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Case Co. Investment In French Hydraulic Excavators: A Signal for the Future?

CORPORATE AFFAIRS

J.I. Case Company, a manufacturer and distributer of farm and construction equipment, has signed a Letter of Intent to Purchase 40 per cent of Poclain S.A., a French-based manufacturer of hydraulic excavators.

Pending approval of the Boards of Directors of the two companies and the French government, Tenneco, the parent company of J.I. Case will acquire stocks and assets of the French company, totalling $65 million.

Poclain is the largest producer of hydraulic excavators in the world and is described as "one of the jewels of the French engineering industry" by the *Financial Times*. The company, however, was on the brink of financial disaster due to the collapse of the internal and export market for heavy farm and construction equipment.

The French family-dominated company has a strong tradition of capital outlay for technological development and had invested heavily in expansion of its own plant and equipment just prior to the 1974 downturn.

Without increased sales expected from the export market, the debt equity ratio of the company increased rapidly over the past years. In addition, French authorities refused to allow Poclain to cut its workforce, resulting in a serious cash flow crisis.

Tenneco is a large Texas-based conglomerate recently in the news because of a dispute with the U.S. Congress over Tenneco's attempt to build a pipeline in the Soviet Union which would facilitate U.S. imports of Siberian natural gas. The company obviously not afraid of starting a little controversy while pushing for increased trade, has created quite a stir by receiving the French firm.

Two articles covering a full-page in the Jan. 26 *Financial Times* tried to play off the deal as an insult to French national pride. However, a financial analyst with Merrill Lynch revealed that Tenneco invested in the company because it foresees an export market to the underdeveloped sector on the basis of recycled petrodollars.

A Real Prognosis For The Rail Industry

RAIL

In descriptive accounts of the performance of the railroad industry during 1976, the American Association of Railroads, the Department of Transportation and various private financial analysts agreed on such phrases as "landmark year," "an excellent recovery year," and even "the beginning of a new era for railroads." If the financial performance of this vital industry during 1976 is viewed narrowly in relation to its recent financial history and apart from its deteriorating physical condition, one can understand how honest men might derive such a distorted picture. The true prognosis for U.S. railroads, as the situation now stands, however, is contrary.

The key revenue producing operation for U.S. railroads is freight traffic. Total freight traffic carried during 1976 was 5 per cent higher than 1975 but still 8 per cent lower than the 1973 and 1974 figures. A closer look at 1976 figures, however, reveal that shipment of capital goods, coal and grain were down in 1976 from the depressed 1975 figures. Automobile shipment up 20 per cent accounted for most of the 1976 increase. This is not a healthy freight market.

Freight revenues however rose to a record in 1976 of $17.6 billion over $15.4 billion in 1975 and $15.7 billion in 1974, thus bringing income substantially above the 1975 deficit and to about half of the 1974 figure. This recovery in income was generated at the expense of an unprecedented 9 per cent reduction in the labor force and 8 per cent increase in freight rates over the two years.

The inability of railroads to remain financially solvent in a weak U.S. economy is not surprising, but that is not the extent of the problem. The post-war history of this industry shows the short circuiting of its potential and physical deterioration.

Today capital spending per ton mile has completed a steady decline to levels half what they were in 1950. In 1976 the locomotive fleet decreased in number for the first time in six years as did the number of freight cars.

Expenditures for maintenance of the Right of Way were up 17 per cent in 1976 over 1975. However, the legacy of 30 years of deferred payments to maintenance levels leaves the industry with well over 100 million crossties and 5 million tons of rail needed to be replaced.

The current amount of this deferred maintenance are estimated to be between $10 and $15 billion. Consequently the number of train accidents has doubled since 1957 and the per cent of those attributed to maintenance of way

