RAILROAD WEEK IN REVIEW

March 3, 2017

"Repurchases only make sense if the shares are bought at a price below intrinsic value. When that rule is followed, the remaining shares experience an immediate gain in intrinsic value." — Warren Buffett, Chairman's Letter, February 2017

BNSF results for 2016 are now available in the Berkshire Hathaway Annual Report, www.berkshirehathaway.com. There's not a lot of detail, just what each major group — industrial products, agriculture, coal and consumer products (combined intermodal and automotive) — did in 2016 with a percentage change from 2015 full-year results. Gleaned from the Berkshire Annual Report, page 86:

Revenue	2016	2015	Change
Industrial Prods	$ 4,800	$ 5,594	-14.2%
Agriculture	$ 4,200	$ 4,200	0.0%
Total Mdse	$ 9,000	$ 9,794	-8.1%
Coal	$ 3,400	$ 4,651	-26.9%
Consumer Prods	$ 6,500	$ 6,559	-0.9%
Totals	$ 18,900	$ 21,005	-10.0%
Rev Units			
Industrial Prods	1,923	2,066	-6.9%
Agriculture	812	755	7.6%
Total Mdse	2,735	2,820	-3.0%
Coal	1,802	2,278	-20.9%
Consumer Prods	5,191	5,135	1.1%
All-in	9,728	10,233	-4.9%
RPU			
Industrial Prods	$ 2,496	$ 2,708	-7.8%
Agriculture	$ 5,175	$ 5,566	-7.0%
Total Mdse	$ 3,291	$ 3,473	-5.2%
Coal	$ 1,887	$ 2,042	-7.6%
Consumer Prods	$ 1,252	$ 1,277	-2.0%
All-in	$ 1,943	$ 2,053	-5.3%

On the revenue side, I estimated the 2015 numbers by applying the year-over-year change reported to the 2016 numbers given. Given the way railroads generally report, I'm saying the difference between my freight revenue and their total revenue lies in Other and FSC. Carloads shown are from the Week 52 AAR car counts and the resulting changes in carloads and RPU are within rounding range of what BNSF is reporting through Berkshire.

Clearly short lines took it in the shorts in the Industrial Products sector. Hardest hit per the AAR week 52 numbers were met ores, metals, aggregates, petroleum products (which I suspect is largely crude; NGLs are pretty constant over time),

Operating expense dropped a respectable 8%; ops income was off 13% to $6.9 billion, even though all expense lines but D&A declined. The OR was 66.3, up 135 basis points, and net income declined 16% to 3.6 billion. I expect BNSF to publish its own 10-K in a few weeks and that it will have real numbers in all columns. (By way of comparison, BNSF revenue units dipped 4.9% to 6.8% at UP, yet RPUs were off 5.3% to UP's off 2.1%.)

Warren Buffet's Chairman's Letter in the Annual Report warrants a careful look, especially regarding his observations on depreciation reporting, share repurchases, and non-GAAP numbers. With respect to the first,

> GAAP-prescribed depreciation charges are necessarily based on historical cost. Yet in certain cases, those charges materially understate true economic costs, and … the problem still prevails, big time, in the railroad industry, where current costs for many depreciable items far outstrip historical costs. The inevitable result is that reported earnings throughout the railroad industry are considerably higher than true economic earnings.
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> At BNSF, to get down to particulars, our GAAP depreciation charge last year was $2.1 billion. But were we to spend that sum and no more annually, our railroad would soon deteriorate and become less competitive. The reality is that – simply to hold our own – we need to spend far more [*$4.3 bn for 2016 - rhb]* than the cost we show for depreciation [*$2.1 billion on the 2016 income statement. - rhb*].

Berkshire has said many times and in many places that it might consider repurchasing its own shares if the street price crept *below 1.2 times book* value. However, this doesn't mean Berkshire will run to the market if that number is reached — roughly $206,000 — but rather that "we will instead attempt to blend a desire to make meaningful purchases at a value-creating price with a related goal of not over-influencing the market." (Street price is now $263,160, 1.5 x book.)

As for share repos in general,

> Repurchases only make sense if the shares are bought at a price below intrinsic value. When that rule is followed, the remaining shares experience an immediate gain in intrinsic value… Ergo, the question of whether a repurchase action is value-enhancing or value-destroying for continuing shareholders is entirely purchase-price dependent. It is puzzling, therefore, that corporate repurchase announcements almost never refer to a price above which repurchases will be eschewed. That certainly wouldn't be the case if a management was buying an outside business. There, price would always factor into a buy-or-pass decision.

Lastly, non-GAAP numbers. Regular WIR readers know I like GAAP numbers because they are constant over time; "adjusted earnings" (non-GAAP) don't necessarily make the same adjustment to income every time, so don't provide a constant picture. Buffett:

> Charlie and I want managements, in their commentary, to describe unusual items – good or bad – that affect the GAAP numbers. After all, the reason we look at these numbers of the past is to make estimates of the future. But a management that regularly attempts to wave away very real costs by highlighting "adjusted per-share earnings" makes us nervous…
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> One of the two favorites of "don't-count-this" managers is"restructuring." Berkshire, I would say, has been restructuring from the first day we took over in 1965. Owning only a northern textile business then gave us no other choice. And today a fair amount of restructuring occurs every year at Berkshire. That's because there are always things that need to change in our hundreds of businesses.
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> We have never, however, singled out restructuring charges and told you to ignore them in estimating our normal earning power. If there were to be some truly major expenses in a single year, I would, of course, mention it in my commentary.

And for dessert, consider EBITDA. A favorite metric for valuing short lines is the EBITDA multiple, the argument being that depreciation and amortization are non-cash charges that take away from the true cash-generating capability of the company in question. As noted above, depreciation is in there because stuff wears out and has to be replaced. Not accounting for that wear over time means a huge hit when the time comes. Buffett again:

> A key characteristic of [railroads] is their huge investment in very long-lived, regulated assets partially funded by large amounts of long-term debt [and where] earning power that under terrible economic conditions would far exceed its interest requirements. Our definition of coverage is the ratio of earnings before interest and taxes to interest, not EBITDA/interest, a commonly-used measure we view as seriously flawed.

To be sure, these shoes may not precisely fit shortline feet, yet I am of the opinion the cautionary tales do. Your comments are eagerly solicited.

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