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The Acquisition of Consolidated Rail Corporation (A)

After eight days of intense negotiations in a New York City hotel room, executives from CSX Corporation (CSX) and Consolidated Rail Corporation (Conrail), the first- and third-largest railroads in the Eastern United States, announced an $8.3 billion merger.[1] This combination would create the second largest rail system in the United States and by far the largest rail system east of the Mississippi River.

John W. Snow, CSX's chief executive officer, announced the merger on October 15, 1996, proclaiming, "This merger of equals represents a strategic combination that will provide excellent value for our customers and our shareholders, and is consistent with sound public policy. This is the right merger at the right time between the right companies."[2] David M. LeVan, Conrail's chief executive officer, concurred. "We are delighted to be merging with our ideal partner. Our companies share an uncompromising commitment to safety, operating excellence, and superior service and have compatible cultures that will expedite realization of the benefits of the merger."[3]

Railroading Background[4]

Although its roots go back to the early 1800s, American railroading did not reach its heyday until the mid-1800s. Yet after two decades of explosive growth, the industry experienced a period of dramatic consolidation in the 1870s as railroads began acquiring other railroads in an attempt to lower costs. Despite the high cost of building and maintaining lines, expansion through acquisition proved to be very profitable because it reduced marginal costs significantly. As costs fell, however, railroads began to compete on price, causing many of them to fail.

Recognizing the inherent danger in this form of competition, many of the surviving railroads formed cartels to allocate traffic and revenues. To prevent monopolistic pricing in a market without substitutes for long-haul transportation, the federal government intervened and established regulations on interstate rates. In the following years, the government extended its regulatory reach to include control of railroad mergers, infrastructure construction, and divestiture of rail lines.

By the turn of the century, railroading had recovered and the industry once again entered an expansionary period. Railroads dominated the freight transportation business until trucking emerged as a powerful competitor in the 1940s. The rise of trucking resulted from not only innovations in motor and tire technologies, but also enormous investment in highway infrastructure by the federal government. Unlike railroads, which were responsible for constructing their own rail lines, trucking

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firms were not responsible for building roads. As a result, trucks could provide cheaper, and more flexible, transportation, especially over short distances.

Railroads responded to declining profitability during the 1950s and early 1960s by trying to abandon unprofitable routes, merge with other railroads, and lower costs. But they faced significant regulatory impediments on all three fronts. The problems became worse in the early 1970s as inflation raised operating expenses. With rising costs, yet fixed prices, railroads were unable to generate profits. By 1972, the six largest Northeastern railroads had filed for bankruptcy. Critics argued that without some form of deregulation, the industry might collapse.

In response to the failures, Congress passed the Stagger's Rail Act of 1980, a deregulatory act that gave railroads the ability to set prices in competitive markets, abandon unprofitable lines, and pursue mergers and acquisitions. This Act caused the structure of the railroad industry to change dramatically. Consolidation reduced the number of Class I railroads (a classification based on revenue) from 40 to nine over the next 15 years. It also changed the way that railroads did business. Between 1980 and 1995, the number of railroad employees fell from 458,000 to 188,000 as railroads slashed crew sizes and computerized dispatching systems.[5] As employment fell, measures of labor productivity, such as carloads per employee, increased commensurately. At the same time, railroads took advantage of their new ability to close unprofitable lines and shut more than one-third of their route-miles.[6]

These changes had their intended effect as industry profitability improved. The industry operating ratio (defined as the ratio of operating expenses to operating revenues—railroad analysts' key profitability measure) fell from 93.3% in 1980 to 80.0% in 1995.[7] With lower costs, railroads began to recapture market share from the trucking industry for the first time in years. By 1995, railroads carried 41% of the U.S. freight, up from 36% in 1985.[8]

Another round of consolidation began in the mid 1990s as railroads saw an opportunity to further reduce costs through economies of scale. In late 1995, Burlington Northern acquired Santa Fe Pacific in a deal valued at $4.0 billion, but only after an intense bidding war with Union Pacific.[9] Burlington Northern Santa Fe (BNSF), the resulting entity, estimated the merger would result in $560 million of synergies annually. In fact, BNSF began to show improvement within a year—operating expenses fell by 1% while revenues increased by 3%.[10] The following year, Union Pacific acquired Southern Pacific for $5.4 billion. Again the companies projected large synergies. In this instance, the estimate was $660 million of synergies annually within five years.[11] Although these deals involved only western railroads, analysts saw them as two more steps down the path towards a time when the country would have only two major transcontinental railroads. Nevertheless, the Surface Transportation Board (STB), the federal regulator of railroads, approved both deals with little interference.

Whereas these mergers focused primarily on consolidating domestic rail traffic, several US railroads were also seeking to capitalize on the possibility of increased North-South rail traffic following the passage of the North American Free Trade Agreement (NAFTA) in 1994. Union Pacific, Kansas City Southern, and Illinois Central all formed joint ventures with Mexican railroads hoping to create seamless rail service between Mexico, the United States, and Canada. What was lacking, however, was full East-West connections, as well as solid ties into and across Canada.

Consolidated Rail Corporation (Conrail)

In 1973, Congress passed the Regional Rail Reorganization Act, which created Philadelphia-based Conrail out of the remains of the six bankrupt, Northeastern railroads. Despite an infusion of more than $3.3 billion of federal funds, Conrail continued to lose money through 1980. Like other railroads, things began to change for Conrail with the passage of the Staggers Act in 1980. It earned its first profit—$39.2 million on revenues of $4.2 billion—in 1981. Within three years, Conrail's net income jumped to $500 million on revenues of $3.4 billion as it reduced headcount and closed unprofitable routes.

