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Cincinnati Southern Railway's potential value varies widely, according to analyses

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How much is the Cincinnati Southern Railway worth?

It depends on who you ask and how they approached the question, according to hundreds of pages of documents released by the city in response to public records requests. The analyses attempted to examine that issue as the board that oversees the city-owned railway negotiated a sale with its current tenant, Norfolk Southern.

Three analyses, two commissioned by the railway board and one by Norfolk Southern, produced a range from $616 million to $2.46 billion.

If voters approve the sale in November, the city will receive $1.6 billion for the 337-mile railroad, which the city completed in 1880 as an economic development tool and way to establish a key north-south railroad from Cincinnati to Chattanooga, Tenn.

Mayor Aftab Pureval, along with the railway trustees and five former mayors, announced the planned sale on Nov. 21, 2022, about four years before the current lease expires. It requires changes to state law governing the railroad, approval from federal regulators and majority support from Cincinnati voters.

“This is, without a doubt, a great deal for the taxpayers,” said Pureval, a Democrat. “It’s within the range of all the evaluations except for two - and it’s above those valuations.”

Paul Muething, an attorney and Republican who chairs the railway board and personally negotiated with Norfolk Southern, said valuing a stretch of railway like this one is like trying to sell a house or commercial building without comparable sales.

“This is a very tough asset to value,” Muething said. “Here, we had a lease that was up for renewal. So you don’t know what the rent's going to be."

Norfolk Southern's current lease with the railway board expires on Dec. 31, 2026. To position itself to negotiate for a higher lease payment than the current $25 million per year, the city hired Bank of Montreal (BMO) Capital Markets, which has experience negotiating railroad sales and leases.

Attorneys for the railway board also hired the Brattle Group Inc. to examine BMO's work and come up with its own estimate.

BMO looked at the question in three different ways:

How much would it cost for Norfolk Southern to reroute the railway traffic to other lines at the lowest possible expense?

For example, if Norfolk Southern used tracks that started in the Chicago area and winded through Illinois, a sliver of Kentucky and Tennessee before reaching Georgia, that would add 90 miles to the trip. The costs of securing the rights to use it would make the Cincinnati Southern Railway worth $1.35 billion to $1.63 billion to Norfolk Southern.

If Norfolk Southern used a route that would add 290 miles to the trip and ran through Ohio, along the border of West Virginia and Kentucky, Virginia and into Tennessee before reaching Georgia, it would make the Cincinnati Southern worth $1.6 billion to $2 billion to Norfolk Southern.

A third route would require reactivating a track between the region and Portsmouth known as "the Peavine Route," which is presently out of service. It would add 260 miles to the journey, making the Cincinnati Southern Railway worth $1.5 billion to $1.9 billion.
Brattle Group agreed with BMO on those numbers.

How much would a third-party, either another railroad or an infrastructure fund whose purpose is to own for-profit transportation resources, pay?

BMO assumed such a fund could strike a long-term trackage rights agreement with Norfolk Southern and a 10% rate of return, as well as other assumptions. The value of the Cincinnati Southern Railway in this scenario ranged from $870 million to $990 million.

Brattle Group thought there was an upside case in this scenario and that the railway board might be able to fetch $1.92 billion to $2.26 billion.

Norfolk Southern also released its own valuation in this scenario, estimating initially that a third-party buyer might pay between $640 million and $725 million. It later revised those estimates upward to between $913 million and $1.49 billion. This is the only method in which Norfolk Southern's own assessment of the railway's value is known.

What's the current value of a rejected, $500 million, 2009 offer made by Norfolk Southern for the railway at the height of the Great Recession when city faced stiff financial headwinds?

BMO did a simple adjustment of that price based on the consumer-price index, which put the railway's value between $616 million and $683 million.

It also analyzed what the railway would be worth based on the endowment the city is considering today, assuming the money is invested and receives a 6% rate of return. That calculation put the railway's value at between $951 million and $1.2 billion.

A third version of that analysis calculated what the railway would be worth based on the federal Surface Transportation Board's weighted average cost of capital. That calculation put its value between $1.2 billion and $1.5 billion.

When Brattle examined that data, it came up with a much wider range of the railway's worth, anywhere from $1.15 billion to $2.46 billion.

Brattle's preliminary assessment of the railway's value in 2021 said the Cincinnati-Chattanooga route is one of Norfolk Southern's "most heavily traveled" ones, and, without it, Norfolk Southern would face longer routes and additional capital investment.

In February 2022, Brattle concluded Norfolk Southern's valuation was "significantly understated" because the railroad lowballed revenue growth potential and profit margins.

