Criteria | Corporates | Industrials:
Key Credit Factors For The Railroad And Package Express Industry

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Key Credit Factors For The Railroad And Package Express Industry

(Editor's Note: This article supersedes "Key Credit Factors For The Railroad And Package Express Industry," published Nov. 19, 2013.)

1. Standard & Poor's Ratings Services is refining and adapting its methodology and assumptions for rating the railroad and package express industry, including freight railroads, package express, and logistics companies. This article should help market participants better understand our approach to reviewing key credit factors in the industry. These criteria are related to our corporate criteria (see "Corporate Methodology," published Nov. 19, 2013) and "Principles Of Credit Ratings," published Feb. 16, 2011.

2. This criteria update and supersede "Key Credit Factors For The Railroad And Package Express Industry," published Nov. 19, 2013, to remove the possibility of using the low-volatility table for a package express company that operates principally as a postal service. This update reflects structural changes in the postal service industry and the challenges associated with the longstanding decline in mail volumes that we believe will not support the use of the low-volatility table in the future. The option of using the low-volatility table for those companies was previously possible under paragraph 67 of the superseded criteria, although it had not been used. Apart from this change, the rest of the criteria remain the same as that in the version published on Nov. 19, 2013.

SCOPE OF THE CRITERIA

3. Standard & Poor's is refining its criteria for the railroad and package express industry. These criteria cover freight railroads (those that derive a majority of their revenues from freight transportation), package express companies, and logistics companies. In the context of these criteria, we are defining logistics companies as those that provide services that support the movement of goods through the supply chain. Examples of the services provided by logistics companies include warehousing, transportation brokerage (acting as an intermediary in arranging transportation on behalf of customers), returns processing, inventory management, and materials handling. Most logistics companies focus on only a handful of these services, although some are more diversified in terms of their service offerings. These criteria do not cover passenger railroads or state-owned freight railroads, which we analyze using transportation infrastructure criteria. Nor do these criteria cover heavy airfreight companies, trucking companies, and shipping companies or other transportation companies that are more subject to cyclical demand. Those companies are covered in the criteria for cyclical transportation companies.

SUMMARY OF THE CRITERIA

4. This update discusses the key credit factors we use when analyzing companies in the railroad and package express industry, after applying our corporate criteria. We view the railroad and package express industry as "low risk" under
our criteria, given its "medium" cyclical risk and "low" degree of competitive risk/growth.

5. In assessing the competitive position of these companies, we put particular emphasis on: market position, product and customer diversity, geographic footprint, and operating efficiency.

6. For the capital intensive companies covered by these criteria (railroads and package express), ability to finance equipment and the use of operating leases (which we capitalize under our corporate criteria) are key considerations in our assessment of financial risk. While most logistics companies are "asset-light" relative to railroads and package express companies, they often use operating leases to finance certain facilities. In addition, logistics companies often incorporate acquisitions as part of their growth strategy, and management's ability to integrate and finance these acquisitions is a key consideration in our assessment of both business and financial risk. Shareholder rewards (such as stock buybacks) are another key consideration in our assessment of financial risk.

IMPACT ON OUTSTANDING RATINGS

7. We do not expect these criteria, in and of themselves, to result in any rating changes.

EFFECTIVE DATE AND TRANSITION

8. These criteria are effective immediately on the publication date.

METHODOLOGY

Part I–Business Risk Analysis

A. Industry Risk

9. Within the framework of Standard & Poor's corporate criteria for assessing industry risk, we view railroads and package express companies as "low" risk (category 2). Our assessment reflects our view of the segment's "intermediate" (3) cyclicality and a "low risk" (2) competitive risk and growth score, based on observed cyclicality in revenue and profit. The industry has averaged peak-to-trough (PTT) declines in revenue and profitability of 7% and 11%, respectively, since 1989 (based on global Compustat data).

10. Fluctuations in economic growth, as measured by gross domestic product, industrial production, fuel prices, housing starts, and consumer confidence are among the key reasons for industry cyclicality. Railroads and package express companies have a high proportion of fixed costs, which means that percentage declines in EBITDA are typically steeper than revenue declines in an economic downturn. Logistics companies, which we include in this industry, typically have more variable cost structures.

11. Railroads and package express companies compete on price, but high barriers to entry, regulatory hurdles, industry
concentration, diversity of services, and geographic reach mitigate this risk. Price competition can be more pronounced in the logistics industry, which is more fragmented.