Based on Conrail's financial strength, Congress began to consider ways of privatizing it. At the time, both Norfolk Southern and CSX had indicated an interest in acquiring Conrail. While CSX argued that the railroad should be split between the two, Norfolk Southern bid $1.6 billion for the entire company. Instead of selling Conrail to either one, Congress decided to sell it in 1987 using an initial public offering (IPO), the largest IPO in U.S. history at that time.

By 1995, Conrail had 23,510 employees, operated 10,701 miles of track, and controlled 29.4% of the Eastern rail freight market. **Exhibit 1** provides comparative operating and financial statistics for selected railroads while **Exhibits 2** and **3** provide balance sheet and income statement information for Conrail. Its routes connected the major Northeastern cities, such as Philadelphia, Baltimore, Boston, and New York, with major Midwestern hubs, such as Chicago, St. Louis, and Detroit. Although Conrail had near monopoly control over the lucrative Northeast rail market, a market many considered to be one of the industry's prize possessions, it was the least efficient railroad in the East. It also faced tough competition from trucking, which had a dominant share of the total Northeast freight market.

CSX Corporation (CSX)

In contrast to Conrail and Norfolk Southern, whose major business was railroading, Richmond, Virginia-based CSX was a diversified transportation company providing intermodal service (transportation of truck-trailers and containers by rail-car), ocean-container shipping, barging, and contract logistics services in addition to railroad services. Its business units included Sea-Land Services, which operated 28 marine terminal facilities and a fleet of 105 container ships; American Commercial Lines, which operated 116 tugboats and 3,200 barges; CSX Intermodal, which provided intermodal services and facilities; CSX Transportation, which provided rail freight services; and several resort and real estate holdings.

CSX's railroad subsidiary was the result of the merger of three railroads: the Seaboard Coast Line, the Chesapeake and Ohio Railway, and the Baltimore and Ohio Railroad. By 1995, CSX had 29,537 employees, operated 18,645 miles of track, and controlled 38.5% of the Eastern rail freight market, the largest share of the three Eastern, Class 1 railroads (see **Exhibit 1**). Its routes connected 20 Southeastern and Midwestern States and the Canadian Province of Ontario. **Exhibit 4** and **5** provide balance sheet and income statement information for CSX.

Norfolk Southern Corporation (Norfolk Southern)

Norfolk Southern, the third major Eastern railroad, had its headquarters in Norfolk, Virginia. Although the company owned several other businesses, including North American Van Lines (a motor carrier) and Pocahontas Land Corporation (a natural resources company that managed natural gas, coal, and timber resources), Norfolk Southern's major business was railroading. It had 24,488 railroad employees, operated 14,415 miles of track, and controlled 32.1% of the Eastern rail freight market in 1995. **Exhibits 4** and **5** present Norfolk Southern's balance sheet and income statement information. Like CSX, its routes connected 20 Southeastern and Midwestern States and the Canadian Province of Ontario.

Industry observers widely regarded Norfolk Southern as the most efficient and best-managed railroad in the United States (see **Exhibit 1**). It also was an industry leader in technological innovation and safety. In fact, in 1995 the railroad received an unprecedented sixth consecutive E. H. Harriman Memorial Gold Medal Award for employee safety.

The CSX-Conrail Merger

The CSX-Conrail merger would create an entity with more than $8.5 billion in rail revenue and almost 70% of the Eastern market. According to the merger plan, CSX-Conrail would locate the combined company's headquarters in Philadelphia, implement a succession plan allowing Conrail's LeVan to replace CSX's Snow as chief executive officer within two years, and increase LeVan's annual compensation by about $2 million so that it was commensurate with Snow's compensation.[12]

Both companies hired investment banks to advise them on the deal and to provide fairness opinions. Conrail retained Lazard Frères and Morgan Stanley as financial advisors. Their fees totaled 0.17% and 0.13% of the deal value, respectively, and both had payments tied to specific deal milestones. For example, Conrail would pay Lazard Frères a total of $14 million divided into three payments: $2.75 million at the time of the merger announcement, $3.75 million once Conrail shareholders approved the merger, and the remainder once the deal was completed. On the other side of the transaction, CSX retained Wasserstein Perella and agreed to pay them $19 million, also divided over three milestones.

The Structure of the CSX-Conrail Deal

CSX offered to acquire Conrail in a two-tiered deal worth $8.3 billion at announcement. On the day they announced the merger, Conrail's stock price jumped from $71.00 to $85.13, while CSX's stock price fell from $49.50 to $46.75. Conrail had been trading around $71.00, plus or minus a few dollars, for most of the past year.

Although two-tiered offers were relatively common in the 1980s, they were used far less frequently in the 1990s. Under the agreement, CSX would purchase 90.5 million Conrail shares ("acquisition shares") to complete the acquisition. This sum included common shares currently outstanding, preferred shares convertible to common shares, and employee incentive stock options exercisable in the event of an acquisition. CSX would pay $92.50 per share in cash for the first 40% of Conrail's acquisition shares (the front-end offer) and would exchange shares in the ratio of 1.85619:1.0 (CSX:Conrail) for the remaining 60% (the back-end offer). Based on CSX's stock price of $46.75, the offer had a blended value of $89.07 per share

CSX planned to execute the front-end offer in two stages. The first stage, a cash tender offer for 17.86 million shares at $92.50 per share, began the day after the merger announcement. These shares represented 19.7% of Conrail's acquisition shares. The second stage, another cash tender offer for an additional 20.3% of Conrail's acquisition shares at the same price, could proceed only after Conrail shareholders approved the deal as required under Pennsylvania law.

