THE RAILROAD WEEK IN REVIEW
NOVEMBER 6, 2009

“We can promise complete confidentiality and a very fast answer — customarily within five minutes — as to whether we’re interested.” – Berkshire Hathaway annual Report, 2006

As one who’s been a Buffet-watcher for years I can safely say the BNSF purchase fits perfectly. Turn to page 25 of the *2006 Annual Report* for these qualifiers under Acquisition Criteria:

(1) Large purchases (at least $75 million of pre-tax earnings unless the business will fit into one of our existing units),
(2) Demonstrated consistent earning power (future projections are of *no* interest to us, nor are “turnaround” situations),
(3) Businesses earning good returns on equity while employing little or no debt,
(4) Management in place (we can’t supply it),
(5) Simple businesses (if there’s lots of technology, we won’t understand it),
(6) An offering price (we don’t want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

A further qualification is that there has to be a huge “moat” around the company that makes it highly improbable that anybody else will have the cash to compete, where “the ability of new entrants to enter the industry is held down by massive capital needs.” Railroads surely meet that requirement.

However, Berkshire co-Chairman Charlie Munger, in his remarks before the 2007 Wesco Annual Meeting, said, “Warren and I have hated railroads our entire lives. They’re capital-intensive, heavily unionized with some make-work rules, heavily regulated, and have long competed with a comparative disadvantage vs. the trucking industry, which uses free public roads. Railroads have long been a terrible business and have been lousy for investors.”

Munger continues, “We did finally change our minds and invested. We threw out our paradigms, but did it too late. We should have done it two years ago, but we were too stupid to do it at the most ideal time. We finally realized that railroads now have a huge competitive advantage, with double-stacked railcars, guided by computers, moving more and more production from China, etc. They have a big advantage over truckers in huge classes of business.”

In this context then it is not surprising that Buffet made the BNSF move. And he moved quickly, too. According to the *Wall Street Journal*, it started with a “courtesy call” October 22 with BNSF President and CEO Matt Rose together with his senior managers. Buffett floated the idea of Berkshire acquiring BNSF: “If I like the company and own the stock, I usually wouldn’t mind owning it.” (Think Borsheim’s, Clayton Homes, MidAmerican Energy, Nebraska Furniture Mart.)

The next day Rose and Buffett met in the Forth Worth hotel where the latter was staying while in town for a Berkshire board meeting. They discussed how the deal would go down, including the $100 per share offer. Both parties huddled with their boards and the next Monday the Burlington board gave its unanimous approval for the transaction. The meeting lasted just three hours.

Here’s how it works (you can sing along with the PowerPoint under the Investors tab at www.bnsf.com). Berkshire pays BNSF $100 a share, roughly a 30 percent premium over the recent close of $70 with 40 percent cash and 60 percent Berkshire “A” stock. BNSF shareholders will

receive a fixed dollar amount of Berkshire stock within the "collar range" of Berkshire A shares, $80-$125,000 per share; if Berkshire shares are outside this range at closing the exchange ratio will be a fixed amount. Holders of smaller BNSF positions will get shares of BKR/B, which will split 50 for one making one share of BRK/B worth about $70.

It's subject to the usual regulatory approval process (the STB has no role; Berkshire does not have a controlling interest in any other railroads and won't even have to close out its positions with Union Pacific and Norfolk Southern). The Proxy statement gets filed later this month, shareholders meet and vote in the first quarter of 2010 and the closing will be shortly after that.

The railroad analyst community's response was generally positive. Ed Wolfe said the deal "implies a trailing EV/EBITDA purchase multiple of 8.7x, below past historical large-cap rail deals closer to 11x-12x. Our sense is that BNI's investors may be somewhat disappointed in the seemingly low multiple on depressed EBITDA levels. The deal requires 2/3 approval from non-Berkshire owners of BNI's stock, but shareholder approval seems likely given Board support and BNI's base of long-only holders. We also don't see any other bidders emerging given BRK's 23% existing stake in BNI."

As to the effect on other rails' share prices, Wolfe writes, "At a similar 8.7x purchase multiple on our 2010 EBITDA estimates, this implies 26% upside for CSX, 25% for UNP and 20% for NSC after yesterday's strong stock moves. However, we view this deal as likely a one-off for the group, and we do not believe there are other private equity or financial buyers currently looking at the large-cap rails. The small-cap rails seem more likely to hold onto yesterday's rally into heightened M&A on their front. Longer term however, we wonder if this caps multiples for the group."

