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UNLOCKING VALUE AT CSX: REsponding to requests from mantle ridge[[1]](#footnote-1)

Ken Mark wrote this case under the supervision of Professor Stephen Foerster solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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On February 14, 2017, the management of CSX Corporation (CSX) had called a special meeting and shareholder vote to respond to demands from the hedge fund Mantle Ridge that included a compensation package estimated at $300 million for Hunter Harrison, the proposed new chief executive officer (CEO) for CSX. In 2016, Mantle Ridge—led by hedge fund activist Paul Hilal, a former colleague of Bill Ackman at Pershing Square Capital Management (Pershing Square)—had acquired a stake of less than 5 per cent of CSX’s outstanding stock. On January 18, 2017, Hilal informed CSX of his firm’s stake in the railway, requested board representation, and proposed the installation of Harrison as CSX’s new CEO. Harrison had abruptly resigned from Canadian Pacific (CP) to work with Mantle Ridge on its activist efforts.

Susan Gray, chief investment officer of NYT, a large U.S. pension fund, had a substantial stake in CSX. She asked:

If we are asked to vote at the upcoming meeting, should we vote in favour of approving the package? If we and others don’t support the package, Harrison won’t be the next CEO of CSX. An alternative is for us to sell our CSX stock now, given that it has had a run-up relative to the market.

Hunter Harrison and Mantle Ridge

Harrison had left CP five months before he was scheduled to retire, in June 2017, to become a consultant to CP at a rate of $1 million per year.[[2]](#footnote-2) Harrison had begun his career as a carman-oiler for the St. Louis–San Francisco Railway in 1964, had been a vice president at Burlington Northern Railroad, and had helped to turn around the Canadian National Railway Company (CN) as its chief operating officer (between 1998 and 2003) and then as its CEO (from 2003 to 2009). He called his change-management philosophy “precision railroading.”[[3]](#footnote-3) This operations-focused strategy delivered higher service levels at lower costs and resulted in a lower operating ratio (the firm’s operating expenses as a percentage of revenues). The operating ratio was an industry-standard gauge of railroads’ efficiency and profitability. Pershing Square, a hedge fund, had acquired common shares in CP in September 2011 and then fought and won a proxy battle with CP’s board of directors to install Harrison as the company’s new CEO.

As Canadian Pacific’s CEO from 2012 to the beginning of 2017, Harrison had improved margins by optimizing the number of locomotives and rail cars used in operations and reducing the company’s workforce by 5,500 jobs.[[4]](#footnote-4) From 2012 to 2017, CP’s operating ratio dropped from 83.3 per cent to 58.6 per cent. CP’s stock price tripled during his tenure.

Hilal, a senior partner at Pershing Square, was one of the executives working with Harrison. Hilal was the partner credited with identifying the CP investment opportunity and recruiting Harrison to the firm. As a director of CP, Hilal oversaw the board’s management resource and compensation committee and served on its finance committee. Hilal left Pershing Square in January 2016 to start Mantle Ridge, an activist firm. Mantle Ridge’s objective was to create value for shareholders by engaging companies’ management teams and boards of directors.[[5]](#footnote-5)

On January 18, 2017, Mantle Ridge contacted CSX with new information: Mantle Ridge had a large position in CSX, with just below 5 per cent of its stock, and Harrison was working with Mantle Ridge on a plan to become CEO of CSX. As Harrison was well known in the industry, the CSX board invited him and Hilal for a discussion; the meeting lasted more than five hours.[[6]](#footnote-6)

In the discussions with CSX, Mantle Ridge also requested board representation—the ability to appoint four out of 16 directors—and a four-year employment agreement with Harrison that included a compensation package valued at $300 million. This compensation package would consist of a combination of base and performance pay, participation in CSX’s incentive programs, $84 million to reimburse Harrison for the compensation he would forego at CP, money to cover a tax indemnity Mantle Ridge provided to Harrison (estimated to be valued at a few tens of millions of dollars), and money to repay Mantle Ridge for its $2 million consulting agreement with Harrison. If CSX agreed to Mantle Ridge’s terms, Harrison would be expected to become CEO effective immediately. Mantle Ridge outlined other demands in a February 6 letter. These included an agreement that Mantle Ridge would be able to select the chairs of CSX’s compensation and governance committees and an amendment to the firm’s bylaws that would permit directors to serve longer terms, past age 75.

