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By Cezary Podkul

## Buffett's \$34bn bet boosts US rail

**The Berkshire buyout of Burlington railroad, described as 'an all-in wager on the economic future of the United States,' could help smaller railroads survive in the difficult economy. Some also view it as sign that the industry's regulatory regime will see more certainty.**

Warren Buffett's Berkshire Hathaway is to acquire Burlington Northern Santa Fe (BN) for \$34 billion in cash and stock, marking the biggest deal in the history of the North American railroad sector and the largest acquisition in Berkshire history.



*Burlington Northern:  
Big bet for Buffett*

The deal, described by Buffett as "an all-in wager on the economic future of the United States", would see Berkshire buy the 77.4 percent of BN shares it does not already own at \$100 per share, or about \$26.3 billion. Including the value of Berkshire's existing 22.5 percent stake in Burlington worth about \$7.6 billion and \$10 billion in outstanding Burlington debt, the total transaction size would reach about \$44 billion.

At that size, the deal would dwarf the 1998 joint takeover of northeastern railroad Conrail by rival carriers CSX and Norfolk Southern in a \$10.5 billion transaction – until now the largest deal in the North American railroad sector.

Analysts and industry insiders say the deal will strengthen BN's already-dominant position in a \$60 billion market and help smaller carriers stay healthy during this difficult economic environment.

**"It's an all-in wager on the economic future of the United States" — Warren Buffett**

### Surprising but not unexpected

The equity markets cheered the news of Warren Buffett's latest bet. BN's shares, which closed at \$76.07 yesterday, made a vertical leap to \$97.54 as of noon eastern time, representing a premium of about 28 percent pre-transaction announcement. The stocks of other large rail carriers, such as CSX, Union Pacific and Kansas City Southern, also moved higher on the news.

Buffett had been steadily building a stake in the Fort Worth, Texas-based railroad for several years and had previously stated that Berkshire was on the lookout for a mammoth purchase. Still, some industry observers were surprised by the scale of Buffett's acquisition.

**"I don't think anyone could have said he was going to come in and gobble up the whole thing"**  
*John Mims*

"I don't think anyone could have said he was going to come in and gobble up the whole thing," said John Mims, an equity research analyst with BB&T Capital Markets in Richmond, Virginia, who covers the stock (BB&T does investment banking business and expects to receive compensation from BN).

Others saw the deal as the fulfillment of a long-held suspicion. "You kind of wondered when you saw Buffett building up a stake in the company a while back and, for me, it's interesting to see it's finally happened," said Mark Rosner, former director of network strategy and public-private partnerships for BN.

Rosner, who most recently worked as a senior vice president at investment bank Macquarie Capital in New York, added the deal “helps reinforce what a reasonable valuation should be in this uncertain market”. BN belongs to a sector of the railroad industry known as “Class I” rail, defined as carriers with more than \$359.6 million in annual revenues. Historically, transactions in the Class I sector have gone for between six to nine times earnings before interest, tax, depreciation and amortisation (EBITDA), Rosner said. “And that’s probably the right valuation for them,” he added.

At \$5.3 billion in EBITDA for the 2008 financial year, according to Thomson ONE Banker, Buffett’s \$44 billion deal would represent about an 8.3 multiple. “I think Buffett got a great price,” Rosner said, adding that the 28 percent premium is not as large when compared with the stock’s 60-day trading history or its all-time high of \$113.05 in May 2008.

Berkshire said it will fund the transaction through a mix of cash and stock. BN shareholders will be given the option to receive either a \$100 cash payment or a variable number of Berkshire class A or class B shares. Berkshire said investors would be given a prorated ownership of class A and class B shares if the ratio of shareholders electing cash and stock does not equal approximately 60-to-40 percent.

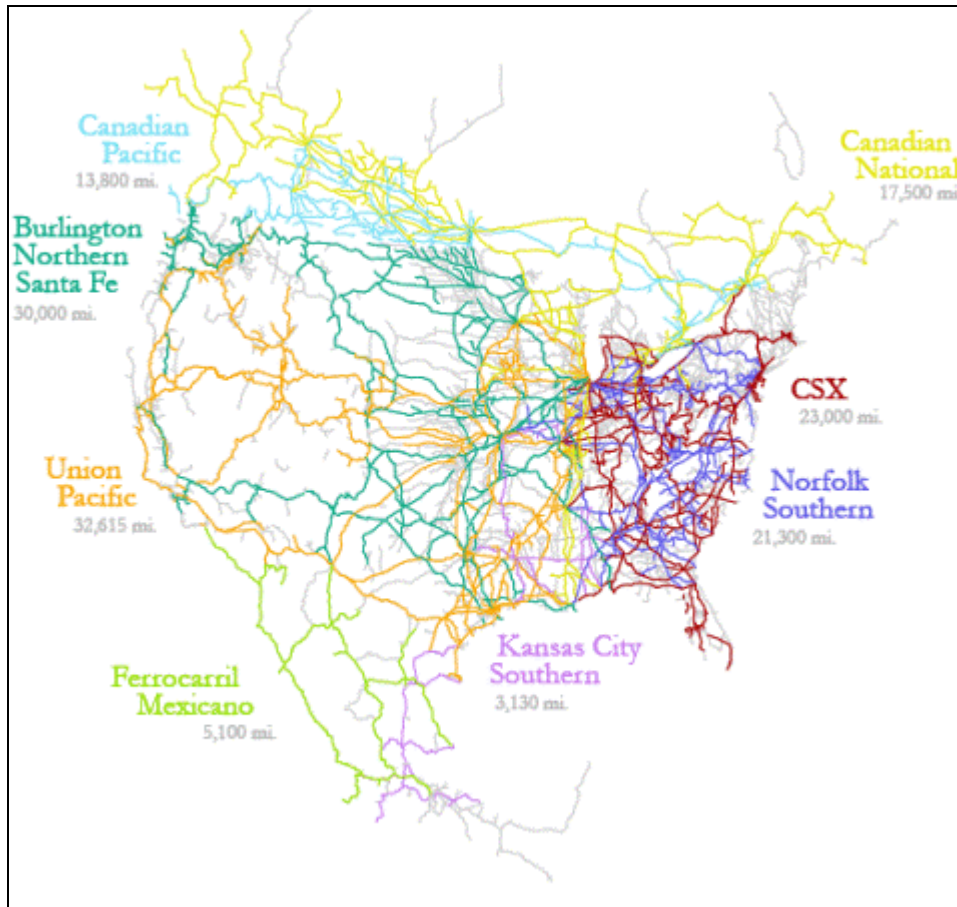
The transaction requires the approval by holders of two-thirds of BN’s shares, excluding Berkshire. The Department of Justice must also sign off on the deal, which is expected to close in the first quarter of 2010. Goldman Sachs and Evercore Partners are advising BN on the deal.