Pennsylvania's Business Corporation Law, one of the toughest antitakeover statutes in the country, regulated acquisitions of Pennsylvania companies. Several of its many provisions were relevant to this transaction. First, the law required bidders holding 20% or more of a company's stock to offer all shareholders the same price unless target shareholders explicitly voted to nullify this provision (the "fair value" statute). The Pennsylvania state government passed this provision after T. Boone Pickens Jr. made an unsolicited, two-tiered offer for Pittsburgh-based Gulf Oil in 1984. Because

CSX had proposed a two-tiered offer with different prices, Conrail shareholders would have to "opt-out" of the Pennsylvania statute before CSX could purchase more than 19.9% of the shares—this regulation was the reason for executing the front-end offer in two stages. Second, the statute limited a bidder's voting rights to a maximum of 20% of total shares outstanding, regardless of the percentage actually owned, unless shareholders or management approved the right to vote all the shares (the "voting rights" statute). Because Conrail's management had approved the merger, CSX satisfied this requirement. Finally, the law required management to consider and protect the interests of employees and the community where the target was located in addition to meeting their fiduciary responsibility to shareholders (the "constituency" statute). One of the most important constituents was Conrail's unionized workforce. On the day of the announcement, the unions, which represented approximately 90% of Conrail's employees, did not state a position in favor or against the merger.[13]

An opt-out vote, as required by the fair value statute, was scheduled for mid-November. At the time of the vote, CSX would own 17.86 million Conrail's shares from the first-stage tender offer, Conrail management would own approximately 1.3 million shares, and employee trusts (which included an employee stock option program and a traditional benefits trust), which reportedly supported the merger, would own another 13.0 million shares. Thus, parties in support of the merger would control 35.5% of the acquisition shares and would need only another 14.6% of the acquisition shares to vote in favor of opting-out for it to pass. Following shareholder approval, and successful completion of the second cash tender offer, CSX would proceed with the back-end offer for the remaining 60% of Conrail's shares. The back-end offer would not be completed until the STB approved the merger, which might not occur until late 1997.

Besides the two-tiered structure, the merger agreement contained several other important provisions. For example, the agreement contained a "break-up" fee, which obligated Conrail to pay CSX $300 million if the transaction did not take place. Break-up fees, which were becoming more common in the 1990s, typically averaged 1-3% of the deal value.[14] Second, Conrail granted CSX the option to purchase 15.96 million newly issued common shares at $92.50 per share. These options, known as "lock-up" options, typically allowed bidders to acquire between 10% to 20% of a target's fully diluted shares.[15] Third, Conrail suspended its "poison pill." Poison pills, also known as shareholder-rights plans, permitted companies to issue discounted shares in the event an outside party achieved a certain ownership level or made an unsolicited takeover offer. In this case, each Conrail shareholder had the right to purchase an additional share at a 50% discount to the current market price for each share owned if an outsider purchased 10% or more of Conrail.[16] Finally, the merger agreement included a clause forbidding Conrail from pursuing merger discussions with any other party for a period of six months (the "no talk" clause).

The no-talk clause essentially forbid Conrail from soliciting other bids. Yet if another offer did emerge, the Conrail board could consider the bid and possibly terminate its merger agreement with CSX under a number of conditions. First, Conrail's board could consider another offer if, by not considering it, the board would be in violation of its fiduciary duty. But Conrail's board would have significant leeway in defining fiduciary duty under the constituency statute of Pennsylvania's antitakeover law. And because Conrail had a "classified board", which meant that only one-third of the directors were elected each year, the board could uphold this statute for several years to come even if one-third of the directors were replaced at the next annual meeting. Alternatively, the board could terminate the merger agreement if another offer made it unlikely that CSX could complete the merger or win the upcoming opt-out vote.

Conrail Acquisition Economics

Over the previous few years, there had been several large mergers in the railroad industry. **Exhibit 6** provides data on the five largest announced railroad acquisitions in recent years. Besides these transactions, there were no other transactions in the past five years in which the total consideration paid was more than $400 million.

Like the previous deals, value creation for the CSX-Conrail deal would result from the merged company's ability to consolidate overlapping operations and to increase revenue through service improvements. CSX and Conrail estimated that cost reduction would yield an additional $370 million in annual operating income by the year 2000, net of merger costs.[17] Over the same period, they projected that revenue increases would yield an additional $180 million in annual operating income.[18] Most of the revenue gains would come at Norfolk Southern's expense, though a significant fraction would also come from the trucking industry. CSX and Conrail were careful to note that the $180 million figure included the expected revenue loss due to providing Norfolk Southern with greater access to markets currently served exclusively by CSX.[19] **Exhibits 7** and **8** present the projected gains in operating income and selected financial market data, respectively.

This merger would improve CSX-Conrail's competitive position in two ways. First, the combined rail networks would facilitate long-haul, contiguous, and, therefore, low-cost service between the Southern ports, the Northeast, and the Midwest. Because Norfolk Southern lacked access to the Northeast market, it would be less able to service long-haul routes from either the South or Midwest. **Exhibit 9** provides a comparison of the pro forma CSX-Conrail and Norfolk Southern rail networks. Second, even in the shorter-haul routes between the Midwest and the South, CSX-Conrail would become more competitive through cost reduction. **Exhibit 10** presents the results of a model of industry economics and efficiency. Using current cost and revenue data combined with estimates of merger synergies and historical trends, the model projects operating ratios for a combined CSX-Conrail and for Norfolk Southern. If CSX-Conrail were to achieve its projected revenue gains and cost savings, it would become more efficient than Norfolk Southern, at least according to this aggregate measure.