In response to Mantle Ridge’s demands, the CSX board outlined two key concerns. First, agreeing to Mantle Ridge’s offer would effectively cede control to a shareholder who owned less than 5 per cent of CSX stock and who would be receiving benefits amounting to more than $100 million. Second, the CSX board took issue with the value of Harrison’s compensation package. In order to find a way forward, the CSX board decided to hold a special meeting of shareholders, asking them to vote on two issues: the employment arrangements proposed by Harrison and Mantle Ridge (including the requested reimbursement) and, if Harrison were hired as CEO, the governance arrangements proposed by Harrison and Mantle Ridge.[[7]](#footnote-7)

The CSX board, in a message to shareholders, added that it did not intend to recommend for or against the proposal. The special shareholders’ meeting would be held on March 16, 2017, and the scheduling of the annual meeting would be deferred until after the special shareholders’ meeting.[[8]](#footnote-8)

CSX, CP, and Peer Company Performance

CSX, founded in 1827 and headquartered in Jacksonville, Florida, was a Class 1 railroad (a railroad with at least $250 million in sales) with 21,000 route miles (33,600 kilometres) of track in 23 states, the District of Columbia, and Canada. It served markets in the eastern United States and had access to 70 port terminals on oceans, rivers, and lakes in the eastern and southeastern United States. In December 2016, it employed 27,000 people—22,000 of whom were unionized employees.[[9]](#footnote-9)

Other major North American railway companies included CP, Union Pacific, CN, and Norfolk Southern. Headquartered in Calgary, Alberta, CP had a North America–wide railroad, with 15,000 miles (24,000 kilometres) of track in 13 states and six provinces.[[10]](#footnote-10) Based in Omaha, Nebraska, Union Pacific was the continent’s largest railroad, with 32,000 miles (51,200 kilometres) of track in 23 states.[[11]](#footnote-11) CN had 20,421 miles (32,673 kilometres) of track and was headquartered in Montreal.[[12]](#footnote-12) Norfolk Southern, based in Norfolk, Virginia, had 20,000 miles (32,000 kilometres) of track and was focused on operating in the eastern United States.[[13]](#footnote-13)

Gray compiled operating ratios for each of CSX, CP, Union Pacific, CN, and Norfolk Southern from 2012 to 2016 (see Exhibit 1). She collected financial ratios for CSX and CP for the same time period (see Exhibit 2). Liquidity ratios revealed how well each firm was positioned to repay its short-term obligations. Efficiency ratios measured how long a company took to convert sales to cash—its cash conversion cycle. These ratios examined how long it took the firms to collect on cash (accounts receivable) and pay their payables (accounts payable), and how many days of inventory they kept on hand. Capacity ratios looked at the firms’ capital structure, or how they were financing operations, focusing on the extent to which firms had capacity to issue more debt. Some of the ratios revealed the firms’ margins of safety or how well positioned they were to cover interest payments owed. Finally, profitability ratios measured the firms’ financial performance, looking at their return on equity, return on assets, and operating income as a percentage of revenues.

Gray collected comparative valuation data to indicate how each railroad was valued in the market on the basis of its net earnings and earnings before interest, taxes, depreciation, and amortization (EBITDA) (see Exhibit 3). She noted that different price-to-earnings (P/E) ratios could be affected by the different accounting conventions firms relied on and also by whether they had capital structure (debt-to-equity) differences. For example, if investors were concerned about a company’s high debt load relative to that of its peers, they could deem the company a riskier investment and value it at a lower P/E ratio. The enterprise value (EV) to EBITDA multiple (EV/EBITDA) was a more cash-flow-oriented approach than the P/E approach, and it minimized the impact of capital structure differences.

Gray also examined stock prices for CSX and CP against the S&P/TSX 60 index (a proxy for the Canadian stock market) and the S&P 500 index (a proxy for the U.S. stock market) for the past five years (see Exhibit 4). She also collected CSX’s financial statements—including income statements, balance sheets, and cash flow statements—for the past five years (see Exhibits 5–7).

Shareholder Reaction

On January 19, 2017, the day after Hilal informed CSX of Mantle Ridge’s investment in CSX, the stock price jumped from $36.88 to $45.51, a gain of 23.4 per cent. In contrast, the S&P 500 fell by 0.4 per cent the same day. From January 19 to February 14, 2017, CSX’s stock price rose another 5.5 per cent to $48.00, and the S&P 500 rose 3.4 per cent.[[14]](#footnote-14) Given the large run-up in CSX stock, Gray wondered if institutional shareholders such as NYT should continue to hold CSX stock and support the Mantle Ridge proposal or if they should sell it. She wondered whether Harrison—or any CEO for that matter—was worth a $300 million compensation package.