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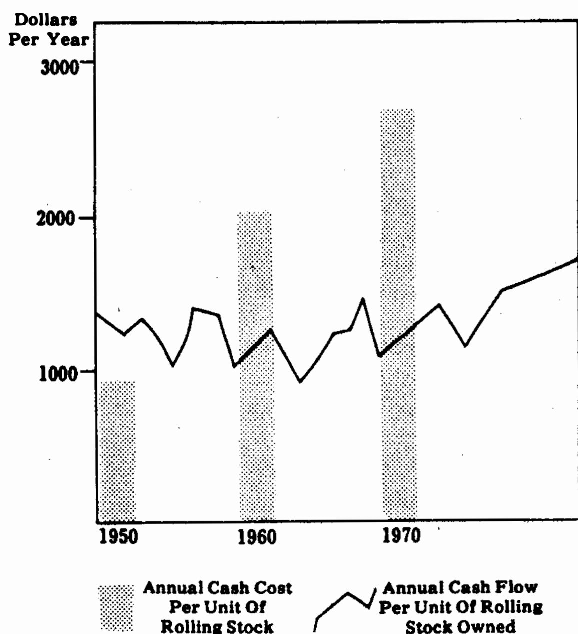
deficiencies has risen from 11 to 37 per cent. In light of these figures, the recent government subsidies increased in maintenance expenditures is not a sound program for the revitalization of rail shipping capacity but necessary base line spending to keep the railroads running. Exemplary of this point is the program for the refurbishing of Northeast rail under the Conrail plan. The reorganization of six bankrupt Northeast railroads with heavy Federal Support is hailed as the answer to the decrepit physical condition of Eastern rail shipping. However, a recent Citibank study showed that combining all government support — totalling $2 to $3 billion plus Conrail's projected income generating power still leaves Conrail $2 billion short of the necessary expenditures for maintenance to bring the right of way up to "normal" conditions over the next five years.

Decades Backlog

The story behind the destruction of this nation's transport system is centered in the 1920s and 1930s and involves the sacrifice of the overall development of a national railroad-truck network in favor of a competitive relationship between the various modes and transport companies. This is documented by the regulation ruling made then by the Interstate Commerce Commission (ICC).

The best evidence of the distorted development of the industry otherwise can be seen in the following type of facts:

1. Trucking handles a major portion of long-haul shipping and is three times as costly in energy as rail;
2. Electrification of rail, making freight transport 30-40 per cent cheaper has not been carried out;
3. Because of the myriad of different companies and assorted bureaucracy and paper work, the average freight car spends two-thirds of its useable life sitting in freight yards.



Perhaps the most amazing thing about the U.S. rail industry is that a number of rail companies have continued to exist as financial entities at all.

At no time in the post-war period has the rate of return for railroads in the U.S. been above 5 per cent. It has been gradually decreasing since 1953 and has been below the rate of return on U.S. government bonds since 1957.

Rate of Return
(millions of dollars)

Year	U.S.	East
1952	4.16	3.80
1957	3.36	3.29
1962	2.74	1.80
1967	2.46	1.58
1970	1.73	.93
1973	3.04	.48
1976 (estimated)	2.44	

Even these low rates are doctored to underestimate the picture. They are doctored in two ways. The ICC has been very generous in allowing railroads to not devalue existing capital and the railroads have padded their accounts with large non-rail income. Needless to say, the private capital markets are all but closed to the industry. NYSE estimates that capital resources available to the industry will fall 14 per cent short of necessary expenditures this year.

The largest chunk of necessary expenditures is Contactual Fixed Charges which includes interest and rents. Since 1962 increases in funded debt, rising interest rates and equipmental leasing arrangements with the banks have increased fixed cost 70 per cent while total income increased only 14 per cent.

Year	Total income	Fixed charge	Ratio
1952	1316	422	3.12
1962	980	367	2.67
1967	1050	462	2.28
1970	846	589	1.44
1973	1209	626	1.93

(Includes non-rail)

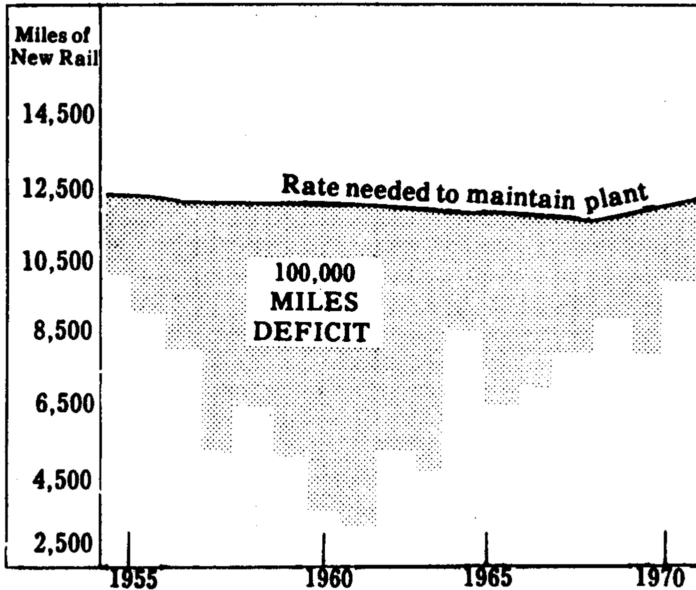
A better measure of the railroad's ability to cover fixed costs is cash flow. Cash flow eliminates non-cash bookkeeping entries like depreciation, doubling and tripling income figures to easily cover fixed costs but not sufficient to cover new capital investment. The graph dramatizes the financial plight of the railroads, showing that since the mid-1950s the annual cash cost per unit of rolling stock is far above the annual cash flowper unit owned.

