Rail move sends important signal to investors

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Published: November 4, 2009 02:00

When Charlie Munger, Warren Buffett's chief aide, addressed the 2007 shareholder meeting of one of the companies in the Berkshire Hathaway group, he was frank about railroad investing. The pair who run Berkshire had been too late to spot a change in the nature of a business they had hated, he admitted.

In light of that admission, Berkshire Hathaway's $26.67bn bid for Burlington Northern and Santa Fe - which values the company at $44bn, including $10bn of debt and the value of the stake Berkshire had accumulated since 2007 - looks like a bold effort to make up for lost time.

"We threw out our paradigms, but did it too late," Mr. Munger said in 2007.

The question now is what light Berkshire Hathaway's offer for the railroad company sheds on the wider prospects of a business Mr. Munger says he and Mr. Buffett had regarded as "terrible" and "lousy for investors".

Henry Posner III, who invests in railways worldwide through his Pittsburgh-based **Railroad Development Corporation**, welcomes the signal the proposed takeover will give to would-be rail investors.

"This is the highest vote of confidence any company can have," Mr. Posner says.

The BNSF takeover conforms to many of Mr. Buffett's famous rules of investment.

The company has some of the most highly regarded managers in the US railroad sector, led by Matthew Rose, chief executive. BNSF management invested heavily in improving capacity earlier this decade, at a point when most investment analysts doubted it was worthwhile.

The result was that, when Union Pacific, the other main railroad in the western US, suffered severe congestion during a surge in container traffic in 2004, BNSF handled the traffic far more easily.

"They are extremely well run," says Anthony Hatch, an independent railroad analyst.

BNSF also faces far fewer competition problems than many railroads have faced in recent years. Railroads compete strongly against trucking companies, which labour with higher fuel and labour costs.

A wave of consolidation in the sector - Burlington Northern merged with the Santa Fe railroad in 1995 - has left two major operators.

Mr. Buffett's move also comes amid an economic downturn that has shown the profitability of the bigger rail companies to be resilient.

While the profitability of many transport operators has slumped, BNSF's third-quarter figures, announced on October 22, showed operating income down only 25.3 per cent on the same quarter in 2008, to $901m. This was in spite of a 27 per cent fall in the third-quarter freight revenue to $3.49bn.

"There are still people out there who believe the rail industry is obsolete and slowly dying," Mr. Hatch says, but adds: "That's not been true for 15 years."

The deal is unlikely to run into the regulatory problems that have held up other railroad mergers.

Thomas Hund, BNSF's finance director, told investors yesterday that, because Berkshire Hathaway controlled no other railroads, the Surface Transportation Board, the regulator, should not need to get involved.

According to Mr. Hatch, the deal also suggests Mr. Buffett is unconcerned at the prospect of more rigorous railroad regulation under Barack Obama's presidency.

Concerns over such prospects have increased since February, when BNSF was ordered to pay $100m reparations to Western Fuels, a coal customer, and cap its rates to the customer for 16 years.

Instead, Henry Posner argues, the transaction could encourage BNSF to take a longer-term view of investment in capacity - potentially improving its service to its customers.

The wider impact of Mr. Buffett's move remains unclear, however. Other companies among the big four US railroads saw share price rises on yesterday's news. Main rival Union Pacific rose 6.8 per cent, while Norfolk Southern rose 2.4 per cent and CSX 6 per cent. CSXUnion PacificInvestor interest is frequently boosted when Mr. Buffett makes a major move in a sector, Mr. Hatch says.

But few investors now are likely to find the resources for as ambitious a bid.

His conversion to believing in the merits of railroad investing is unlikely to remain unique, but his ability to swallow large operators might be, according to Mr. Hatch.

"I don't think there are a lot of other private investors who can afford this kind of price, particularly in the current environment."

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