For example, the railroad's evaluation assumed a 1% annual price growth, but projections call for long-term inflation of 2.5%.

"Rail prices grew faster than inflation over the past 25 years, particularly in the last five years," Brattle noted.

"Likely reasonable adjustments would increase this range to $837 million to $2.36 billion," Brattle concluded. "The key to resolving this wide valuation is access to data that we can use to understand the specific economic and operational aspects of (the Cincinnati Southern Railway) and to test (Norfolk Southern's) claims."

Norfolk Southern never turned over that data, likely because it would have helped the city in a potential arbitration case with the city over the lease payment if the railway's sale is derailed, Muething said.

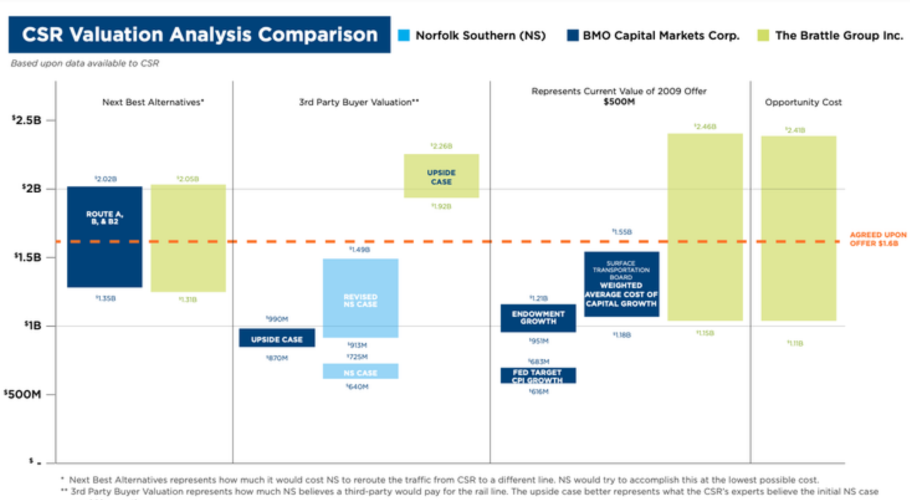

Image: City of Cincinnati law department

(To see an enlarged version of this chart, click here.)

In April of last year, Norfolk Southern made its final offer of $1.6 billion and said its own analysis showed a prospective infrastructure fund would pay between $913 million and $1.5 billion for the railway.

While two of Brattle's analyses put the high end of the railway's potential value at $2.46 billion, Cincinnati officials downplayed the likelihood of the city ever getting that.

"The broad spectrum of valuation from Brattle ... is such a wide range that it really calls into the question the confidence Brattle felt in those numbers," Pureval said.

The potential lease payments play a major role in the likely value of the railroad, Muething said. The only way the city would ever get $2.46 billion for the railroad is if the lease payments went up considerably, but the arbitration process is unlikely to deliver such payments.

"We weren't going to get to $2.46 billion from Norfolk Southern. We never were," Muething said.

A 2020 analysis by BMO that examined some Norfolk Southern and rail industry data estimated the annual lease payment should fall between $43.6 million and $73.4 million, with a $58.4 million payment being at the center of the assumed range. The railway board repeatedly proposed a $65 million lease payment to the railroad, while Norfolk Southern's highest offer has been $37.3 million.

Once the city invests the $1.6 billion lump-sum it is to receive, it believes it will generate $88 million in the first year, with $56 million set aside for city infrastructure and the balance reinvested to grow the principal.

"The city of Cincinnati has not participated in Norfolk Southern's impressive financial performance, with

(Cincinnati Southern Railway) lease payments expanding only 68.2% since 1992," the analysis said.

The railroad's earnings before interest, taxes, depreciation and amortization increased 350%.

The city believes it is at a disadvantage if the lease payments end up going to arbitration because of the level of the current lease payments.

"The result of selling for $1.6 billion, which is well within the range of all the (valuation) methodologies, gives such a better result in terms of the money available to the city on annual basis," Muething said. "It's very, very difficult to say we should ignore that and opt for arbitration."

The arbitration process is lengthy. A Nov. 29 *Business Courier* story details what each side must do in arbitration and the potential pitfalls. A sale is the better deal, both Pureval and Muething said.

"Calling this an arbitration process is generous. It is tilted against the city," Muething said.

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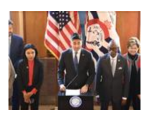

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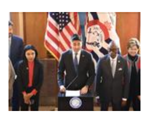

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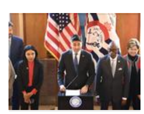

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