Publicly, CSX claimed the merger was "... about growth and the future of the rail industry that sets the second act for a U.S. rail renaissance."20 Yet one analyst gave a more cynical interpretation. He said that CSX's motives were primarily driven by the "... fear that someone else was going to do it first. CSX-Conrail smacks of a preemptive strike. CSX doesn't want Norfolk Southern to get Conrail."21

The Conrail Shareholder Decision

On October 16, 1996, the day after CSX and Conrail announced the merger, CSX commenced the first stage of its cash tender offer at $92.50 per share. Sometime before November 15th, the day on which CSX's offer expired, Conrail shareholders would have to decide whether to tender their shares. Given the ownership structure at the time (non-taxable institutions, tax-paying institutions, individuals, and insiders owned 48%, 34%, 17%, and 1% of Conrail's acquisition shares, respectively), it was not clear who would tender shares or how many.[22] If shareholders tendered more than 19.7% of the shares, then CSX would buy the shares on a pro rata basis; if shareholders tendered less than 19.7%, CSX could either buy them all or withdraw its offer.

Exhibit 1 Selected Railroad Statistics (1995)

	BNSF[a]	Conrail	CSX	Norfolk Southern	Union Pacific
Railroad Operations Results ($ millions)					
Operating Revenues	$8,150	$3,686	$4,819	$4,012	$6,602
Operating Expenses	6,617	3,230	3,951	2,950	5,207
Operating Income	1,533	456	868	1,062	1,395
Operating Ratio (%)[b]	81.2%	79.9%	76.7%	73.5%	78.9%
Railroad Operations Data					
Railroad Employees	45,656	23,510	29,537	24,488	35,001
Miles of Track Operated	31,326	10,701	18,645	14,415	22,785
Total Carloads Originated (thousands)	5,967	2,531	4,402	3,435	4,010
Tons Originated (thousands)	388,423	134,651	320,419	223,000	257,483
Railroad Productivity Data ($)					
Revenue per Employee	$178,509	$156,784	$163,151	$193,690	$188,623
Revenue per Mile of Track Operated	260,167	344,454	258,461	278,321	289,752
Revenue per Carload Originated	1,366	1,456	1,095	1,168	1,646
Revenue per Ton Originated	20.98	27.37	15.04	17.99	25.64
Financial Ratios (%)					
Return on Sales	9.0%	11.4%	6.9%	15.3%	12.6%
Return on Average Equity	14.6	9.0	15.5	15.0	16.5
Leverage (Debt/Equity at book value)	84.0	59.5	40.1	33.6	110.7
Current Ratio	53.3	108.9	64.7	111.4	88.4
P/E Ratio	11.7	12.9	11.6	12.8	19.5
Stock Price ($ per share)					
High	$83.88	$73.88	$45.63	$81.25	$47.09
Low	47.50	51.00	35.13	60.63	31.59
Year-end	78.00	70.00	45.63	79.38	44.48

Sources: Union Pacific, Conrail, CSX, and Norfolk Southern *1995 Annual Reports; Datastream; Bloomberg;* Association of American Railroads, *Railroad Facts*, 1996; *Value Line Investment Survey*, September 20, 1996; *Morgan Stanley Dean Witter*, U.S. and the Americas Investment Research Report, "Investment Case for Railroads," November 1997; and casewriter's estimates.

[a]Burlington Northern merged with Santa Fe Pacific on September 22, 1995, to form Burlington Northern Santa Fe (BNSF). The data provided are either pro forma results, or estimates thereof, for 1995.

[b]The operating ratio measures a company's operating efficiency. In this case, it is defined as the ratio of operating expenses to operating revenues, excluding one-time charges. In 1995, CSX incurred a $257 million charge and Conrail incurred a $285 million charge.

Exhibit 2 Conrail Consolidated Balance Sheet ($ millions)

	1992	1993	1994	1995	3Q 1996[a]
ASSETS					
Cash	$ 40	$ 38	$ 43	$ 73	$ 33
Accounts receivable	592	644	646	614	655
Deferred income taxes	0	227	249	333	337
Materials and supplies	121	132	164	158	144
Other current assets	37	21	23	28	30
Total current assets	790	1,062	1,125	1,206	1,199
Property and equipment	6,013	6,313	6,498	6,408	6,495
Other assets	512	573	699	810	693
Total assets	**$7,315**	**$7,948**	**$8,322**	**$8,424**	**$8,387**
LIABILITIES AND EQUITY					
Accounts payable	$ 63	$ 62	$ 119	$ 113	$ 158
Current portion of long-term debt	207	146	130	181	138
Short-term debt	127	79	112	89	65
Other current liabilities	882	788	840	787	889
Total current liabilities	1,279	1,075	1,201	1,170	1,250
Long-term debt	1,577	1,959	1,940	1,911	1,891
Deferred income taxes	644	1,081	1,203	1,393	1,420
Other long-term liabilities	1,067	1,049	1,053	973	888
Total liabilities	**$4,567**	**$5,164**	**$5,397**	**$5,447**	**$5,449**
Total stockholders' equity	2,748	2,784	2,925	2,977	2,938
Total Liabilities and Equity	**$7,315**	**$7,948**	**$8,322**	**$8,424**	**$8,387**

Sources: Conrail 1993 and 1995 *Annual Reports*, and Conrail *Form 10-Q*, November 14, 1996.

