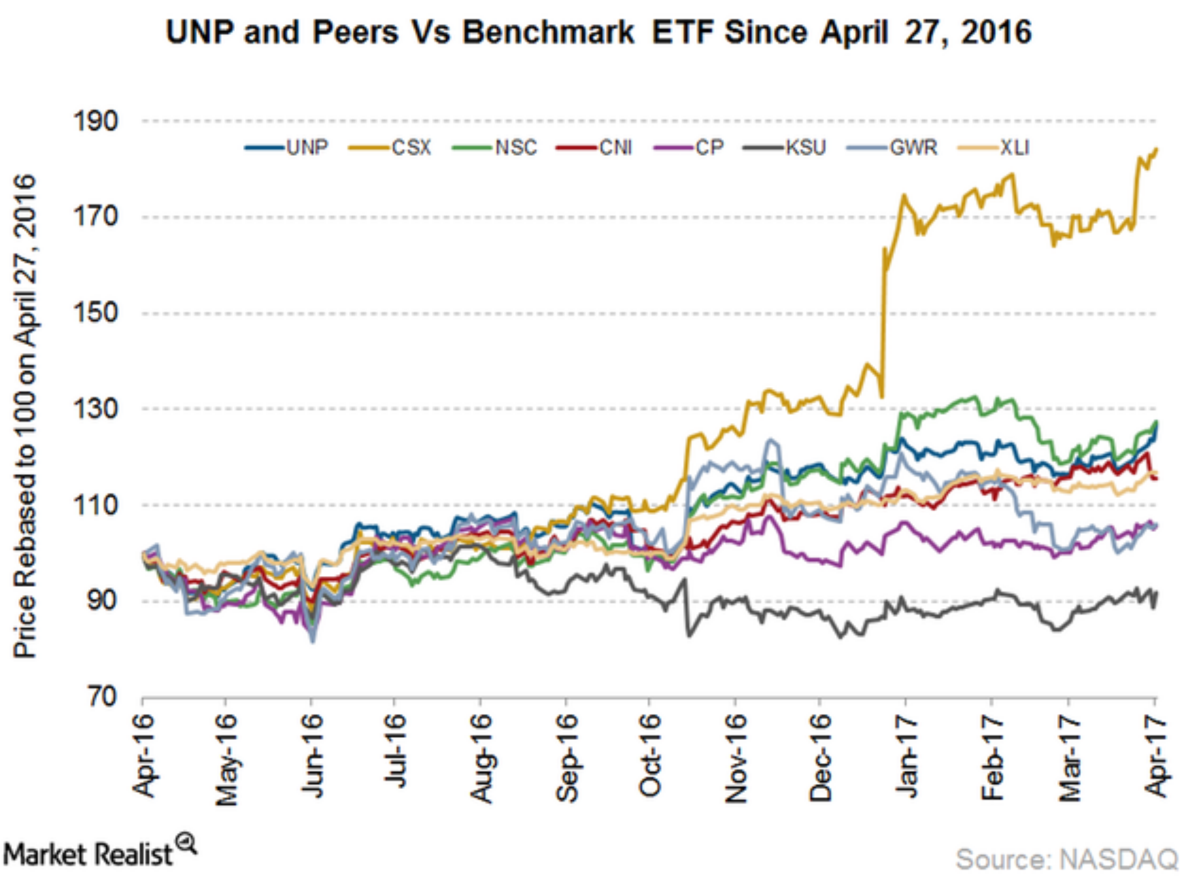
By Barna Capital Group

CSX (CSX) Corporation stock performance is the second stage of pump and dump tactic by Mantle Ridge.



After the market close on Wednesday April 19, CSX corporation has released its highly anticipated earnings report for the first quarter of 2017. It was indeed highly anticipated since Hunter Harrison, a railroad veteran has joined the company as the new CEO in January (named in March). Harrison is well known by Wall Street for his miraculous turn around of Canadian Pacific Railway a few years ago, backed by none other, but Bill Ackman himself.

CSX stock has been trading around $22 dollars per share just over a year ago, now its trading around $51. Company market cap has increased by $25 billion dollars. Has the change been backed up by performance - NO. In fact, the company is in worse financial shape than it was in the last 3 years due to growing debt. Lets break it down.

