

Methodology

*Rating Companies in the Railway Industry*

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*Insight beyond the rating.*

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All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.



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# Rating Companies in the Railway Industry

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Note: DBRS provides third-party, independent evaluations in four major areas: the corporate sector, financial institutions, public finance and structured finance. The corporate sector consists of a wide variety of industries.



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## I. Overview

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DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on forward-looking measurements that assess a company's ability and willingness to make timely payments on outstanding obligations (whether principal, interest or dividend) with respect to the terms of an obligation. Ratings are not buy, hold or sell recommendations and they do not address the market price of a security.

DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry-specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations. The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness that would be more critical for a peer company. Conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.

DBRS rating methodology is underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to global economic changes, DBRS generally factors the impact of a cyclical economic environment into its rating. Consequently, DBRS takes a longer-term "through the cycle" view of a company and, as such, rating changes are not based solely on normal economic cycles. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future. An equally important aspect of DBRS analysis is its broad industry coverage, which it undertakes in order to understand the major differences and subtle nuances within a particular industry and to form an appropriate rating of a company relative to its competitors.

As a framework, DBRS rating methodologies consist of three components that together form the basis of the rating: an assessment of the company's general business risk profile based on cross-industry and macro business considerations; an assessment of the company's financial risk profile primarily based on quantitative ratio analysis; and consideration of industry-specific factors and measures particularly unique to the company. To some extent, the business risk and financial risk profiles are interrelated. The degree of financial risk considered acceptable for a company depends to a large measure on the business risks it faces.

Critical in the determination of a rating is the application of the analyst's experience and expertise in forming an initial rating opinion and recommendation for the rating committee and the role of the DBRS rating committee as the final decision maker. DBRS rating committees, which comprise experienced and knowledgeable DBRS personnel, strive to provide objective and independent rating decisions that are based upon all relevant information and factors, incorporate both global and local considerations, apply DBRS-approved methodologies and reflect the opinion of DBRS.

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## II. General Business Risk Profile

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A fundamental component of DBRS analysis is the consideration of macro business factors that apply to most, if not all, industries within the corporate sector. The general business risk profile is largely a qualitative assessment of the environment a company is affected by and operates in. An assessment of the general business risk profile serves as a backdrop for the analysis of the company's financial risk profile as well as other qualitative and quantitative factors that are particularly unique to the company. Differing business risk profiles impact the assessment of a company's financial risk profile, and thus, it is important to understand the extraneous influences and business factors a company is or could be affected by despite its financial strength.

### KEY CONSIDERATIONS IN EVALUATING A COMPANY'S BUSINESS RISK PROFILE

The following considerations, while not intended to be an exhaustive list, indicate the key areas DBRS considers in evaluating a company's business risk profile:

#### *Economic Environment*

The importance of the industry within the overall economy, in terms of either how it impacts or is impacted by the economy, shapes a company's viability. Also of importance is how the industry is influenced by current economic factors such as inflation or deflation, supply and demand, interest rates, currency swings and demographics.

#### *Legislative and Regulatory Environment*

Whether an industry is regulated is key, as the degree of regulation and legislative oversight can severely restrict or assist a company depending on its stage of growth, industry influence and regulatory relations. A regulated industry imposes a certain rigour and governance. It is also important to understand the frequency of change or stability in industry rules and whether regulations may require companies to make costly modifications to their infrastructure.

#### *Competitive Environment*

The nature of the market structure (e.g., monopoly versus oligopoly) determines the extent of competitiveness and the barriers to entry a company may face. Many industries are undergoing significant structural changes such as consolidation or deconsolidation, excess capacity or competitive threats from new capacity in "low-cost" countries such as China, Brazil and Russia in both domestic and international markets. Even small changes in the competitive environment can have a profound impact on a company.

#### *Country Risk*

Governments often intervene in their economies and occasionally make substantial changes in policy regarding competition, ownership, wage and price controls, restrictions on foreign currency, capital and imports/exports, among other things. Such policy changes can significantly affect a company, and therefore, considerations include the company's main location or country of operation, the extent of government intervention and support and the degree of economic and political stability. The assessment of country risk is not limited to direct government actions to interfere with the private sector, but also encompasses the full range of financial and economic events that can spill across a country, causing widespread defaults in otherwise healthy corporate credits. As such, country risk can have considerable implications for corporate ratings. A country ceiling is assigned to corporate foreign currency ratings based on the country's susceptibility to systemic shocks and the private sector's ability to maintain its foreign currency debt payments when shocks occur.

### *Industry Cyclicalities*

Cyclicalities is influenced by factors such as levels of consumer spending, consumer confidence and the strength of the economy. The degree of cyclicalities is influenced by the market segment in which a company specializes. Non-cyclical industries are better able to withstand dramatic economic changes as are companies with more predictable cycles than those with significant peaks and troughs. It is important to examine a company's strategies and performance over the longer term and understand them in cyclical highs and lows.