In the face of declining earnings and cash flow, the railroads are increasing dividend payments from 50 to 60 per cent of ordinary income in the mid-1960s to 80 to 90 per cent in the 1970s.

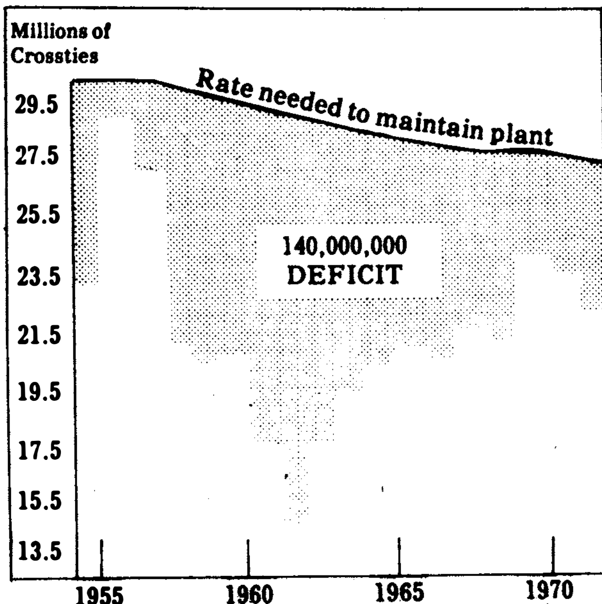
Role of Holding Companies

Over recent years there has developed an accelerating trend for railroad companies to diversify. Owning large

amounts of land and national resources, the railroads are increasingly anxious to invest in mining and other enterprises especially when long-term contracts can be obtained. Whether the holding companies created to facilitate the flow of funds between railroad companies and associated investments, are in fact, milking the railroads is the question at hand.



Sante Fe Corp. which operates the Sante Fe Railroad gets over 50 per cent of its income from oil; Union Pacific generates more income from oil and real estate than from rail operations; Illinois Central has been operating at a deficit supported by its other investments.



After three decades of decay and the favored development of long-haul trucking, railroads as an industry can no longer generate the income necessary to raise money in the credit markets for necessary payments to deferred maintenance. The formation of a holding company serves a number of purposes. The flow of funds between a railroad and a holding company is unregulated by the ICC. Railroads will often send money or large portions of their assets upstream to their holding companies because the holding companies are more likely to be able to sell bonds.

In 1974, Illinois and Central Gulf passed up $16 million to its holding company IC Industries. In 1971 Union Pacific transferred a major portion of its assets to its holding company.

The relationship is made clearer in the following chart:

Sante Fe Company	Income	Pre-tax Earning
Rail	1420	51.0
Truck	35	-1.6
Pipeline	23	-1.0
Petroleum	137	82.0
Forest	49	5.1
Real Estate	137	6.4

(in millions of dollars)

The main advantage to rail despite its low rate of return is high cash flow generated for use by the holding company; while the low rate of return of rail operations per se enables the holding companies to force rate increases and become eligible for government aid.

Financial analysts agree that even if forthcoming declines in freight revenues force major railroads into a deficit, their holding companies will support them and only those rail companies that haven't diversified will be in trouble.

In a report issued in August, 1976 Goldman Sachs investment house recommended staying away from rail stocks unless there is movement toward holding companies exploitation of natural resources or mergers that cheapen operating costs.

Others like Pennsylvania Governor Milton Shapp continue to call for some form of government support for the rebuilding of the railroads. Shapp proposed the creation of a government-backed $15 billion trust fund as the minimum necessary outlay to get rail into shape. But a crucial institutional problem of the railways must be solved to effect the most efficient transport network technically possible. The Department of Transportation or similarly constituted agency would have to be given power to supersede the management decisions of individual transport companies for the development of the network as a whole. Those companies not able to remain in business under the government directed-use of operating revenues and government grants and loans will have to be forced to merge or nationalize. The R and D Department of the Department of Transportation estimated that a nationally organized interfaced transport system, if upgraded to minimum safety operating standards, could with present levels of equipment handle five times the freight carrying traffic that is now handled by the trucks and rails together.