RAIL

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Buffett's Berkshire buys BNSF

Investor Warren Buffett, the 'Oracle of Omaha', is big on the future of railroads and has the ear of the Obama administration, as Barry Parker reports

The proclivity of Warren Buffett's Berkshire Hathaway Corporation for tangible assets is well known. Buffett is no stranger to the transport business. He is a savvy investor who began building a stake in Burlington Northern Sante Fé (BNSF) as far back as early 2006.

In early November, Berkshire Hathaway raised its stake in the Class I railroad to 100 per cent by acquiring the 77.4 per cent it did not already own for USD26 billion, in a mix of 60 per cent cash and 40 per cent stock plus the assumption of roughly USD10 billion of BNSF debt. Market capitalisation of BNSF is now USD34 billion - 340 million shares at USD100 per share - making the overall deal worth USD44 billion.

Observers have cited many different business reasons for Berkshire Hathaway's acquisition of BNSF. Possibilities include movements of clean coal in the western US states; a revitalised intermodal business connecting US west coast ports with consumers in the US heartland; and a play on modal shifts (from trucking) as fuel prices rise. In a

June presentation to a US congressional subcommittee, Matthew K Rose, BNSF's chairman, president and chief executive officer (CEO), laid out the 'sweet spot' on a graph, talking about a vast mode optimisation opportunity in which long-haul rails would feed short-haul trucks moving goods to ultimate destinations.

One irony is that "very little will change" in terms of BNSF financing, according to Jason Seidl, rail analyst at investment bank Dahlman Rose. Seidl tells Jane's: "BNSF did not have problems with capital, even before the Buffett announcement."

Seidl also counsels investors not to expect a torrent of copycat deals, with private equity investors unlikely to begin buying up other railroads. However, he does recommend the sector to investors, citing "already strong [and in some cases record] cash on their balance sheets" that would be further fuel¡led by incremental traffic growth, firm pricing and strong free cashflows. He suggests that cash generation would lead to increased dividends and likely share repurchases - a move that boosts share prices - by the railroads.

At a very high level, Berkshire Hatha¡way's predominant insurance businesses - which generate cash that must be invested - are in stark contrast to the capital-consuming railroad business. Of course, the devil is in the details of synchronising investable insurance premiums, requisite reserves to cover insurance claims and a railroad's voracious appetite for long-term capital. BNSF's CEO Rose, citing a 2007 US Department of Transportation study, projected a USD39 billion shortfall for the big railroads over the next 25 years.

Not surprisingly, credit rating agencies see the deal as a positive for the target company and a negative for the acquirer. Standard & Poor's (S&P) put BNSF - rated BBB, near the low tier of investment grades - on Credit Watch with "positive implications", meaning that its rating might be improved by one notch, up to BBB+. In contrast, S&P expressed caution about Berkshire Hathaway's rating, currently a coveted AAA.

Recent BNSF financials show USD1.7 billion of capital expenditures during the first nine months of 2009 and a further USD600 million for acquisition of equipment - similar to the same period a year earlier. Purchases of company stock, which reached close to USD900 million between the first and third quarters of 2008, were minimal in the same period of 2009, which saw cashflow from operations down to USD2.6 billion from USD3.3 billion. In addition to cash thrown off from operations, BNSF finan¡cing includes debt sales as needed, including USD750 million of 10-year bonds sold in September at 4.7 per cent, sale/leasebacks and receivables sales. Debt-to-total capitalisation, adjusted for leases and unfunded pensions, stands at 52.4 per cent on a USD38.5 billion balance sheet, with USD9.2 billion being financed by deferred taxes.

Going private may bring positive implications for BNSF's place in the competitive dynamic of large railroads. One school of thought is that BNSF's capital programme may be less fettered, without the pressure of quarterly reporting of results. Indeed, during competitor CSX's flap in 2008 with UK hedge fund TCI, lowering of capital expenditures and distributing cash were major objectives of the dissidents. As shipping companies have discovered, capital programmes and building out infrastructure are sometimes incompatible with the expectations of shareholders looking for steadily rising dividends and distributions.

Besides substantial operating cashflows, which can fund BNSF's normal maintenance and new equipment cap¡ex requirements, the imprimatur of Berkshire Hathaway - and the improved ratings - could give BNSF a strategic advantage in coming years. Rose has suggested that positive train control - an electronic control system - will require BNSF to invest between USD1.3 billion and USD1.8 billion over the next five years. Market talk suggests that BNSF might look at electrification of freight tracks. Such a project would have profound environmental benefits - as emissions from diesel-burning locomotives are eliminated - but no immediate financial return.

The politics of the situation provide further hints into Buffett's rationale. US President Barack Obama - a Democrat from railroad hub Chicago - has repeatedly stressed his interest in the rails. Rose, regarded as a forward thinker in the railroad world, was the only railroad CEO who was a member of the now expired, prestigious National Surface Transportation Policy and Revenue Study Commission, which recommended investment tax credits - contrasted with deferrals where taxes eventually come due - for rail investments, as well as increased partnerships between government and private companies.

Amid concern about efforts towards increased economic regulation of the rails, Seidl comments: "We do not believe such an astute investor as Warren Buffett would have made his largest acquisition to date if he thought over-reaching regulation was around the proverbial corner."

Buffett, who has the ear of the Obama administration, has signalled that strong railroads are good for US business at a time when Obama's stimulus plan is taking political flak and the president needs to be seen as a pro-business leader.