1. Cyclicality

12. We assess the railroad and package express industry as having "intermediate" (3) cyclicality. The industry has demonstrated moderate cyclicality—relative to other industries—in both revenue and profitability, which are two key measures we use to derive an industry's cyclicality score (see "Methodology: Industry Risk," published Nov. 19, 2013). Based on our analysis of global Compustat data, railroads/package express companies experienced an average PTT decline in revenues of about 7% during recessions since 1989. The steepest decline was 13.5% during the 2008-2009 economic downturn. For the railroads, we believe revenue cyclicality may be slightly higher in the future because of their increased focus on providing intermodal services—carrying cargo containers and trailers, often containing consumer products, that shipping or trucking companies (the other "modes" of transportation) deliver to or from the railroad. In addition, rapidly growing shipments of crude oil offer opportunities but also potential volatility amid commodity price or regulation changes.

13. Since 1989 railroads and package express companies have experienced an average PTT decline in EBITDA margin of about 11% during recessions. The steepest decline was 14.8% during the 2008-2009 downturn. Despite somewhat increased revenue cyclicality, we believe that railroad profitability will be less cyclical in the future due to aggressive cost controls and efficient asset utilization, which North American freight railroads demonstrated during the 2008-2009 downturn.

2. Competitive risk and growth

14. We view railroads and package express companies as having a "low" (2) competitive risk and growth score based on our scoring of these four subfactors:

- Effectiveness of industry barriers to entry;
- Level and trend of industry profit margins;
- Risk of secular change and substitution by products, services, and technologies; and
- Risk in growth trends.

15. Within this industry, railroads have a somewhat lower risk than package express and logistics companies, and package express companies have a somewhat lower risk than logistics companies do.

   a) Effectiveness of barriers to entry: "Low risk"

16. Railroads and package express companies require significant capital investment to build and maintain their networks and information systems, and this serves as an effective barrier to entry. These companies are also partially regulated by governments, which may also serve as a barrier to entry for some companies wishing to enter the market. Logistics companies are higher risk than the other companies in this industry group because the logistics industry is very fragmented and barriers to entry are comparatively low. Many participants in the logistics industry have a low market share, and much of the industry is comprised of small, local operators. This differs with the railroad and package express industry, which is dominated by several large players in each segment. Still, the contractual nature of the business and switching costs do provide some barriers to entry.

17. Railroads own proprietary rights-of-way in the form of complex track networks. Building new, competing rail lines
would be very costly, and in some places impossible due to regulatory constraints and land scarcity. Among the Class 1 railroads (as the Association of American Railroads defines them based on freight revenues), we believe the competitive risks are "low," given:

- Limited potential for substitution from other railroads and, to a lesser extent, from alternate freight modes (such as trucking and barging);
- The contractual nature of the business; and
- Meaningful fixed costs and ongoing capital investment needs.

18. Access to capital is relatively easy for railroads and package express companies because lenders and leasing companies consider most transportation equipment good collateral, given that they can repossess and sell it or lease it to a new user. In the U.S. and Canada, rail equipment financing enjoys special status in the countries' insolvency regimes, reducing risk to creditors. This means access to capital is less of a barrier to entry than it is for some other capital-intensive industries. It is also not much of a barrier to entry for logistics companies, as these companies do not face significant capital expenditure requirements and usually generate free operating cash flow on a consistent basis. However, access to capital may be a barrier for a logistics company pursuing a "growth through acquisition" strategy.

19. For package express companies and, to some extent for railroads, an extensive network can create barriers to entry by making it difficult for newcomers to match the breadth of service offerings and economies of scale.

b) Level and trend of industry profit margins: "Low risk"

20. Railroads and package express companies generally mitigate the effect of volatile fuel prices by using various price recovery mechanisms, such as surcharges or built-in price escalators in contracts. But timing differences can affect margins in any given quarter. Although these companies do not suffer economic consequences from a rise in fuel prices, they will likely report some margin compression as a result of the pass-through of increased fuel prices (i.e. operating income will be unchanged, but the revenue denominator will be higher, leading to a slightly lower margin). Logistics companies, by their nature, generally have low exposure to fuel price fluctuations because the transport of goods is not their main business.