### *Management*

The capability and strength of management is a pivotal factor to company success. An objective profile of management can be obtained by assessing the following: the appropriateness of core strategies; rigour of key policies, processes and practices; management's reaction to problem situations; its appetite for growth, either organically by adding new segments or through acquisition; its ability to smoothly integrate acquisitions without business disruption; and its track record in achieving financial results. Retention strategies and succession planning for senior roles are also critical considerations.

### *Corporate Governance*

Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no one "right" approach for all companies. A good board can have a profound impact on growing companies, those in fragile financial states or those undergoing significant change. Beyond a review of management, assessment should focus on the appropriateness of board composition and structure (including the independence and expertise of the audit committee) to approve executive compensation and corporate strategy, and to oversee execution and opportunities for management self-interest. Other important areas include the extent of disclosure of financial and non-financial information (including aggressiveness of accounting practices and control weaknesses), share ownership (including director's) and shareholder rights.

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## III. General Financial Risk Profile

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The financial risk profile is largely a quantitative assessment of the company's financial strength and an estimation of its future performance and financial profile. DBRS reviews three key areas: earnings, cash flow and additional measures for balance sheet and financial flexibility. Within each area, DBRS focuses on key metrics and considerations, which are assessed over time noting that the trend in the ratios is also important to the rating. However, ratios alone cannot be used as an absolute test of financial strength. With a focus on future expectations, the primary goal of financial risk assessment is to understand the interrelationship between the numbers, interpret what they mean and determine what they indicate about the company's ability to service and repay debt on a timely basis given the industry background.

### **KEY CONSIDERATIONS IN EVALUATING A COMPANY'S FINANCIAL RISK PROFILE**

The following financial considerations and ratios tend to be analyzed for the majority of industries in the corporate sector. There may be additional quantitative factors and ratios that are considered on an industry-specific basis, which are noted under Section IV – Industry-Specific Factors.

Also refer to the *Corporate Sector – Glossary of Ratio Definitions* at [www.dbrs.com](http://www.dbrs.com).

#### *(1) Earnings*

DBRS earnings analysis focuses on core or normalized earnings and in doing so considers issues such as the sources, mix and quality of revenue; the volatility or stability of revenue; the underlying cost base (e.g., the company is a low-cost producer); optimal product pricing; and potential growth opportunities.



Accordingly, earnings as presented in the financial statements are often adjusted for non-recurring items or items not considered part of ongoing operations. DBRS generally reviews company budgets and forecasts for future periods. Segmented breakdowns by division are also typically part of DBRS's analysis.

Typical earnings ratios include

- Gross margin
- Return on common equity
- Return on capital
- EBIT margin and EBITDA margin

### *(2) Cash Flow/Coverage*

DBRS cash flow analysis focuses on the core cash flow generating ability of the company to service current debt obligations and other cash requirements as well as the future direction of cash flow. From a credit analysis perspective, insufficient cash sources can create financial flexibility problems even though net income metrics may be favourable. DBRS evaluates the sustainability and quality of a company's core cash flow by focusing on cash flow from operations and free cash flow before and after working capital changes. Using core or normalized earnings as a base, DBRS adjusts cash flow from operations for as many non-recurring items as possible. In terms of outlook, DBRS focuses on the projected direction of free cash flow, the liquidity and coverage ratios, and the company's ability to internally versus externally fund debt reduction and future capital expenditure and dividend/stock repurchase programs, as applicable.

Typical cash flow ratios include

- EBIT interest coverage and EBITDA interest coverage
- EBIT fixed charges coverage
- Cash flow/total debt and cash flow/adjusted total debt
- Cash flow/capital expenditures
- Capital expenditures/depreciation
- Debt/EBITDA
- Dividend payout ratio

### *(3) Balance Sheet and Financial Flexibility Considerations*

As part of determining the overall financial risk profile, DBRS evaluates various other factors to measure the strength and quality of the company's assets and its financial flexibility.

From a balance sheet perspective, DBRS focuses on the quality and composition of assets including goodwill and other intangibles, off-balance-sheet risk, and capital strength including the quality of capital, appropriateness of leverage to asset quality, and the ability to raise new capital. DBRS also reviews the company's strategies for growth including capital expenditures, plans for maintenance or expansion, and the expected source for funding these requirements. Where the numbers are considered significant and the adjustments would meaningfully impact the credit analysis, DBRS adjusts certain ratios for items such as operating leases, derivatives, securitizations, hybrid issues, off-balance-sheet liabilities and various other accounting issues.