	Mar. 31, 2017	Mar. 25, 2016	Mar. 27, 2015	Mar. 28, 2014	$ Change	% Change
Revenue	**$ 2,869**	$ 2,618	**$ 3,027**	$ 3,012	*$ 15*	*—%*
Expense						
Labor and Fringe	**789**	796	**879**	814	*(65)*	*(8)*
Materials, Supplies and Other	**567**	550	**627**	629	*2*	*—*
Fuel	**218**	150	**270**	446	*176*	*39*
Depreciation	**320**	313	**295**	283	*(12)*	*(4)*
Equipment and Other Rents	**90**	105	**113**	101	*(12)*	*(12)*
Restructuring Charge [a]	**173**	—				
Total Expense	**2,157**	1,914	**2,184**	2,273	*89*	*4*
Operating Income	**712**	704	**843**	739	*104*	*14*
Interest Expense	**(137)**	(143)	**(134)**	(140)	*6*	*4*
Other Income - Net	**7**	7	**2**	7	*(5)*	*—*
Earnings Before Income Taxes	**582**	568	**711**	606	*105*	*17*
Income Tax Expense	**(220)**	(212)	**(269)**	(208)	*(61)*	*(29)*
Net Earnings	**$ 362**	$ 356	**$ 442**	$ 398	*$ 44*	*11%*
Operating Ratio	**75.2%**	73.1%	**72.2%**	75.5%		
Per Common Share						
Net Earnings Per Share, Assuming Dilution	**$ 0.39**	$ 0.37	**$ 0.45**	$ 0.40	*$ 0.05*	*13%*
Average Shares Outstanding, Assuming Dilution *(millions)*	**929**	963	**992**	1,008		

As you can see in the statements above, the company has only increased its revenue and net income comparing to the year before, while still lagging behind 2015 and 2014 by roughly 5%. Especially lagging on the EPS considering that the share count has gone down 7% since Q1 2014. **Also please notice that the dates of Q1 end have always been shortened to the last working Friday, while in the Q1 2017, the report goes all the way to March 31, giving it a 6 day extension, that is a 6.66% increase in the books.** Not a bad move Mr. Harrison, I'm sure no one will notice.

As for the Net Earnings, Mr. Harrison, and the report itself has mentioned numerously that there was a $173 million restructuring Charge, while Labour costs have gone down 7 million for the same reason - firing American workers. But that's fine, that's a huge ratio. No big deal here.
Now lets take a look at cash flow, it gets even more interesting here…

	Mar. 31, 2017	Mar. 25, 2016	Mar. 27, 2015	Mar. 28, 2014
OPERATING ACTIVITIES				
Net Earnings	$ 362	$ 356	$ 442	$ 398
Depreciation	320	313	295	283
Restructuring Charge [(b)]	161	—	6	(1)
Deferred Income Taxes	59	80	(53)	(81)
Other Operating Activities - Net	141	5	690	599
Net Cash Provided by Operating Activities	1,043	754		
INVESTING ACTIVITIES			(598)	(475)
Property Additions	(441)	(425)	(105)	(165)
Purchase of Short-term Investments	(75)	(235)	140	409
Proceeds from Sales of Short-term Investments	205	670	63	4
Other Investing Activities	25	31	(500)	(227)
Net Cash (Used in) Provided by Investing Activities	(286)	41		
FINANCING ACTIVITIES			—	(209)
Dividends Paid	(166)	(173)	(158)	(151)
Shares Repurchased [(c)]	(258)	(249)	(127)	(127)
Other Financing Activities - Net [(d)]	(6)	(270)	(13)	(2)
Net Cash Used in Financing Activities	(430)	(692)	(298)	(489)
Net Increase in Cash and Cash Equivalents	327	103	(108)	(117)
CASH AND CASH EQUIVALENTS				
Cash and Cash Equivalents at Beginning of Period	603	628	669	592
Cash and Cash Equivalents at End of Period	$ 930	$ 731	$ 561	$ 475

Net earnings have come up a mere 6 million dollars year over year, remember that market cap went up by roughly 25 Billion dollars in the same period. $362 million for Q1 2017 is 22% behind Q1 2015, while Q1 2016 is 25%. From the Q1 17 earnings call, Mr. Harrison sounded very optimistic when he promised 25% increase in Net Earnings compared to 2016, that would bring us to the same values as 2015. You may ask why I only use Q1 reports for each year, that's because Harrison only joined CSX this quarter and the news of him joining brought in about $12 billion dollars in value before he even took a seat at his new desk. NOW the interesting part - **Q1 2017 has $161 million in remaining restructuring charge.** Why would you add that amount to your cash flow? Lets just say that the net increase in cash was 166 million vs 327 million reported. Not bad comparing to 103 million increase in 2016, where previous management decided to spend 270 million on locomotives, which Mr. Harrison now gets to use for free. Another line that bothers us is the 141 million in Other Operating Activities. Read the whole report, didn't find any elaboration.

Now that we compared the first quarters, with some unanswered questions, lets take a look at company valuation over the same periods.