Tony Hatch takes a somewhat broader view: "There has long been a case to be made for private ownership of rails. The tension between short term outlook (and quarterly performance) and long term capex (assets that last 50 years or more) means that a privately held company might well be able to act more strategically than tactically. The rails have been moving in that direction over the last cycle as I have argued (see their capex in this recession).

"Although couched in the guise of a 'patriotic investment' in the US economy (it is that), it is also a shrewd bet on a leader of the railway renaissance at a cyclical low point - and when rival bidders able to outspend Mr. Buffet are hard to find and perhaps nonexistent. Interestingly, BNSF is actually the most *global* of the US rails, with a third if its business in normal times coming from intermodal and half of that in international boxes from Asia, driven by globalization and its cousin, offshore outsourcing.

"BNSF can gain some competitive advantage by better planning its capital cycle, and by having a connected owner; BNSF would do better for Mr. Buffet if left alone (as happens most often with his deals). The industry can benefit by having a perceived heroic/patriotic investor as owner rather than "greedy Wall Street types." Whatever the irony, changing the paradigm in DC would benefit the industry – and the nation."

It's hard to say at this early stage of the game how this transaction will affect the short lines. If, as Tony suggests, Buffett stays true to form, BNSF will continue to excel at its core business: running a long-distance, high-speed heavy-haul railroad. If on the other hand, it appears certain branch-line operations are dragging down returns, Mr. B might notice. The Alice Schroeder Buffett biography, *The Snowball*, goes into great detail about Buffett's close dealings with Salomon's management when they went afoul of the Treasury, with the Long-Term Capital Management bailout, and with the leadership turmoil at Coke on the heels of Roberto Goizueta's passing.

The BNSF Industrial Products Group is perhaps the most challenging. It covers such broad categories as packaged and fresh food and beverages, chemicals, building and construction products and petroleum items. Third quarter revenues were off 34 percent on a 24 percent slippage in volume. Year to date, revenues are down 31 percent on 29 percent fewer loads while year-to-date average revenue per carload is off three percent. Next year's volumes and revenues are not likely to improve much over these levels.

A lot of this is switching-intensive where the first-mile, last mile part of the move incurs most of the cost. It's also where most BNSF short lines live. Since Buffet has repeatedly displayed his penchant for moving quickly to capitalize on opportunities to improve results, what happens if he starts asking questions about moves where the equipment cost is high and the revenue-to-cost ratio is low?

For BNSF branches, it could mean a downsizing. For non-performing short lines it could mean a serious wood-shedding (see *Snowball*, page 605, re "Sternlight letter," starting at the top of the page). At the very least, it ought to cause BNSF shortline operators to make sure their operations are squeaky clean so that when BNSF *does* find opportunities to create new short lines there are many sharp operators prepared to move quickly to a solution.

Wolfe Research this week released an exhaustive, thorough and fair assessment of the recent IPO for RailAmerica. In a nutshell, "The Second Act feels better. Act I ran from 1992 to 2007 when RA was a Listed company that had a reputation of over-paying for dilutive acquisitions and generating inconsistent operating results." [*Exactly. I even had a Class I guy ask whether RA was in the railroad business or running a mutual fund that buys and sells railroads. -- RHB.*) Fortress ended Act I.

Wolfe again: "During its two years as a private company, RailAmerica replaced its entire senior management team with industry veterans who have helped materially reduce its cost structure and improve the consistency of its earnings and cash flows. We believe the company has several years of cost and productivity improvement remaining. We expect RailAmerica to benefit from continued tax advantages, as we expect Congress to renew short-line tax credits for the foreseeable future.

"Short-line railroads should also continue to benefit from a solid acquisition pipeline, as well as lower capital intensity and a less unionized workforce relative to the large-cap rails. They have the added advantage of facing less regulatory pressure [*in pricing anyway, as short lines typically don't set rates with customers – RHB*] and will likely benefit from local and state government stimulus projects to build roads, bridges and tunnels.

"We have initiated coverage of RailAmerica with an Outperform rating and year-end 2010 target price of $15, based on target forward adjusted EV/EBITDAR and P/E multiples that represent midpoints between the large-cap railroads and more-proven, small-cap comparable Genesee & Wyoming. Based on the prior day's closing price of $11.62, this implies 29% upside for the stock over the next 14 months."

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