[a]Nine months ended September 30, 1996.

Exhibit 3 Conrail Consolidated Income Statement ($ millions, except earnings per share)

	1992	1993	1994	1995	3Q 1996[a]
Operating Revenues	**$3,345**	**$3,453**	**$3,733**	**$3,686**	**$2,771**
Operating Expenses					
Way and structures	$465	$492	$499	$485	$364
Equipment	692	703	815	766	614
General and administrative	348	384	350	370	252
Transportation	1,306	1,283	1,379	1,324	1,048
Special charges	--	--	84	285	135
Total Expenses	**$2,811**	**$2,862**	**$3,127**	**$3,230**	**$2,413**
Income from Operations	**$534**	**$591**	**$606**	**$456**	**$358**
Interest expense	(172)	(185)	(192)	(194)	(137)
Other income	98	114	118	130	83
Loss on disposition of subsidiary[b]	--	(80)	--	--	--
Income before taxes	**$460**	**$440**	**$532**	**$392**	**$304**
Income taxes	178	206	208	128	109
Changes in accounting principles	--	(74)	--	--	--
Net Income	**$282**	**$160**	**$324**	**$264**	**$195**
Average number of primary shares outstanding (thousands)	79,742	79,575	78,620	78,837	77,443
Total number of fully diluted (Acquisition) shares outstanding (thousands)[c]					**90,500**
Fully Diluted Earnings Per Share before effect of charges[d,e]	**$2.97**	**$3.00**	**$4.08**	**$4.69**	**$3.01**

Sources: Conrail 1993 and 1995 *Annual Reports;* Conrail *Form 10-Q*, November 14, 1996; CSX *Schedule 14D-1*, October 16, 1996, and casewriter estimates.

[a]Nine months ended September 30, 1996.

[b]In September 1993, Conrail recorded a loss for the disposition of its investment in Concord Resources Group, Inc.

[c]The number of fully diluted shares assumes conversion of the preferred stock and exercise of all outstanding options (except CSX's lock-up options). It is measured as of the announcement date and equals the total number of shares CSX would have to purchase to acquire Conrail.

[d]Based on net income adjusted for the effects of preferred dividends, net of income tax benefits.

[e]Adjusted for extraordinary charges, loss on disposition of subsidiary, and changes in accounting principles.

Exhibit 4 CSX and Norfolk Southern Consolidated Balance Sheets ($ millions)

	CSX[a]		Norfolk Southern	
	1995	3Q 1996[b]	1995	3Q 1996[c]
ASSETS				
Cash	$ 660	$ 515	$ 68	$ 188
Accounts receivable	832	928	704	776
Deferred income taxes	148	151	145	152
Materials and supplies	220	217	62	58
Other current assets	75	108	365	284
Total current assets	1,935	1919	1,344	1,458
Property and equipment	11,297	11,720	9,259	9,460
Other assets	1,050	1,002	303	345
Total assets	$14,282	$14,641	$10,905	$11,263
LIABILITIES AND EQUITY				
Accounts payable	$ 1,121	$1,073	$ 733	$ 747
Current portion of long-term debt	486	201	86	79
Short-term debt	148	276	45	45
Other current liabilities	1,236	1,149	342	338
Total current liabilities	2,991	2,699	1,206	1,209
Long-term debt	2,222	2,288	1,553	1,811
Deferred income taxes	2,560	2,657	2,299	2,351
Other long-term liabilities	2,267	2,182	1,018	1,037
Total liabilities	$10,040	$ 9,826	$ 6,076	$ 6,408
Total stockholders' equity	4,242	4,815	4,829	4,855
Total Liabilities and Equity	$14,282	$14,641	$10,905	$11,263

Sources: CSX and Norfolk Southern 1995 *Annual Reports;* CSX *Form 10-Q*, October 31, 1996; and Norfolk Southern *Form 10-Q*, November 13, 1996.

[a]Includes all CSX operations, rail and non-rail.

[b]Nine months ended September 27, 1996.

[c]Nine months ended September 30, 1996.

Exhibit 5 CSX and Norfolk Southern Consolidated Income Statement ($ millions, except earnings per share)

	CSX					Norfolk Southern				
	1992	1993	1994	1995	3Q 1996[a]	1992	1993	1994	1995	3Q 1996[b]
Operating Revenues										
Railway	$4,434	$4,380	$4,625	$4,819	$3,661	$3,777	$3,746	$3,918	$4,012	$3,075
Motor carrier	--	--	--	--	--	830	714	663	656	515
Container shipping	3,148	3,246	3,492	4,008	2,977	--	--	--	--	--
Other	1,152	1,314	1,491	1,677	1,245	--	--	--	--	--
Total Revenues	**$8,734**	**$8,940**	**$9,608**	**$10,504**	**$7,833**	**$4,607**	**$4,460**	**$4,581**	**$4,668**	**$3,590**
Operating Expenses										
Railway	$4,313	$3,643	$3,696	$3,951	$2,836	$2,851	$2,831	$2,875	$2,950	$2,213
Other	3,456	4,291	4,680	5,124	3,901	869	769	641	632	490
Special charges	699	93	-	257	-	-	-	-	-	-
Total Expenses	**$8,468**	**$8,027**	**$8,376**	**$9,332**	**$6,737**	**$3,720**	**$3,600**	**$3,516**	**$3,582**	**$2,703**
Income from Operations	**$266**	**$913**	**$1,232**	**$1,172**	**$1,096**	**$887**	**$860**	**$1,065**	**$1,086**	**$887**
Interest expense	(276)	(298)	(281)	(270)	(188)	(109)	(98)	(102)	(113)	(68)
Other income	3	18	55	72	19	98	137	85	142	68
Income before taxes	(7)	633	1,006	974	927	875	899	1,049	1,115	887
Income taxes	27	(274)	(354)	(356)	(325)	(318)	(350)	(381)	(402)	(317)
Accounting adjustments	--	--	--	--	--	--	223	--	--	--
Net Income	**$20**	**$359**	**$652**	**$618**	**$602**	**$558**	**$772**	**$668**	**$713**	**$570**
Average shares outstanding (thousands)	205,814	207,830	209,303	210,270	212,567	141,624	139,350	136,367	131,067	126,912
Earnings Per Share before effect of changes	**$2.31**	**$2.02**	**$3.12**	**$3.73**	**$2.83**	**$3.94**	**$3.94**	**$4.90**	**$5.44**	**$4.49**
Earnings Per Share[c]	**$0.08**	**$1.73**	**$3.12**	**$2.94**	**$2.83**	**$3.94**	**$5.54**	**$4.90**	**$5.44**	**$4.49**