21. Companies in this industry are subject to some cyclicality, but not to the same degree as airlines, trucking, and shipping companies. Changing trade patterns can lower demand and capacity utilization, but companies can typically address these pressures by parking equipment and reconfiguring networks—although as they pursue these activities they may face some profit erosion. Many of the larger package express companies offer a range of products and may see a "trading down" to cheaper services by their customers during a downturn. This may translate into lower consolidated margins, depending on the pricing of the various services. Logistics companies typically have fairly flexible cost structures and can adjust costs in line with fluctuations in demand, though profits may decline in the short term until the cost cuts are fully implemented.

22. Railroad revenues are primarily generated on a contractual basis. Accordingly, price increases are often built-in to contracts or negotiated each year. Although market conditions affect pricing, we believe railroads benefit from relative pricing stability due to limited competition and the diversity of commodities carried. Fuel surcharge mechanisms are included in most railroad contracts. If fuel prices rise quickly, there can sometimes be a lag in recovering fuel costs.
23. On the cost side, railroads have been very effective at improving operating efficiency and managing expenses. We believe there is low risk of a significant decline in margins. Most railroads have demonstrated strong operating efficiency and we expect this to continue.

24. Since the 2008-2009 downturn, railroads and package express companies have generally managed to improve their profit margins through effective cost controls, productivity gains, pricing discipline, and stronger operating efficiency. Although these improvements should be sustainable, profits will continue to vary with the demand cycle. Industry profit margins tend to be the strongest for railroads, followed by package express and logistics companies, with the latter generally the weakest of the three.

25. Railroads and package express companies experience relatively low cyclicality, since demand for their services tends to be more stable and higher-margin given relatively limited competition and high barriers to entry. Demand for logistics companies should remain subject to a medium level of cyclicality as declines or corrections in inventory levels and warehousing activity, or new product launches typically have an effect on asset utilization and pricing, which can significantly affect costs and profit margins. The overall trend of profit margins in the railroad and package express industry is modestly positive, with varying levels of volatility based on the maturity of demand and competitive dynamics.

c) Risk of secular change and substitution by service offerings: "Medium risk"

26. Railroads face potential substitution from trucking companies and barge lines, although the degree of competition from these modes varies, depending on the type of cargo and the distance it is being transported. Geographic factors also affect the viability of alternate transportation modes (e.g. barge competition is limited to where there are rivers). Package express companies are vulnerable to potential substitution from shipping lines on intercontinental routes, especially during periods of high fuel prices and low interest rates. Those conditions make it cheaper for corporate customers to finance the somewhat higher inventory levels required when using ships, which are much slower than air express. Customers may also turn to railroads and trucking companies as potential substitutes for package express companies, although the competitiveness of these alternative modes of transport depends upon the type of cargo, and the route and time requirements of customers. In general, for both railroads and package express companies, the risk of substitution is governed by the tradeoff between speed, reliability, and cost.

27. We view the risk of secular change as medium for railroads. The movement of particular commodities can shift based on fundamental changes in consumption, the price of the underlying commodity, and regulatory changes (e.g. environmental regulations, which are reducing demand for coal by utilities). The substitution risk for railroads differs by factors such as type of cargo being transported, destination, the viability of competitors, and service quality. Still, relative to the other subsectors, railroads have a lower risk of substitution due to the contractual nature of their revenue base, high barriers to entry, and limited alternatives on many routes.

28. For package express companies we also view the risk of secular change as medium. The level of risk depends on such factors as the nature of the product, time sensitivity, reliability and frequency of alternatives, and range of products utilized. The risk of substitution is typically governed by the tradeoff between speed and reliability and cost. Express services (i.e. time certain, next day) are the quickest and most reliable but also the most expensive. Express companies also typically offer economy services, which promise less specific delivery times but are cheaper than express services.
Depending on the product being transported, other competitors can include worldwide postal services, various motor carriers, freight forwarders, and air couriers.

29. Logistics companies may lose business to diversified conglomerates that offer logistics services as part of their suite of services. The biggest risk of substitution for logistics companies lies in the potential for customers to bring their logistics requirements back in house (although the general trend has been toward more outsourcing to logistics companies).

30. Changing supply chains and trade patterns can hurt all companies in the railroad and package express industry in the short term, but the larger companies can typically adjust their networks to accommodate such changes over time.