2014 Q1 ER	$28.03 PPS	$28.25B MC	17.51 P/E
2015 Q1 ER	$37.12 PPS	$36.82B MC	20.62 P/E
2016 Q1 ER	$27.53 PPS	$26.51B MC	18.61 P/E
2017 Q1 ER	**$51.50 PPS**	**$47.45B MC**	**32.05 P/E**

Lets take overall market conditions into consideration and add 14% to the 2016 value, gained by DJT we will get $31.40 per share, then we add the 5.4% increase in EPS, we get fair value of $33.09, plus dividends = $34.00 per share. Before you jump down our throats, this is a very simple market to market, year to year comparison. Let's continue.

Let's compare outstanding debt.

	Total Liabilities	Long-Term Debt
Q1 14	$21,877 B	$9,514 B
Q1 15	$21,823 B	$9,513 B
Q1 16	$23,720 B	$10,962 B
Q1 17	$24,043 B	$10,963 B

Long term debt hasn't decreased, while Total Liabilities have gone up $323 million, please remember that interest rates keep going up, while the company hasn't paid back a penny of long term debt in a year. Frankly, they can't afford to, and will go deeper in debt, keeping up with Dividends and Buybacks that they just increased, that is why they filed to sell $850 million worth of Notes on April 26th, 2017. We will get back to how the new management plans on pumping the stock.

CSX announced Q1 dividend of 0.20 per share, which should come out to $180 million dollars. They also announced a new buyback program of $1 Billion dollars. At this price they should only buy back roughly 20 million shares. But there is a very interesting option deal that came with hiring Mr. Harrison equivalent to 9 million shares. Basically, the CEO just announced that it will use half of the buy back to buy nearly half of the shares that he will receive if the price is right. In fact this whole research is winding down to how Mr. Harrison is very motivated to pump the stock price. **While Debt to EBITDA is growing from 2.3x to 2.5x YOY, according to Q1 ER CC slides.**
Going back to the Imaginary 0.51 EPS. Harrison numerously mentioned the restructuring charge of 173 million dollars that dragged down the actual EPS to 0.39. He reiterated that this one-time charge will allow substantial cuts on labor costs. But he failed to mention that his salary alone is $5 million dollars per year plus an $84 million reimbursement he left behind at Canadian Pacific Railway, plus, and this is awesome on his part, CSX would have to cover taxes on that payment, amounting to as much as $23 million. Including options for the next 4 years, Harrison will cost CSX roughly $220 million, or $55 million per year. He asked for the right to purchase 9 million shares at the strike on the day of his appointment as CEO. Harrisons pay package doesn't compare to previous CEO Michael Ward, who received $39 million for the last 4 years, and more than doubles Harrisons own pay package of $94 million for the last 4 years at CP.

According to Payscale.com, average CSX employee salary is $64,000 per year. **<u>The difference in Harrison's salary to previous CEO, would pay</u>**

<u>for 718 average workers.</u> The total amount of workers layed off (covered by 173 million restructuring charge) is 765, according to Q1 ER. CSX should save about $3 million dollars per year, by replacing 765 employees with Harrison. We do not even want to get into directors compensations that came with the deal, lead by Paul Hilal at Mantle Ridge. We are sure that the new staff will cost the company more than the 765 fired workers.

Let's talk a little bit about this deal that activist Paul Hilal made with CSX board. He replaced CEO with Harrison, a 72 year old veteran, who turned Canadian Pacific Railway around in the last couple of years. Well, first, it wasn't his idea. Before deciding to run CP, Harrison was in retirement after a five-decade carrier. He was convinced to come out of retirement by Pershing Squares Bill Ackman. Paul Hilal used to work at Pershing Square and left a few years ago to start Mantle Ridge. Before convincing Harrison to quit at CP and move to CSX, Mantle Ridge has built up a 4.9% stake in the company. Not a bad activist move, but its not original. The stake is now worth roughly $2.5 billion. In fact, Mantle Ridge agreed to guarantee the $84 million payment from CSX to Harrison by the annual CSX meeting and has already paid $55 million of that amount according to latest 13-G. Who wouldn't agree to that if the news of possible move by Harrison brings your investment up by roughly a Billion dollars? But we think it is not going to be so simple to keep the inflated valuation going forwards. When Harrison joined CP, the company was in very bad shape, in fact it was the worst performing company in the sector, which is not the case with CSX. CSX had a set back in 2016, as did the whole transport sector. It's a much easier task to improve a complete loser, compared to improving the largest railway operator in Eastern US, Margin-wise. Even Harrison said that he sees a 25% improvement in Earnings in 2017 compared to 2016, which would basically bring it to 2015 levels, and they travelled the first 10% without him. Mantle Ridge move was a basic pump-job for the stock. Use a big, known name in the industry to raise the stock price and worry about the consequences later. Whether Harrison delivers is still unknown. We believe that CSX will not outperform its rivals, such as Norfolk Southern (NSC)
We believe that Mantle Ridge will do everything in their power to keep stock price inflated. It was clear during the negotiation process that Harrison cares only about his financial gain from joining CSX, and he is not likely to stick around if the stock price will stay below his strike of 49.75 per share after receiving the 84 million + tax package. Which he will receive regardless of staying or leaving, and Mantle Ridge will be stuck with the bill.