Sources: CSX and Norfolk Southern 1993 and 1995 *Annual Reports*; CSX *Form 10-Q*, October 31, 1996; Norfolk Southern *Form 10-Q*, November 13, 1996; and casewriter estimates.

[a]Nine months ended September 27, 1996.

[b]Nine months ended September 30, 1996.

[c]Adjusted for special charges and accounting adjustments.

Note: CSX stock split 2 for 1 in December 1995. Prior years have been restated.

Exhibit 6 Recent Railroad Acquisitions and Conrail Financial Data

Target	Acquirer	Announcement Date	Deal Attitude	Offer Status	Target Financial Data: Assets ($ millions)	Target Financial Data: Revenues ($ millions)	Target Financial Data: Debt/Equity (at book)
Santa Fe Pacific	Burlington Northern	29-Jun-94	Friendly	Completed	$5,941	$2,795	0.96
Kansas City Southern	Illinois Central	19-Jul-94	Friendly	Withdrawn	1,399	$495	1.42
Santa Fe Pacific	Union Pacific	5-Oct-94	Hostile	Withdrawn	5,941	2,795	0.96
Chicago and North Western	Union Pacific[a]	10-Mar-95	Friendly	Completed	2,203	1,116	3.86
Southern Pacific	Union Pacific	2-Aug-95	Friendly	Completed	4,359	3,159	1.38

Target	Acquirer	Offer Price per Share[b] as a Multiple of: EPS[d]	Offer Price per Share[b] as a Multiple of: Book Value	Total Enterprise Value[b,c] as a Multiple of: Sales	Total Enterprise Value[b,c] as a Multiple of: EBITDA[d]	Four-Week Acquisition Premium (%)	Projected Merger Synergies ($ millions)	Projected Synergies as a Percent of the Target's Operating Expenses
Santa Fe Pacific	Burlington Northern	21.4X	4.5X	2.6X	13.1X	73%	$560	22.3%
Kansas City Southern	Illinois Central	14.6	1.7	3.6	9.9	n/a[e]	n/a	n/a
Santa Fe Pacific	Union Pacific	13.4	2.8	1.8	9.2	52	n/a	n/a
Chicago and North Western	Union Pacific	18.3	5.5	2.4	8.5	34	$250	27.7
Southern Pacific	Union Pacific	18.4	3.7	1.7	12.2	54	$660	24.5

Conrail Financial Data

	$ in Millions		$ per Fully Diluted Share		
Assets (3Q 1996)	$8,387	**EPS (last 4Q)**	$4.84	**Debt/Equity**	0.71 (at book value)
Debt (3Q 1996)	2,094	**EPS (1996 est.)**	4.91		
Sales (last 4Q)	3,722	**EPS (1997 est.)**	5.69	**Number of**	
EBITDA (last 4Q)	1,017	**Book Value (3Q 1996)**	32.46	**Acquisition Shares**	90.5 million

Sources: Securities Data Company, Inc.; Conrail *Forms 10-Q*, November 11, 1995, May 13, 1996, August 5, 1996, and November 18, 1996, and 1995 *Annual Report*; CSX *Schedule 14D-1*, October 16, 1996; Chicago and North Western *Form 10-K*, March, 22, 1995; *Natwest* Analyst Reports; *Value Line Investment Survey*, September 20, 1996; and casewriter's estimates.

[a]Union Pacific purchased the 72.5% of Chicago and North Western that it did not already own.

[b]All multiples are based on the fully diluted number of shares outstanding at announcement.

[c]Total Enterprise Value = common equity (at market) + preferred equity + cost to retire in-the-money options + debt (at book) - cash and marketable securities.

[d]Based on *current* year earnings estimates, before extraordinary items.

[e]Because Kansas City Southern Railroad was a division of a conglomerate, it did not have traded equity.

Exhibit 7 Projected Gains in Operating Income from a CSX-Conrail Merger ($ millions)

	1997E	1998E	1999E	2000E	2001E[a]
Gain in Operating Income from Cost Reduction[b]	$0	$111	$259	$370	$381
Gain in Operating Income from Revenue Increase					
Gain coming from Norfolk Southern	$0	$ 50	$ 89	$117	$121
Gain coming from other sources	0	27	48	63	65
Total Gain from Revenue Increase	$0	$77	$137	$180	$185
Total Gain in Operating Income[c]	**$0**	**$188**	**$396**	**$550**	**$567**

Sources: Casewriter's estimates based on data from *1996 Natwest Analyst Reports.*

[a]Grows at the rate of inflation (3%) after the year 2000.