31. Consolidation among customers can also adversely affect companies. This is particularly true for logistics companies, whose customer base is typically more concentrated than those of railroads or package express companies.

   **d) Risk in growth trends: "Low risk"**

32. Growth prospects and susceptibility to the economy vary by type of cargo and traffic. In general, most of the markets railroads and package express companies serve are mature, but have fairly good long-term prospects (at least as good as GDP growth) and a low risk of overall declines. For package express companies and some logistics companies, sales generated through e-commerce, expansion of global trade, emerging-market growth, and increased outsourcing represent additional sources of growth.

33. For railroads, we characterize the risk of growth trends as "low risk." Railroads operate in relatively mature markets with modest but fairly stable and predictable growth rates. One major railroad commodity, coal, is under pressure because of competition from low-priced natural gas and because of environmental concerns, but railroads have good growth prospects in other areas, such as intermodal container shipping. Railroads' relative fuel efficiency supports some shifting of traffic from trucks to intermodal movement on rail.

34. Logistics companies have stronger growth prospects. The outsourcing of logistics has been growing and still only represents a fraction of the overall logistics market. As supply chains become more complex and continue to evolve, the trend toward outsourced logistics is likely to continue to grow at twice the rate of the railroad and package express businesses.

**B. Country Risk**

35. Our primary measure to determine exposure to country risk is revenues. This is because we believe revenues provide a more consistent measure of participation in a market than earnings or cash flow, which will vary depending on number of factors. The distribution of assets is not a useful indicator because transportation assets may not remain consistently within one country or region. Also, data on the distribution of assets are less consistently available than are revenue data.

36. Country-related risk factors can have a substantial effect on company creditworthiness, both directly and indirectly. Although our sovereign credit ratings suggest the general risk local entities face, the sovereign ratings may not fully capture the risk applicable to the private sector. We look beyond the sovereign rating to evaluate the specific
economic, demographic, and other country risks that may affect the entity's creditworthiness.

37. In assessing country risk for a railroad, package express, or logistics company, our analysis uses the same methodology as with other corporate issuers (see "Corporate Methodology," published Nov. 19, 2013).

C. Competitive Position (Including Profitability)

38. Our assessment of the competitive positions of companies in this industry varies by subsegment. Our universe of rated package express companies is small, and we believe that these companies have "satisfactory" or better competitive positions based on strong market positions, significant barriers to entry, and good (customer, end market, geographic) diversity. The rated railroads also have competitive position assessments that mostly range from "fair" to "strong" based on substantial market share, ownership of proprietary rights-of-way, and strong operating efficiency, while the competitive position assessments of rated logistics companies mostly range from "vulnerable" to "fair" based on the sector's low entry barriers, high level of fragmentation, and competitive dynamics. To determine these designations, we assess various factors, including competitive advantage, scale, scope and diversity, and operating efficiency, as discussed in more detail below. The competitive position group profile (CPGP) assigned to most railroads is "capital or asset focus," as they require sizable capital investments and asset outlays to sustain market position. In rare cases, we could assign a "services and products focus" or "national industry and utilities" CPGP to a railroad, particularly in cases where the railroad has a virtual monopoly.

39. After evaluating separately competitive advantage, scale, scope and diversity, and operating efficiency, we determine the preliminary competitive position assessment by ascribing a specific weight to each component. The applicable weightings will depend on the company's CPGP. The CPGP assigned to the majority of railroad and package express companies that we rate is "capital or asset focus." In arriving at that conclusion, we weight the first three components of competitive position as follows: competitive advantage (30%); scale, scope and diversity (30%); and operating efficiency (40%). The component weighting for companies assigned the "services or products focus" CPGP is as follows: competitive advantage (45%); scale, scope and diversity (30%); and operating efficiency (25%).

1. Competitive advantage

40. In order to evaluate competitive advantage in this industry, we focus on:

- Overall route network for railroads and package express companies (coverage area, position of hubs, and major infrastructure investments);
- Strength of position within markets served (market share in key markets/regions that generate large and growing potential revenues, range of service offerings, length of key customer relationships, barriers to entry in key markets);
- Service standards (speed, timeliness of delivery, low rate of damage or loss, ability to track shipments easily) and reputation;
- Size of revenue base and unit sales, an advantage given the economies of scale for these companies; and
- Effectiveness of the marketing strategy and sales force, particularly for package express companies but increasingly also for logistics companies and railroads.