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Exhibit 1: Operating Ratios for CP, Union Pacific, CN, CSX, and Norfolk Southern, 2012–2016 (in U.S. dollars)



Source: Compiled by case authors based on various annual reports, 2012–2016, accessed November 8, 2017, https://www.csx.com/index.cfm/investors/annual-materials/; http://investor.cpr.ca/financials/default.aspx; https://www.up.com

/investor/annual/; www.cn.ca/en/Investors; http://www.nscorp.com/content/nscorp/en/investor-relations/financial-reports/annual-reports.html.

Exhibit 2: Financial Ratios FOR CSX and CP





EBIT = earnings before interest and taxes; EBITDA = earnings and earnings before interest, taxes, depreciation, and amortization

Source: Created by case authors. Compiled by case authors based on various annual reports, 2012–2016, accessed November 8, 2017. www.csx.com/index.cfm/investors/annual-materials/; http://investor.cpr.ca/financials/default.aspx.

Exhibit 3: Comparables Analysis



Source: “CSX Corporation,” 20, Morningstar Equity Research, February 19, 2017, accessed October 1, 2017.

Exhibit 4: Stock Prices



Source: Created by case authors using data from Yahoo! Finance, accessed December 4, 2017, https://ca.finance.yahoo.com/.

Exhibit 5: CSX Income Statements (In Millions of U.S. dollars)



Source: Created by case authors using data from Mergent.

Exhibit 6: CSX Balance Sheets (In Millions of U.S. dollars)



Source: Created by case authors using data from Mergent.

Exhibit 7: CSX Cash Flow Statements (In Millions of U.S. dollars)



Source: Created by case authors using data from Mergent.

1. This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of CSX Corporation, Mantle Ridge, or any of their employees. [↑](#footnote-ref-1)
2. All figures are in US$ unless otherwise specified. [↑](#footnote-ref-2)
3. “Precision Railroading Philosophy Can Build a Leading Transcontinental Railway, CP Argues in White Paper,” CP, April 7, 2016, accessed December 4, 2017, www.cpr.ca/en/investors/precision-railroading-philosophy-can-build-a-leading-transcontinental-railway. [↑](#footnote-ref-3)
4. Eric Atkins, “Hunter Harrison Steps Down at CP to Join Push for Change at U.S. Railway,” *Globe and Mail*, January 18, 2017, accessed December 4, 2017, www.theglobeandmail.com/report-on-business/harrison-to-leave-cp-at-end-of-january-earlier-than-planned/article33659527/. [↑](#footnote-ref-4)
5. “About Us,” Mantle Ridge, accessed December 4, 2017, https://www.mantleridge.com/about/. [↑](#footnote-ref-5)
6. “Timeline of CP Rail’s Proxy Battle,” *Toronto Star*, May 17, 2012, accessed December 4, 2017, https://www.thestar.com/business/2012/05/17/timeline\_of\_cp\_rails\_proxy\_battle.html; accessed July 23rd, 2017. [↑](#footnote-ref-6)
7. “CSX Calls Special Meeting in Light of Extraordinary Mantle Ridge and Hunter Harrison Requests,” CSX: About Us, February 14, 2017, accessed December 4, 2017, https://www.csx.com/index.cfm/about-us/media/press-releases/csx-calls-special-meeting-in-light-of-extraordinary-mantle-ridge-and-hunter-harrison-requests/. [↑](#footnote-ref-7)
8. Ibid. [↑](#footnote-ref-8)
9. “140,000-mile Private Rail Network Delivers for America’s Economy: CSX Transportation,” Freight Rail Works (Association of American Railroads), accessed December 18, 2017, http://archive.freightrailworks.org/network/csx-transportation/. [↑](#footnote-ref-9)
10. “140,000-mile Private Rail Network Delivers for America’s Economy: Canadian Pacific,” Freight Rail Works (Association of American Railroads), accessed December 4, 2017, http://archive.freightrailworks.org/network/canadian-pacific/. [↑](#footnote-ref-10)
11. “140,000-mile Private Rail Network Delivers for America’s Economy: Union Pacific,” Freight Rail Works (Association of American Railroads), accessed December 4, 2017, http://archive.freightrailworks.org/network/union-pacific/. [↑](#footnote-ref-11)
12. “140,000-mile Private Rail Network Delivers for America’s Economy: Canadian National,” Freight Rail Works (Association of American Railroads), accessed December 4, 2017, http://archive.freightrailworks.org/network/canadian-national/. [↑](#footnote-ref-12)
13. “140,000-mile Private Rail Network Delivers for America’s Economy: Norfolk Southern,” Freight Rail Works (Association of American Railroads), accessed December 4, 2017, http://archive.freightrailworks.org/network/norfolk-southern/. [↑](#footnote-ref-13)
14. Yahoo Finance, accessed December 4, 2017, https://ca.finance.yahoo.com. [↑](#footnote-ref-14)