[b]Net of merger costs.

[c]Pre-tax gain; the applicable federal income tax rate was 35%.

Exhibit 8 Selected Financial Market Data

	Week Ending October 18, 1996
Yields on U.S. Treasury Bills, Notes, and Bonds	
3-month	5.11%
6-month	5.40
1-year	5.55
2-year	5.91
5-year	6.28
10-year	6.54
30-year	6.83
Yields on Long-term Corporate Bonds	
Aaa	7.40
Aa	7.59
A	7.71
Baa	8.08
Interest Rates	
Federal Funds	5.22
3-month Commercial Paper	5.42
3-month Certificate of Deposit	5.40
Prime Rate	8.25
Value Line Equity Betas	
Conrail	1.30
CSX	1.35
Norfolk Southern	1.15

Sources: *Federal Reserve Bulletin,* January 1997; and *Value Line Investment Survey,* October 11, 1997.

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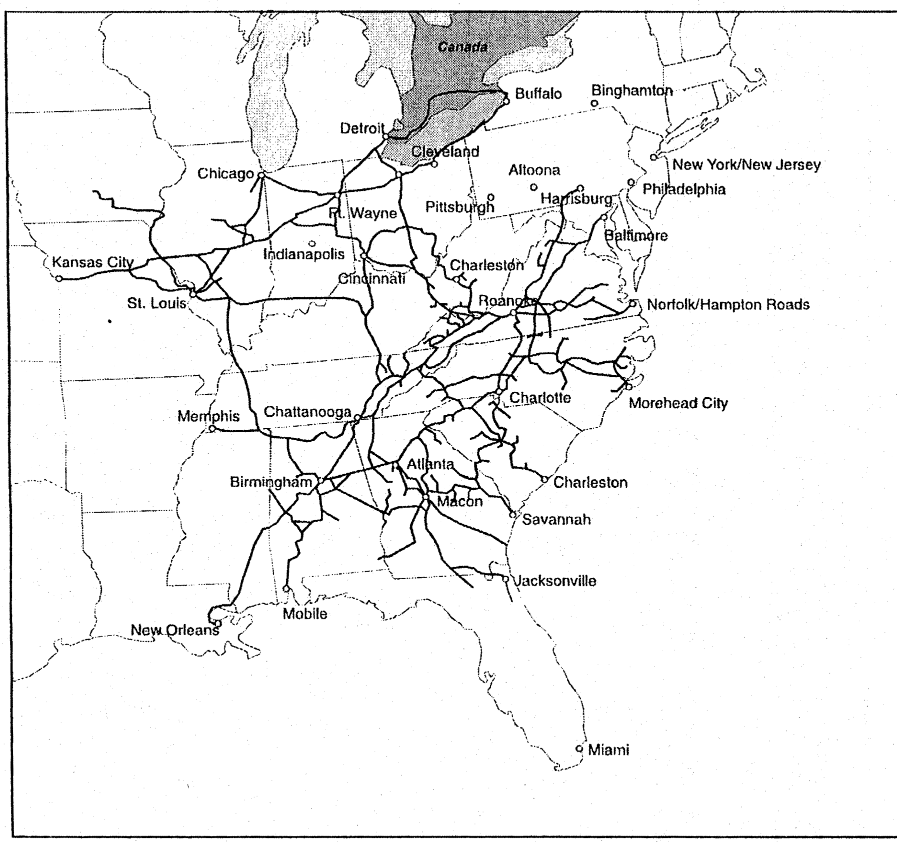
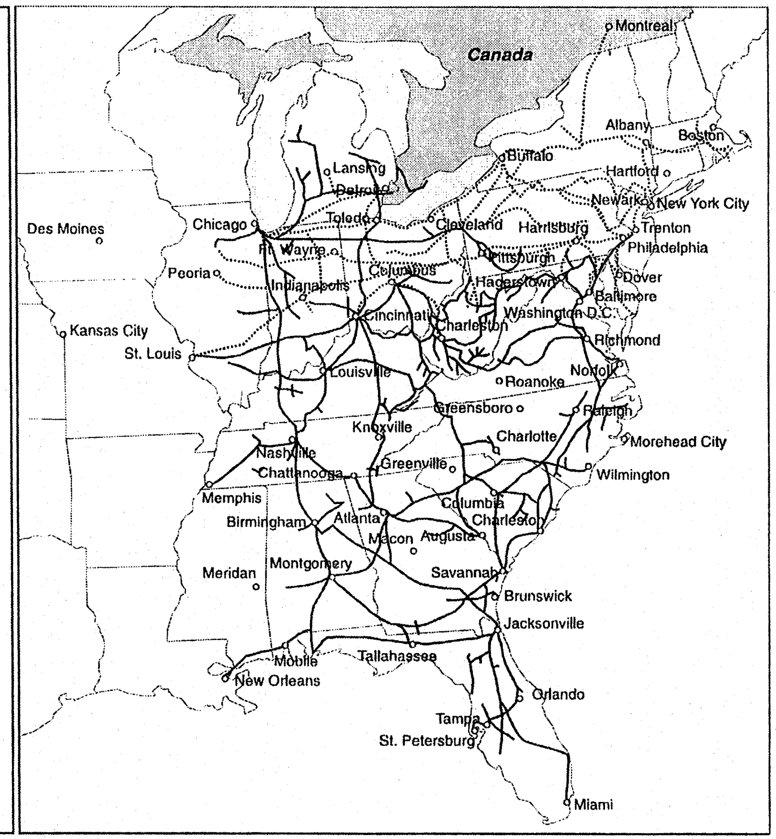
Exhibit 9 Norfolk Southern Rail Network and CSX-Conrail Rail Network