41. In order to evaluate competitive advantage for railroads, our assessment also considers:

- Direct access to factories, utilities, mines, and ports that generate substantial freight traffic and for which rail
transportation offers a good transportation option; and
• Safety standards and reputation, particularly in the transportation of hazardous materials--such as chemicals.

42. In order to evaluate competitive advantage for package express companies, our assessment also considers:

• New products and complementary offerings, which technological capabilities often trigger and companies can use to deepen customer relationships by meeting specific customer needs. This can lower costs, improve service, and increase efficiency--thus raising barriers to switching to a competitor.

43. In order to evaluate competitive advantage for logistics companies, our assessment also considers:

• Degree of involvement in a major customer's supply chain management, including contractual provisions, that can impose material switching costs on customers;
• Degree to which services provided are more "value-added," rather than commodity; and
• Pricing and contract terms, which can determine profit potential and exposure to downside risks.

44. A railroad, package express, or logistics company with a "strong" or "strong/adequate" competitive advantage assessment is characterized by several or all of the following:

• A leading or very substantial market share in the markets where the company competes;
• Control of scarce infrastructure or long-term contracts that can establish barriers to entry and thereby generate superior pricing or stable revenues;
• Strong technological capabilities that allow a company to build and maintain complex transportation networks and information systems;
• Varied service offerings that, from a consumer perspective, enable differentiation from peers;
• Better-than-average service (as measured by on-time performance, computerized billing, and tracking services, etc.); and
• Strong name/brand recognition, particularly for package express companies.

45. A railroad, package express, or logistics company with a "weak" or "adequate/weak" assessment of its competitive advantage typically is characterized by several or all of:

• Has a relatively modest market share;
• Lacks infrastructure, long-term contracts, or clearly differentiated service, leaving the company to compete mostly on price;
• Lacks leverage with key product manufacturers, vendors, and suppliers;
• Lacks well-developed information technology resources;
• Typically is a price follower;
• Provides a very limited service offering;
• Lacks customer and geographic diversity;
• May face operational or service challenges; and
• Lacks a differentiated brand.

2. Scale, scope, and diversity

46. In order to evaluate scale, scope, and diversity for railroads, our assessment includes:

• Scale, which we measure by freight revenues, volumes, track miles, diversity of customers and end markets served, and types of services provided; and
• Coverage by the track network, which is a factor for both competitive advantage and scale, scope and diversity.

47. In order to evaluate scale, scope, and diversity for package express companies, our assessment includes:

• The route network and position of hubs (to create an integrated network that can handle various products, has access to major markets, and provides national and global coverage);
• Diversity of regions served, which we measure by revenues and operating profits; and
• Diversity of customers and industries served.

48. In order to evaluate scale, scope, and diversity for logistics companies, our assessment includes:

• Scale, which we measure by revenues, diversity and size of customers and end markets, and number and specialization of services provided; and
• Geographic footprint--location, plus the diversity and characteristics of markets.

49. A "strong" or "strong/adequate" assessment of scale, scope and diversity typically is characterized by a combination of:

• Participation in a variety of markets with favorable supply/demand fundamentals and that are not closely correlated;
• Scale of equipment fleet, IT resources, and service offerings that support above-average revenue generation and profit due to better utilization, economies of scale, or a wide range of services that are attractive to customers;
• Diversification of service offerings; and
• Good customer diversity.

50. A "weak" or "adequate/weak" assessment of scale, scope and diversity typically is characterized by a combination of:

• Small market share that leaves the company vulnerable to larger competitors and may force it to compete mainly on price;
• Participation in only a few markets, especially if those markets have unfavorable growth prospects or are intensely competitive; and
• Concentration in terms of customers, service offerings, and end markets served.

3. Operating efficiency

51. To assess railroads' operating efficiency we may use:

• Operating ratio (operating expenses, including depreciation, as a percent of operating revenues; lower is better);
• Revenue per unit (carload or, for intermodal traffic, per container); and
• Measures related to service quality, such as on-time delivery.

52. To assess package express companies' operating efficiency we may use:

• Revenue per unit of delivery (e.g. package);
• Operating margins, in particular EBIT margins; and
• Measures related to service quality, such as on-time delivery statistics.