Typical balance sheet ratios include

- Current ratio
- Turnover – receivables and inventory
- Asset coverage (times)
- Per cent total debt to capital and per cent adjusted total debt to capital
- Per cent adjusted net debt to capital

The following factors focus on the company's liquidity:

- Maintaining sufficient bank lines or cash balances;
- Prudent use of cash balances for dividends or stock repurchases;



- Terms and conditions of credit facilities including unique terms and/or financial covenants;
- Debt management approach, including dependence on short-term versus long-term debt, fixed versus variable rate debt and debt maturity schedule;
- Interest rate and/or foreign exchange exposure;
- Relationship and strength or weakness of a parent holding company or associated companies, if applicable.

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## IV. Industry-Specific Factors

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Each industry within the corporate sector has unique features that cannot be broadly applied across all industries. For example, capital spending is a key area in the utilities industry, reserves are particular to the mining industry, adequate R&D is critical for the pharmaceutical industry, and seasonality has a significant impact on merchandisers. Against the backdrop of the general business and financial risk profiles, a company's unique strengths, weaknesses and industry-specific issues need to be factored into the credit analysis to form an appropriate rating. These particular business and financial issues and measures also help to shape the company's status relative to its peers.

### KEY CONSIDERATIONS IN EVALUATING A COMPANY WITHIN THE RAILWAY INDUSTRY

The railway industry applies to companies principally engaged in the transportation of merchandise and bulk commodities by rail. The methodology is broadly applied to all railway companies in North America, despite specific differences between regional and long-haul rail carriers, as the key rating drivers are similar.

A summary of the key considerations and drivers of DBRS ratings for railway companies are listed below. The summary is segmented into primary and secondary factors to reflect the relative importance of each when reviewing a particular company. The following considerations supplement the macro-business and -financial considerations in Section II and Section III, respectively.

### PRIMARY FACTORS

#### *Financial Volatility*

Railway companies are exposed to cyclical changes in demand related to the economy and commodity-price fluctuations that can lead to volatility in financial performance. The extent of the impact is assessed primarily based on a company's mix of shipment revenue and volumes, which often include a wide variety of bulk commodities, merchandise and intermodal traffic. Companies with the greatest share of merchandise and intermodal-related volumes are typically most sensitive to prevailing economic conditions because demand is affected by industrial production and GDP. However, most railway companies transport a large amount of bulk commodities that are generally non-cyclical (e.g., thermal coal and grain). As such, these shipments tend to add a degree of stability to earnings, although they can be disrupted by other factors (e.g., weather-related issues). DBRS also assesses prevailing industry supply conditions, namely, network and port capacity, because supply-demand fundamentals largely dictate pricing. As an example, strong demand for rail transportation since mid-2003 (mainly from rising Asian trade) combined with tight industry capacity has contributed to steadily rising industry prices.

#### *Network Fluidity*

DBRS views companies with fluid networks favourably as congestion and bottlenecks on certain routes can constrain overall volume growth and impair earnings from inefficiencies and sharply higher costs. While large networks can provide significant benefits in terms of economies of scale, customer reach and market position (see Secondary Factors), capacity constraints would impair many of these benefits.

### ***Diversification***

DBRS takes into consideration the extent to which railway companies' shipments and revenues are diversified by end market and region. Most railway companies serve a well-diversified mix of end markets, which adds earnings stability, mainly due to reduced reliance on a particular commodity or customer. However, there are often measurable differences between the end markets served by railway companies, and DBRS assesses the exposure to a particular segment or region to help gauge future financial stability.

### **Geographic Diversification**

The extent to which sales are diversified among domestic, trans-border (U.S.-Canadian) and international customers is taken into consideration, as is the geographic location of the network (DBRS only rates railway companies based in North America). Revenues and earnings distributed among regional segments in measurable proportions reduce exposure to changing business conditions in a particular market. The impact of foreign exchange volatility is also often reduced with diversification, although this is modest for U.S.-based railway companies. Port congestion (particularly on the U.S. west coast) and network bottlenecks have had a negative impact on operating efficiency in certain instances and led to higher costs and the need for significant capacity expansion. As such, a company's network orientation is reviewed. Furthermore, weather is also taken into account; Canadian-based railways, for example, are more exposed to weather-related issues and difficult terrain, which have a greater potential to disrupt normal operations.

### **Customer and Business Diversification**

DBRS assesses the mix of shipment volumes and revenues by end market as a gauge of financial risk, given the inherent volatility in certain sectors. Railway company revenues are generally well diversified by customer and end market, which contributes to the relatively favourable business risk profile of the industry. However, companies with above-average exposure to a specific segment relative to those with more balanced end-market exposures may experience more pronounced fluctuations in financial results. The industry fundamentals and outlook of the larger revenue segments are investigated in greater detail when evaluating a railway company's credit profile. In addition, the composition of customer contracts (e.g., short- versus longer-term contracts and pricing terms) and the history of customer relationships are also reviewed as a means of assessing revenue stability.