Peers.

Kansas City Southern (KSU) reported Q1 Earnings on Monday, the improvements in financials were significantly better than CSX. Revenue increased by 8% YOY, while CSX has only gained roughly 2% on revenue YOY. Adjusted EPS came in 14% better than Q1 2016 for KS, while CSX reported only 5.4% increase in EPS over Q1 2016. And this whole time KSU has been losing on the depreciation of the Mexican Peso. As the result, the stock of the company fell 3% initially and closed slightly green, keeping P/E ratio of 20.24 compared to CSX 32.05

I waited to write this up until Norfolk Southern released their Earnings Report and it came in exactly as I had expected. NSC is the closest peer to CSX in terms of revenue and business model. Also their business area overlaps with CSX east and down from Indiana. NSC reported +14% on EPS YOY vs. +4% on YOY EPS at CSX. Norfolk Southern beat CSX increases on all metrics, especially coal. The stock reacted with less that 1% gain on the day, while CSX went up 10% on the day of the release. NSC continues to trade at 20 P/E, while CSX P/E is around 32. NSC stock is up roughly 50% YOY, while CSX is up roughly 110% YOY.

Coal.

Largest contributor to Railway revenue is Coal. In fact, Q1 2017 in coal revenue has added $123 million to CSX revenue. Basically half of the net change in Revenue YOY. The other half was brought in by the Industrials, which include Minerals, Automotive, Metals and Equipment. Then again, none of this increase has been contributed by Mr. Harrisons management. First half of 2016 was a difficult time all across the Economy. Oil prices plummeted below $30 per barrel and stock markets corrected roughly 15%. YOY volumes and revenue

Coal	**205**	200	*3*	**522**	399	*31*	**2,546**	1,995	*28*
Intermodal	**688**	678	*1*	**434**	405	*7*	**631**	597	*6*

Coal production 2015 - 2018

Supply	(million short tons)			
U.S. Coal Production	897.0	738.7	767.9	*785.2*
Imports	11.3	9.8	10.2	*9.7*
Exports	74.0	60.3	60.3	*52.2*

In this chart provided by eia.gov we can see that overall coal production has increased by 3.9% from 2016. Meanwhile, according to Q1 ER - Q1 2017 coal shipping volume at CSX has increased 3%, adding roughly 4% to overall revenue. The EIA expects an increase of coal production of 2.2% through 2018, which is lower than the increase between 2016 and 2017. So far revenue jump since 2016 has not in any way been a result of hiring Harrison as new CEO, but due to overall market and economy conditions.

We believe that the premium on the stock, brought by optimism about Harrison as the new CEO, doesn't make any sense and soon enough investors will realize this, probably after Mantle Ridge trims their position in the stock. The same happened with Pershing Square and CP stock, as soon as Ackman sold, the stock has gone down 33% from highs, while Harrison was still CEO. The problem is CP was in far worse shape when Harrison started there with operating ratio of 83.3, while CSX operating ratio is 69.4 (industry average)

We believe that Management and Activist Fund that backs him are very motivated to overstating the actual conditions of the company. At the time of writing this article, the stock went up another 2% because Harrison reported buying 300k shares at $50.20. Why would anyone do that having 9 million options at 49.75 other than to pump stock?

We also noticed a lot of repeating social media promotion on the stock. On Twitter, the buyback alone is mentioned every hour by new bot accounts. No one mentions the $850 million filed prospectus to issue notes on April 26, 2017.

We are also very concerned by President Trumps' harsh words about NAFTA (North American Free Trade Agreement) and his idea of hiking import taxes at the border. If he either changes the deal on NAFTA or gets a positive reaction to hiking import taxes, CSX revenue will be hit substantially, due to amount of shipments to and from Canada and Mexico. We are also concerned about dying retail sector, which accounts for a large part of Intermodal Revenue. I'm sure everyone is concerned about a possible trade war President Trump seems to favour.

To sum it up, the stock is now in step 2 of 4 in the pump and dump scheme. First - hire a big known name in the industry to improve a well performing company. Second, pump stock at all cost.

The company will not outperform its peers, which are trading at much lower valuations. Harrison is unlikely to deliver what is expected of him. We see fair value at $37 per share.