The New Merger Strategy Won't Help Canadian Pacific Railway Limited

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) is in the news again because it is not giving up on its attempt to merge with **Norfolk Southern Corp.** (NYSE:NSC), one of the main railroads in the United States. Its first offer was for Norfolk Southern investors to receive $46.72 in cash and an additional 0.348 shares of the new railroad. When that was rejected, Canadian Pacific went back to the drawing board.

Its second offer is one that will have Norfolk investors rewarded sooner, but with less cash. The new offer is for $32.86 in cash plus 0.451 shares of stock in the new company. The reason investors might like this is because they would get the cash in May 2016 rather than at the end of 2017. This is through a tactic known as a "voting trust."

In essence, one of the railroads (most likely Canadian Pacific) will be held in this voting trust, which will result in the two companies remaining independent, but Norfolk investors get their money early.

Canadian Pacific hopes that the early money will encourage investors to push the executive team to make a deal. If the deal were to happen, Canadian Pacific would gain access to 20,000 miles of Norfolk Southern track across 22 states. It would have access to the entire eastern United States. But most importantly, it would connect with Norfolk track in Chicago and Kansas City, allowing the railroad to continue operating rather than switching trains.

Right now, Canadian Pacific has to pull into Chicago, unload all of the goods that it is carrying, and then have them loaded on to a competitor railroad to go the rest of the way. If this merger occurs, there will be no delay in Chicago.

Regulators won't let it happen

While the voting trust is an interesting way to expedite the deal process, it's incredibly unlikely that the Surface Transportation Board (STB) of the United States is going to allow the merger to take place. What the STB looks for with mergers is whether or not the merger will help the "public interest." The STB said in a ruling that if two Class I railroads were to merge, it would require a demonstration that competition would be preserved.

How does taking two of the largest railroads in North America and combining them together result in more competition? It doesn't. And the STB is serious about preventing these sorts of anti-competitive mergers. On December 20, 1999, BNSF Railway (which Warren Buffett now owns) and **Canadian National Railway Company** announced that the two railroads would be forming North American Railways, a company with 50,000 miles of track.

The STB intervened and put a 15-month moratorium on the merger. The two companies sued, but after a while, they gave up and called off the merger. I anticipate that the same thing will occur with Norfolk Southern and Canadian Pacific if the latter can convince the former that a merger is a good idea.

My recommendation is to wait. First Canadian Pacific will need to convince Norfolk Southern that this is a good deal. Once that is done, the STB will get involved and look to prevent the merger if competition is not preserved. If the momentum changes and it appears that the merger could happen, owning shares of that large railroad may be a smart move. But right now, there remains too much uncertainty for me to act.

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