53. When assessing these operating statistics, we take into consideration geographic concentrations, as market characteristics can vary greatly among countries and regions.
To assess logistics companies' operating efficiency we may use:

- EBIT margins;
- Working capital management (e.g. days' receivables); and
- Percentage of idle real estate properties, such as warehouses (to the extent such information is available).

We compare these items against what we deem to be the closest peers, although logistics companies vary in the types of services they provide, and this can cause differences beyond what is truly a difference in operating efficiency.

We characterize "strong" or "strong/adequate" operating efficiency by several or all of the following:

- Sustainable material operating cost advantage created by economies of scale, lower labor costs, more fuel efficient equipment, or process efficiencies (see below for the operating statistics we use to measure these characteristics among the segments);
- Sustainable superior revenue generation reflecting efficient management of route networks, equipment, and employees—so long as that business model does not result in noncompetitive operating costs (measured by operating statistics that vary among segments);
- Revenue equipment or IT resources whose age or suitability is superior to those of competitors;
- Relatively stable and positive labor relations and good access to labor and terms of whatever labor contracts may be in place;
- Regulations that do not impose a competitive disadvantage;
- Good working capital management, particularly for logistics companies; and
- Effective management of capacity additions.

"Weak" or "adequate/weak" operating efficiency is characterized by several or all of:

- Operating costs that are higher than those of competitors and which are not offset by sustainable superior revenue generation, resulting in below-average operating profitability;
- Below-average revenue generation due to the way a company manages its assets and employees, and that is not offset by consistently lower costs, resulting in below-average operating profitability;
- Poor working capital management; and
- Poor management of capacity additions.

4. Profitability

The profitability assessment can confirm or modify the preliminary competitive position assessment. The profitability score consists of two components: 1) the level of profitability, and 2) the volatility of profitability. We combine the two components into the final profitability assessment using a matrix (see "Corporate Methodology," published Nov. 19, 2013).

a. Level of profitability

The level of profitability is assessed as 1) above average; 2) average; 3) below average. For railroad and package express companies, we focus on EBIT margins. Because of the pronounced differences in capital intensity between segments (e.g. railroads are much more capital intensive than many logistics companies), we believe that EBITDA margins, which add back depreciation, do not give a representative comparison. We assess the level of profitability as:

- EBIT margin above 24% is "above average,"
- EBIT margin between 6% and 24% is "average," and
• EBIT margin under 6% is "below average."

b. Volatility of profitability

60. The volatility of profitability is calculated on a six-point scale, from "1" (lowest volatility) to "6" (highest volatility).

61. In accordance with our corporate criteria, we generally calculate the volatility of profitability using the standard error of regression (SER), subject to having at least seven years of historical annual data. We generally use EBITDA margin as the metric to calculate the SER for railroads and package express companies, although we may also use nominal EBITDA or return on capital (ROC). Also in accordance with the corporate criteria, we may--subject to certain conditions--adjust the SER score by up two categories worse (more volatile) or better (less volatile). If we do not have sufficient historical information to calculate the SER, we follow the corporate criteria guidelines to determine the volatility of profitability component.

Part II-Financial Risk Analysis

D. Accounting And Analytical Adjustments

62. In assessing the accounting characteristics of a company in the railroads and package express industry, we use the same methodology as with other corporate issuers (see "Corporate Methodology," published Nov. 19, 2013). Our analysis of a company's financial statements begins with a review of the accounting to determine whether the statements accurately measure a company's performance and position relative to its peers and the larger universe of corporate entities. To allow for globally consistent and comparable financial analyses, our rating analysis may include quantitative adjustments to a company's reported results. These adjustments also enable better alignment of a company's reported figures with our view of underlying economic conditions. Moreover, they allow a more accurate portrayal of a company's ongoing business. Adjustments that pertain broadly to all corporate sectors, including this sector, are discussed in "Corporate Methodology: Ratios And Adjustments," published Nov. 19, 2013.

63. Our accounting adjustments for railroads and package express companies parallel the methodologies we apply to companies in other industries. The adjustments particularly significant in our approach are:

• Operating lease adjustments (reflecting the capital-intensive nature of the industry and the economic incentives that sometimes lead companies to finance equipment through operating leases);
• Retiree liabilities (including multi-employer pension plan liabilities for some companies), particularly for package express companies with a sizable unionized workforce; and
• Self-insurance reserves (related to workers' compensation, only a factor for U.S. companies).

