – Union Pacific Corp. (UNP.N)

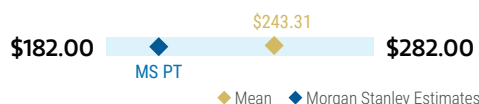
We See Cyclical + Secular Headwinds and PSR OR Expectations Are High

PRICE TARGET \$200.00

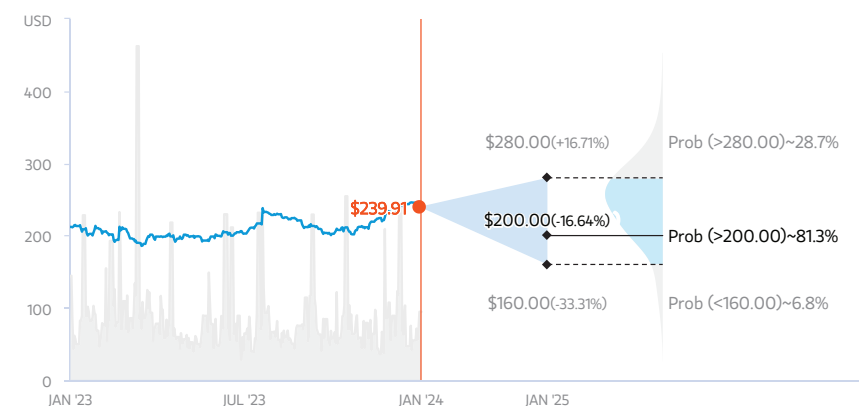
We use a 10-year DCF assuming 6.9% WACC and terminal cash flow perpetual growth rate of 1.5%. Our DCF valuation implies a fwd P/E of ~19x, which is ~inline with UNP's historical avg. We believe US rails deserve to trade at discounts to historical valuation due to structural growth and pricing headwinds relative to history but believe UNP can retain a more normal multiple during the current "mean reversion" trade.

Consensus Price Target Distribution

Source: Refinitiv, Morgan Stanley Research



RISK REWARD CHART AND OPTIONS IMPLIED PROBABILITIES (12M)



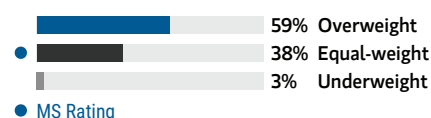
Key: — Historical Stock Performance ● Current Stock Price ◆ Price Target

Source: Refinitiv, Morgan Stanley Research, Morgan Stanley Institutional Equities Division. The probabilities of our Bull, Base, and Bear case scenarios playing out were estimated with implied volatility data from the options market as of 05 Jan, 2024. All figures are approximate risk-neutral probabilities of the stock reaching beyond the scenario price in either three-months' or one-years' time. View explanation of Options Probabilities methodology [here](#)

EQUAL-WEIGHT THESIS

UNP probably has the most interesting investor positioning going into 2024. With the market looking to buy into US rails for mean reversion following 2023 underperformance while potentially rotating out of idiosyncratic winners, UNP appears to have been targeted as the lead destination, led by the CEO transition. Still, progress toward 55% OR continues but gains may be harder to come by, secular volume headwinds remain and competition could intensify. Altogether the stock looks close to fair value here.

Consensus Rating Distribution



Source: Refinitiv, Morgan Stanley Research

Risk Reward Themes

Secular Growth: *Negative*
Contrarian: *Negative*

View descriptions of Risk Rewards Themes [here](#)

BULL CASE

\$280.00

22x Bull Case on NTM EPS

Economic recovery accelerates. The broader economy accelerates driving a sharper and higher freight upcycle. Volumes benefit from the broader growth with industrial and consumer end markets participating and driving carloads +MSD%. IM sees less competition from truck as spot spikes again. Cost inflation moderates driving operating leverage and EBIT +HSD% y/y.

BASE CASE

\$200.00

19x Base Case on NTM EPS

A Restock Upcycle. The economy continues to chug along in 2024 and a restock drives a freight upcycle. Carloads grow as the freight cycle inflects in early 2024 but only modestly at +LSD% led primarily by IM. Yield is positive in FY24 but only just so which is likely below expectations. Cost inflation / greater resourcing limits OR gains y/y and drives EBIT +MSD% y/y.

BEAR CASE

\$160.00

17x Bear Case on NTM EPS

From Recovery to Recession. The economy tips into a recession pushing out any cycle inflection and service levels fail to materially improve. IM conversion lags as truck rates remain very competitive while other end markets suffer from the softer macro backdrop. Cost savings prove more difficult to come by than previous downturns. OR deteriorates again despite the easy comp.