### **Solidifying position**

If the deal closes, it could help BN strengthen its position within the Class I rail market, which consists of seven large publicly traded railroads that all together posted \$61 billion in total operating revenues last year, according to a ranking compiled by the Association of American Railroads.

BN topped the association’s rankings in 2008, raking in \$18.1 billion in total operating revenues, or 29.6 percent of the industry total. Its closest competitor, Union Pacific, was close behind at \$17.9 billion, or 29.2 percent of the industry total.

BN and Union Pacific both operate primarily in the Western United States, while CSX and NSF dominate the Eastern US. The Canadian Class I carriers, Canadian National and Canadian Pacific, dominate the Canadian market and cut through the Midwest US.



North American rail sector: series of duopolies / Source: Freebase

“The North American [rail] market is a series of duopolies,” Rosner said. He believes, though, that Buffett may have chosen to invest in Burlington over Union Pacific because, within their market, Burlington has been better able to execute on various strategies, from growing its market share of the intermodal segment to a lot of bulk commodities like coal and grain. “That’s where I think BN has come out very, very strongly over the years,” Rosner said.

Looking forward, Mims said “BN is well positioned for a big rebound in consumer spending”, and may see additional benefits from the deal, such as a lower cost of capital, thanks to Berkshire’s size and hefty balance sheet. Berkshire, a diversified holding company with interests in more than 70 businesses globally, had \$21.4 billion of cash on its balance sheet as of 30 June, 2009.

Mims also believes BN will benefit from no longer being in the spotlight of the public equity markets. “The biggest hang-up rails have always had, being public, is you’ve got to keep investors happy on a quarterly basis and your capex budgets are for assets and investments that are going to last for 40 or 50 years,” he said. Not having to answer to quarterly Wall Street expectations “may allow them to have a longer term view, which may make it more difficult for other railroads to keep up,” he said.

### Helping smaller rails

However, smaller railroads – known as Class II carriers – could stand to benefit from the deal. Many of them derive much of their traffic from their larger, Class I counterparts and depend on them for their profitability.

“North America is a network [rail] business and to the extent that connecting railroads are not healthy, that has an impact on the network because most traffic includes two or more carriers,” said **Henry Posner III**, chief executive officer of the **Railroad Development Corporation** (RDC) in Pittsburgh, Pennsylvania.

Posner’s RDC is the owner of the Iowa Interstate Railroad, a 500-mile long Class II carrier headquartered in the Midwest state known for its ethanol production. The Iowa Interstate has four connections with BN, Posner said, and “we count on [BN] being healthy and fluid and active in that market so that our ethanol producers can be competitive”.

**“Anything that makes them healthier is good for us”**

*Henry Posner III*

“Anything that makes them healthier is good for us,” Posner added.

The veteran railroad executive also believes that having Warren Buffett place such a big bet on the industry is also a welcome development. “It means an important investor is putting a value on the railroad industry, so, if nothing else, it is comforting to know that our investments mean something,” Posner said.

### **More regulatory certainty**

The deal may also augur more regulatory certainty for rail carriers. “The railroad industry has sort of been holding its breath to see what’s going to happen in Washington,” Rosner said.

Until Congress passed the Staggers Rail Act in 1980, the industry was heavily regulated and had little freedom to set its rates and manage operations.

The lifting of those regulations triggered what many in the industry call the “railroad renaissance,” in which railroads’ productivity grew at a steady clip - as did profitability. But now that profitability has made the industry a subject on scrutiny on Capitol Hill.

**“The railroad industry has sort of been holding its breath to see what’s going to happen in Washington” — Mark Rosner**

Industry leaders have been urging Congress not excessively regulate the railroads. Speaking at the 5th annual Public-Private Partnership USA Summit earlier this year, BN chief executive officer Matt Rose said public policy should steer clear of antitrust legislation that would subject the rail industry to more oversight by courts and regulatory bodies.

Holly Arthur, a spokesperson for the American Railroad Association, said there wasn’t any particular bill in Congress about which the association was concerned. But she said its position has been to guard against excessive regulation that would harm the industry.

“The two big threats are: what’s going to happen to coal and will we be re-regulated?” Posner said, adding that the impact of climate change regulation on shipments of coal could pose a lot of uncertainty for rail carriers.

“Until that regulation comes out, there’s still going to be money sitting on the sidelines,” said BB&T’s Mims. “This big bet certainly adds strength to the argument that it’s not going to be as bad as some people think.”

Rosner agrees: “To make this kind of bet in this industry, Buffett must have a lot of confidence as to what the outcome will be of those deliberations will be,” he said.

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