E. Cash Flow/Leverage Analysis

64. In assessing the cash flow adequacy of a railroad or package express company, our analysis uses the same methodology as with other corporate issuers (see "Corporate Methodology," published Nov. 19, 2013). Cash flow/leverage analysis is scored on a six-point scale ranging from (1) minimal to (6) highly leveraged. We determine these scores by aggregating the assessments of a range of credit ratios, predominantly cash-flow-based, which
complement each other by focusing attention on the different levels of a company's cash flow in relation to its obligations.

65. The corporate methodology provides benchmark ranges for various cash flow ratios we associate with different cash flow leverage assessments for standard volatility, medial volatility, and low volatility industries. The tables of benchmark ratios differ for a given ratio and cash flow leverage assessment along two dimensions: the starting point for the ratio range and the width of the ratio range.

66. If an industry's volatility levels are low, the threshold levels for the applicable ratios to achieve a given cash flow leverage assessment are less stringent, although the width of the ratio range is narrower. Conversely, if an industry has standard levels of volatility, the threshold levels for the applicable ratios to achieve a given cash flow leverage assessment may be elevated, but with a wider range of values.

67. We apply our "medial-volatility" table to companies with a majority of revenues generated from the movement of freight on a railroad with a corporate industry country risk assessment (CICRA) of '2', business risk profile assessments of "fair" or better, and for which we use a CPGP other than national industries and utilities when we are analyzing their competitive positions. If we use the national industries and utilities CPGP (see table 11 of "Corporate Methodology," published Nov. 19, 2013), we would apply either the standard-volatility or low-volatility table in accordance with the corporate criteria.

68. We apply the "standard-volatility" table in the corporate criteria to freight railroads with a business risk profile assessment of "weak" or worse. We also apply the "standard-volatility" table for package express and logistics companies.

1. Core ratios

69. We calculate two core credit ratios--FFO to debt and debt to EBITDA--in accordance with our criteria "Corporate Criteria: Ratios And Adjustments," published Nov. 19, 2013.

70. Consistent with the corporate criteria relating to ratios and adjustments, we may net a portion of a company's cash balance against its debt. In so doing, we consider our criteria that apply the surplus cash adjustment to all issuers:

   • With a business risk of "fair" or better,
   • That are not owned by financial sponsors, as defined in our criteria, and
   • Whose demonstrated or projected volatility of discretionary cash flow does not exceed the surplus cash that we estimate, under our criteria, to be available for debt repayment.

2. Supplemental ratios

71. In addition to our analysis of a company's core ratios, we also consider supplemental ratios in order to develop a fuller understanding of a company's credit risk profile and fine-tune our cash flow analysis. In our view, a railroad or package express company's inability to meet cash interest payments or a debt maturity would be the most likely cause of a cash default during an industry downturn. Therefore, we consider as supplemental ratios:

   • Coverage ratios (FFO + cash interest)/cash interest and EBITDA/interest; and
   • Free operating cash flow to debt (this captures the capital intensity of railroads in particular).
Part III-Rating Modifiers

F. Diversification/Portfolio Effect

72. Diversification/portfolio effect analysis for a railroad or package express company uses the same methodology as for other corporate issuers (see “Corporate Methodology,” published Nov. 19, 2013).

G. Capital Structure

73. We use the same general methodology as for other corporate issuers (see "Corporate Methodology," published Nov. 19, 2013).

74. For railroads and package express companies, the debt maturity profile is generally the most meaningful subfactor.

H. Liquidity

75. We use the same general methodology as for other corporate issuers (see "Corporate Methodology," published Nov. 19, 2013).

I. Financial Policy

76. In assessing financial policy for a railroad or package express company, our analysis uses the same methodology as for other corporate issuers (see “Corporate Methodology,” published Nov. 19, 2013).

J. Management And Governance

77. In assessing management and governance for a railroad or package express company, our analysis uses the same methodology as for other corporate issuers (see "Corporate Methodology," published Nov. 19, 2013).

K. Comparable Ratings Analysis

78. In the comparable ratings analysis of a railroad or package express company, we use the same methodology as for other corporate issuers (see “Corporate Methodology,” published Nov. 19, 2013).

RELATED CRITERIA AND RESEARCH

- Corporate Methodology, Nov. 19, 2013
- Corporate Criteria: Ratios And Adjustments, Nov. 19, 2013
These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.