

RAILROAD WEEK IN REVIEW

March 2, 2018

“At Berkshire, we evaluate acquisitions on an all-equity basis, knowing that our taste for overall debt is very low... We also never factor in, nor do we often find, synergies.”

“The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own.”

“About 44% of the 2017 Berkshire Hathaway profit [pre-tax benefit] came from two subsidiaries — BNSF, our railroad, and Berkshire Hathaway Energy.”

“Berkshire regularly incurs capital expenditures that far exceed its depreciation charge. Partially offsetting this good news is the fact that BNSF (like all other railroads) records depreciation charges that fall well short of the sums regularly needed to keep the railroad in first-class shape.”

“Charlie and I view the marketable common stocks that Berkshire owns as interests in businesses, not as ticker symbols to be bought or sold based on their “chart” patterns, the “target” prices of analysts, or the opinions of media pundits.” — all Warren Buffett, Annual Letter, February 24, 2018

BNSF reported full year 2017 results in both the Berkshire Hathaway 10-K and in the railroad’s own 10-K. Not being followed by a horde of sell-side analysts, BNSF can forgo the usual quarterly slicing and dicing, and focus on full-year numbers, which are, in my opinion, a better mirror on what the company is all about, leaving out the vagaries of weather and shipper temperament. That said...

BNSF grew full-year revenue units by 5.3 percent. (Based the railroad’s Week 52 — December 30 — AAR report, I estimate Q4 revenue units up 3.8 percent.) Full-year freight revenues came in at \$20.4 billion, up 7.8 percent. RPU gained 2.4 percent to \$1,986; the coal RPU delta was three times that, up 6.9 percent to \$2,006.

Full year operating expense was \$13.5 billion, up 6.4 percent; operating income was \$7.3 billion, up 9.9 percent. The operating ratio was 64.8 vs 65.6 a year ago, down 74 basis points. Fuel surcharges added \$853 million — up 47 percent — in freight revenue; absent this, the OR was unchanged at 67.6. Net income before taxes (recent tax law changes make YOY after-tax comps meaningless) \$7.6 billion, up 15.2%.

There is little detail on specific commodity lines. But the 10-K yields some color:

- System RPU increased 2 percent primarily as a result of higher fuel surcharges, increased RPU in some commodities, and changes in business mix.
- Consumer Products volumes increased due to higher domestic intermodal, international intermodal, and automotive volumes. The increases were primarily due to improving economic conditions, normalizing of retail inventories, new services, and higher market share.
- Industrial Products volumes increased primarily due to higher sand, bentonite, and other commodities that support drilling. Steel and taconite were up; crude oil dropped as pipelines' capacity increased.
- Agricultural Products volumes were relatively flat due to higher shipments of domestic grain as well as ethanol and other grain products, offset by lower grain exports.
- Coal volumes increased due to continued effects of higher natural gas prices leading to more utility coal usage. This was partially offset by the effects of unit retirements at coal generating facilities, increased renewable generation, and coal inventory adjustments at customer facilities.

Short lines and regionals ought to be particularly pleased by the IP numbers: 25% of total revs, 18% of rev units, modest 5% gain in RPU.

The BNSF Railroad has been reported to be worth about \$75 billion in round numbers. Total Berkshire assets are roughly \$590 billion, of which BNSF accounts for roughly 13 percent of the total Berkshire pie. Recall Berkshire bought BNSF in 2009 for \$35 billion, returning since then more than \$22 billion in the form of dividends while growing its profits.

As noted above, BNSF earned \$6.3 billion pre-tax in 2017. Conservatively valuing the railroad at 12 times the pre-tax profit leads to a valuation of \$75.6 billion. By comparison, UP produced a pre-tax net income of \$7.4 billion, and has a market cap \$108 billion, 14 times earnings. From this one might conclude BNSF is worth more than \$75 billion — an even bigger slice of the Berkshire pie.

Speakers at the recent Southwest Association of Rail Shippers spring meeting touched on the subject of cross-border moves in and out of Mexico. Doing so is paper-intensive, expensive, complicated, and time-consuming, adding some five percent to the cost of the product. Happily, energy reform can help. SWARS presenters seemed optimistic, according to a note from PFL Petroleum. The consensus is that Mexico's refinery infrastructure is going to continue to lag and that demand for refined products out of the gulf coast will continue to be strong.

The outlook is bullish for plastic pellet production in the gulf, given the 20 percent increase in capacity this year alone. Frac sand movement via rail from the Midwest is up in the air longer term — competing basins closer to production areas are taking hold and it is too early to pick winners and losers.

PFL also notes that crude oil ended the week on a positive note closing above \$60 per barrel and closing out at \$63.75 US per barrel in an overall bullish commodity complex. As a result, demand for loaded car storage in key staging areas is in full swing with many deals being discussed and transacted. As a result, cars destined for crude and other services continue to roll out of storage. Lease rates for cars pointed at the market took a breather last week.

The Trains magazine April issue is the annual short line special. Six independent short lines are featured with thumbnails of history, miles, motive power, and commodities. Five of the six connect with UP, BNSF, or both. The table below highlights the commodity groups these short lines live on and their relative importance to the respective Class Is. Hence, some clues.

If you're a grain road doing business with both, BNSF is the better bet. If you're in the frac sand and aggregates business, UP gets the nod, as it does in metals. If you connect with only one, the table shows the relative importance of each to the interchanging Class I.

	UP 2018	UP 2017	UP Chg	BNSF 2018	BNSF 2017	BNSF Chg
Grain	44,293	51,951	-15%	81,571	79,019	3%
Grain Mill Prods	22,114	24,223	-9%	27,183	24,290	12%
Chemicals	122,352	118,793	3%	62,511	61,539	2%
Crushed Stone+	65,495	54,258	21%	43,843	40,664	8%
Metals & Prods	16,260	14,319	14%	12,584	12,301	2%
Paper etc	11,745	11,920	-1%	10,197	9,583	6%
Lumber etc.	16,179	14,889	9%	11,244	10,240	10%
Total CL	298,438	290,353	3%	249,133	237,636	5%
Total Rev Units	1,125,659	1,132,061	-1%	1,392,115	1,346,665	3%
CL % Total	26.5%	25.6%		17.9%	17.6%	
<i>Source: Railroad websites</i>						

The long-anticipated CSX Investors' Day was held March 1. Can't say much about it at this point; look for my summary next week. Hard on the heels of this comes the 29th consecutive Annual Shortline Workshop, March 4-5. I'll give you my take next week as well, suitably framed by the Investors' Day activities.

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