RAILROAD WEEK IN REVIEW

March 1, 2024

"Over the years, Berkshire has attracted an unusual number of 'lifetime' investors who trust Berkshire with their savings without any expectation of resale (resembling in attitude people who save in order to buy a farm or rental property rather than people who prefer using their excess funds to purchase lottery tickets or 'hot' stocks). We cherish their presence and believe they are entitled to hear every year both the good and bad news, delivered directly from their CEO and not from an investor-relations officer or communications consultant forever serving up optimism and syrupy mush." — Warren Buffett, Letter to Shareholders, February 24, 2024

Every year for the past 50+ years, Berkshire Hathaway CEO Warren Buffett has led off the 10-K annual report with his Letter to Shareholders, a commentary on the various Berkshire businesses. With respect to BNSF, I find his remarks quite refreshing and useful because they tell us how BNSF approaches the business and what we can expect from them. For the next few paragraphs, everything you read will be in Warren's words. I am not going to bother with quotation marks.

Rail is essential to America's economic future. It is clearly the most efficient way – measured by cost, fuel usage and carbon intensity – of moving heavy materials to distant destinations. Trucking wins for short hauls, but many goods that Americans need must travel to customers many hundreds or even several thousands of miles away. The country can't run without rail, and the industry's capital needs will always be huge. Indeed, compared to most American businesses, railroads eat capital.

BNSF is the largest of six major rail systems that blanket North America. Our railroad carries its 23,759 miles of main track, 99 tunnels, 13,495 bridges, 7,521 locomotives and assorted other fixed assets at $70 billion on its balance sheet. But my guess is that it would cost at least $500 billion to replicate those assets and decades to complete the job.

BNSF must annually spend more than its depreciation charge to simply maintain its present level of business. This reality is bad for owners, whatever the industry in which they have invested, but it is particularly disadvantageous in capital-intensive industries. At BNSF, the outlays in excess of GAAP depreciation charges since our purchase 14 years ago have totaled a staggering $22 billion or more than $1.5 billion annually. Ouch!

That sort of gap means BNSF dividends paid to Berkshire, its owner, will regularly fall considerably short of BNSF's reported earnings unless we regularly increase the railroad's debt. And that we do not intend to do.

Consequently, Berkshire is receiving an acceptable return on its purchase price, though less than it might appear, and also a pittance on the replacement value of the property. That's no surprise to me or Berkshire's board of directors. It explains why we could buy BNSF in 2010 at a small fraction of its replacement value.

North America's rail system moves huge quantities of coal, grain, autos, imported and exported goods, etc. one-way for long distances and those trips often create a revenue problem for back-hauls. Weather conditions are extreme and frequently hamper or even stymie the utilization of track, bridges and equipment. Flooding can be a nightmare. None of this is a surprise. While I sit in an always-comfortable office, railroading is an outdoor activity with many employees working under trying and sometimes dangerous conditions.

An evolving problem is that a growing percentage of Americans are not looking for the difficult, and often lonely, employment conditions inherent in some rail operations. Engineers must deal with the fact that among an American population of 335 million, some forlorn or mentally-disturbed Americans are going to elect suicide by lying in front of a 100-car, extraordinarily heavy train that can't be stopped in less than a mile or more. Would you like to be the helpless engineer? This trauma happens about once a day in North America; it is far more common in Europe and will always be with us. [end quote]

For the purposes of discussion, BNSF divides its revenue unit universe thusly:

Consumer Products: The Consumer Products freight business provided 34 percent of freight revenues for the year ended December 31, 2023, and consisted of the following business units: Domestic Intermodal (including Truckload/Intermodal Marketing Companies and Expedited Truckload/Less-than-Truckload/Parcel), International Intermodal, and Automotive.

Industrial Products: The Industrial Products freight business provided 25 percent of freight revenues for the year ended December 31, 2023, and consisted of the following five business units: Construction Products, Petroleum Products, Building Products, Chemicals and Plastics Products, and Food and Beverages.

Agricultural Products: The transportation of Agricultural Products provided 24 percent of freight revenues for the year ended December 31, 2023. These products include corn, wheat, ethanol, soybeans, bulk foods, fertilizer, oil seeds and meals, feeds, oils, flour and mill products, specialty grains, milo, barley, oats and rye, and malt.

Coal: The transportation of coal contributed 17 percent of freight revenues for the year ended December 31, 2023, with more than 90 percent of all of BNSF Railway's coal tons originating from the Powder River Basin of Wyoming and Montana.

For these broad categories, such as industrial products and agriculture, you may find it useful to go to the BNSF weekly carload reports to the AAR. There you can break down industrial products into aggregates, lumber, paper, metals, and so on to mirror more closely your railroad's commodity base.

BNSF's financial performance was underwhelming, not surprising given the sorry state of the economy from a manufacturing and consumer durable goods viewpoint. Full year freight revenue in 2023 was $22.9 billion, down six percent, on nine million revenue units, down three percent. For the Q, freight revenue was $6 billion, off three percent, on 2.4 million revenue units, up four percent. Full year RPU was $2,549, down a point; RPU in the Q dipped seven percent to $2,534.

Quarterly operating expense was $4.3 billion, down six percent; operating income was $1.9 billion, down seven percent for a 68.8 operating ratio — up a lousy 29 basis points. Full year operating expense was $16.5 billion, down five percent; operating income was $7.4 billion, down 14 percent, bringing the four-year operating ratio to 69 even, a two-point improvement. Below the line, the quarter's net income dropped 8 percent to $1.4 billion; for the year it was $5.1 billion down 14 percent. Note the absence of interest expense and share buybacks, so the reported net income is the income you get as a shareholder.

Myself, I am a Berkshire Hathaway shareholder and have been for a couple of decades at least. I was there when they bought Burlington Northern Santa Fe, and had several interesting conversations with their CEO Matt Rose about the benefits of "going private" and not being beholden to the whims of Wall Street.

Vice Chair Charlie Munger, a vital part of what Berkshire has come to be over the years, and who passed away just weeks ago, quite disdained the "lottery ticket" approach to investing now in vogue. And Buffett credits Munger with being the "architect" of today's Berkshire Hathaway. Say Amen to that. RIP Charlie Munger.