



Letter to the Editor – Buffett and Burlington Northern

November 24, 2009

The following is in response to our article, [Bruce Greenwald on Positioning First Eagle's Funds](#), which we published last week.

To the Editor:

I read with some amusement professor Greenwald's discussion of Berkshire Hathaway's purchase of Burlington Northern (BNI), I could not disagree with his analysis more. One of my Native American friends says that one must be careful not to view things with "old eyes" and I fear that is what is happening to the professor's view of Burlington Northern.

When I first began to look at railroads in the 1980's, they were the very epitome of capital-intensive, labor-intensive companies consistently earning less than their cost of capital and that was during a period when they all had millions of acres low cost land holdings with attached mineral rights. At that time, the one true measure of a railroad's operating success, its operating ratio, was rarely below 90%. Union work rules were killing them.

Since that time, a reduction in government regulation, mergers and disposals of surplus lines, changing crew consist rules, technology and improved motive power efficiency have combined to make railroads productive and highly profitable companies. They have created huge cash flows which have funded debt reduction and capital spending, making them much more profitable. Today, any railroad with a operating ratio in excess of 75% is considered to be poorly managed. They have not accomplished this by diversifying their business; their resource land grants are long gone they are almost pure rails now. They have not done it with increased leverage as they carry less debt and preferred than they did 10 years ago. They have done it by sticking to their knitting, serving the customer, driving down costs, capital discipline, technology investments and just hardnosed business practice.

An example of increased efficiency: changes in engine design have reduced the number of motive units needed per train, reducing costs in terms of both fuel and crew. Recently, GE introduced a new line of motive units with 16 cylinder higher horsepower diesel engines that, at sustained speeds, turn off four cylinders and maintain their speed on the remaining 12. The fuel savings are in the area of 30% for comparable runs.

The other issue unique to BNI is that the nature of its traffic has allowed it to replace many of its previously fixed costs with variable costs, giving it greater financial flexibility



and the ability to change in an instant to accommodate business conditions. This in turn allows greater capital discipline and better returns.

While Buffett's purchase of BNI does not seem to satisfy Berkshire's traditional pattern of purchasing irreplaceable franchises, it does meet a more basic precept of being a toll-taker by offering a product an economy cannot do without. Most of the traffic on today's railroads cannot be moved by any other modality. If we are going to continue to import goods from lower cost developing world countries, then the BNI route structure from the west coast ports to the mid west will be one of the few (two actually) to move that traffic.

Did he overpay? Maybe. Does it revalue all the rails? No. Will it work out for Buffett and his shareholders? Probably and better than most viewing it with "old eyes" can see at this point.

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