### ***Cost Position***

Operating efficiency and the state of capital assets are key considerations in rating railway companies. DBRS typically views a company's operating ratio (operating expenses as a share of operating revenues) as the primary measure of efficiency and notes the trend in the ratio relative to industry peers and the industry average. High competition and maturity in certain markets requires railway companies to continue to improve service levels and reduce expenses. DBRS reviews all larger-scale efficiency programs, which include train-scheduling initiatives, information technology investments and rail-yard enhancements. Efficiency programs and capital investments to upgrade and/or expand network assets have contributed to the gradual decline in the industry's operating ratio in recent years. DBRS assesses the average age of a company's locomotive fleet and the funds invested in network capacity and upgrades; younger locomotive fleets (i.e., with increased fuel efficiency) and modernized network infrastructure (i.e., requiring less maintenance) on a relative basis generally correlate with higher relative operating efficiency.

Labour accounts for the largest share of a railway company's operating expenses at roughly 30% to 40%. The majority of labour is unionized, where contracts (and national bargaining in the United States) limit the ability of railway companies to reduce wages and staff levels. However, DBRS notes trends in employment, which can be managed via attrition (given an aging workforce within the industry) relative to ton miles partly as a gauge of labour productivity and efficiency. In addition, legacy costs for pension and health-care benefits (notably for companies with large, underfunded pensions) add to expenses and increase the potential for large operating cash outflows.

### *Energy Intensity*

Rail transportation is a highly energy-intensive business, and fuel costs are a significant component of operating expenses. The management of fuel expenses is a key consideration in reviewing railway company efficiency. Fuel has become an increasingly larger share of operating costs, mainly due to the sharp increase in the price of diesel. The nature of the surcharge (e.g., the benchmark used and the lag between cost and recovery) and the extent to which customer contracts include fuel surcharges are noted.

## SECONDARY FACTORS

### *Competition*

DBRS assesses the competitive position of railway companies in their respective core markets. Class 1 railway companies typically compete with one primary railway competitor for the majority of longer-haul routes and with a variety of trucking companies for regional, shorter-haul routes. Companies operating on complex, shorter-haul networks generally face a higher degree of competition, which can limit margin upside mainly as a result of increased price sensitivity and lower relative efficiency. Generally, competition is based on price, but service and reliability have become increasingly important as many product shipments are time-sensitive. Trends in various railway company service and productivity metrics (e.g., revenue-to-gross ton mile statistics, terminal dwell time and safety records) are reviewed to help assess service levels and stability in financial performance. Trucks are a much more expensive option for shippers (partly related to fuel costs) and unable to transport certain bulk commodities effectively, but they are generally more reliable and flexible. Improving railway reliability and service, combined with lower relative prices, and trucking industry issues (e.g., labour shortages, road congestion and stricter regulations) have enabled railway companies to gain market share from trucking companies in recent years, namely, on longer-haul routes.

### *Size*

The scale of a company, particularly with respect to annual sales and network capacity, often provides added support for the rating. High relative sales provide an indication of market position and of a company's ability to compete. In particular, larger sales can translate into a greater market advantage, opportunities for efficiency gains and the ability to offset competitive threats. In addition, larger networks typically provide more opportunities for point-to-point shipments, which reduce the potential for delays and the costs associated with using a competing railway company's lines (e.g., access fees) and enable companies to service a larger number of prospective customers. The share of a company's network that is double-track is also considered as the likelihood for costly delays during periods of rising demand is reduced.

### *Barriers to Entry*

Barriers to entry in the railway industry are high and contribute to the industry's relatively favourable business risk profile. Barriers to entry are mainly related to the significant financial requirements involved (e.g., laying new track, which requires rights of way and land, and acquiring locomotives and rolling stock) and the significant capital expenditures needed to maintain significant network infrastructures. High barriers to entry generally increase the competitive position of a railway company, which adds a degree of sales stability.

### *Technology*

The pace of technological change in the railway industry is modest. However, innovation and information technology have increased in importance mainly as they relate to expense control and service improvement. Examples include significant and ongoing investments in logistics for scheduling, tracking shipments and internal resources, and billing. The ability to offer more favourable service relative to key competitors can be a competitive advantage and provide opportunities for higher relative prices, volumes and margins.



### *Legislation*

Railway activity in the United States is regulated by the Surface Transportation Board (STB), which oversees mergers and acquisitions and has the authority to investigate railway pricing activity. Several regional acquisitions by the Class 1 railway companies have taken place in recent years, with no approval issues. However, the STB implemented new and more stringent rules in 2001 for evaluating mergers, which make large-scale mergers more difficult to complete (in fact, none have been proposed since the new rules came into effect). Other railway legislation is monitored for potential changes, including those relating to freight-rate regulation (e.g., the Western Canadian grain revenue cap) and open access.

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