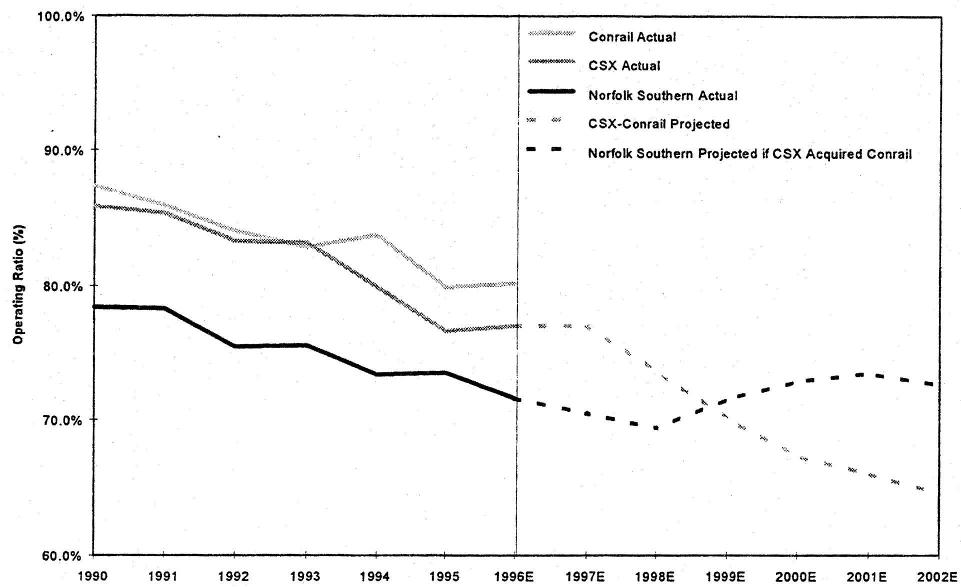


Norfolk Southern Rail Network



Pro Forma CSX-Conrail Rail Network

Exhibit 10 Projected Impact of a CSX-Conrail Merger on Operating Ratios



Sources: Actual operating ratios are based on data from: CSX, Norfolk Southern, and Conrail 1993 and 1995, and 1996 *Annual Reports*; and *Morgan Stanley Dean Witter*, U.S. and the Americas Investment Research Report, "Investment Case for Railroads," November 1997. Projections are casewriter's estimates based on these sources and additional data from *1996 Natwest Analyst Reports.*

Note: The operating ratio measures a company's operating efficiency. In this case, it is defined as the ratio of operating expenses to operating revenues, excluding one-time charges.

Endnotes

[1] Charles Slack, Rail Giants Flew Stealth to Merger," *Richmond Times-Dispatch*, October 20, 1996, p. A1.

[2] "CSX and Conrail to Combine in Pro-Competitive, Strategic Merger," *CSX Press Release*, October 15, 1996.

[3] Ibid.

[4] This section draws to a limited extent on "Note on Railroad and Trucking Deregulation," HBS No. 793-041.

[5] Association of American Railroads, *Railroad Facts*, September 1996, p. 55.

[6] Ibid., p. 44, and casewriter's calculations.

[7] Ibid., pp. 12 and 14, Andras R. Petery, "Investment Case for Railroads: Opportunities After the Correction," Morgan Stanley Dean Witter, November 1997, p. 19, and casewriter's calculations.

[8] "How Conrail Became a Hot Ticket," *The New York Times National Edition*, November 1, 1996, p. C1.

[9] Richard A. Oppel Jr., "Burlington Northern Wins Bid, But At What Cost?" *The Dallas Morning News*, February 1, 1995, p. 1D.

[10] Wayne C. Nef, *Value Line Investment Survey*, September 20, 1996, p. 285.

[11] Ibid., p. 292.

[12] Conrail 1996 Notice of Annual Meeting of Shareholders, April 3, 1996, and CSX Schedule 14-D, December 6, 1996.

[13] Rip Watson, "Conrail, CSX to Sit Down With Union Chiefs: Goal is to Outline Merger Plan, Gain Support for $8.4 Billion Deal," *The Journal of Commerce*, November 15, 1996, p.1A.

[14] William G. Lawlor, "The Mounting Risks in Buying Public Targets," *Mergers & Acquisitions*, July/August 1996, pp. 27–32.

[15] Ibid.

[16] CSX *Schedule 14-D*, October 16, 1996.

[17] Anthony Hatch and Jeff Julkowski, "CSX and CRR Strengthen Their Marriage," *NatWest Securities*, November 7, 1996, p. 1, and casewriter's estimates.

[18] Ibid.

[19] Ibid.

[20] Suzanne Wooton, "CSX to Buy Conrail for $8.4 Billion," *Baltimore Sun*, October 16, 1996, p. 1A.

[21] Christopher Dinsmore, "Merger Could Leave Norfolk Southern in a Competitive Hole," *Virginian-Pilot*, October 20, 1996, p. D1.

[22] Based on analysis of 13f filings provided by the Carson Group, Conrail 1996 *Notice of Annual Meeting of Shareholders*, April 3, 1996, and casewriter's estimates. I would like to thank Jay Light for helping classify investors by type.