

Warren Buffett, Chairman and CEO of Berkshire Hathaway, is perhaps the greatest investor of our time, if not ever. At buffettologist.com, we have been studying, practicing, and learning from the teachings of the Oracle of Omaha for years. As such, we have created this blog to share our insights on Mr. Buffett, other Buffett disciples, and value investing.

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Why Burlington Northern?

A colleague of mine, Matt Nellans, and I have been discussing Berkshire Hathaway's (BRK-B) proposed acquisition of Burlington Northern Santa Fe (BNI). And to put it mildly, the Burlington purchase is very different from most other acquisitions Berkshire Chairman Warren Buffett has ever completed. In order to complete the deal, Buffett is issuing debt, giving up some of Berkshire stock, splitting Berkshire stock, and paying top dollar to acquire the railroad company—all of which are actions that are very uncharacteristic of the Berkshire Chairman.

Let's first look at Burlington and ask why would Buffett want the railroad company. To begin, the competitive dynamics of the railroad business have improved over the last several decades. Consolidation in the industry, improved efficiencies in transporting via rail, and higher fuel prices have all made railroads a more efficient means of transporting goods compared to using trucking companies. Furthermore, Burlington's footprint is over the western states of the country. In simple terms, goods and materials are shipped via boat from Asia and arrive into the country in Long Beach or Oakland, and then need to be transported long distances to Dallas, Chicago, New York or elsewhere. Who better to transport these goods than Burlington? My colleague Matt puts it even more succinctly, when he refers to the United States as a human body, and posits that Burlington is the proverbial circulatory system of the western states of the country. The body simply can't function without its circulatory system running at full steam.

Buffett is also noted for wanting to acquire or make investments in businesses that are shielded from competition. He has typically used the moat and castle analogy to illustrate this concept, preferring businesses that have a wide moat around their franchises. In Burlington, if someone wanted to install a new railroad in the western states, not only would they need billions and billions and billions of dollars for the labor and materials, but they would also need government approval, rights of way agreements, and significant land holdings on which to place their rail. Furthermore, they would then need to build additional infrastructure around their rail, acquire shipping contracts, purchase equipment, purchase fuel, and the list goes on. Thus, Burlington is shielded from competition by not only the high fixed costs of starting a new railroad, but also by government. And as Matt points out, Burlington is guaranteed a decent return on capital by law, making it even more difficult for someone to penetrate its business. To be sure, the moat around Burlington is wide.

If we then examine the way Berkshire is financing the deal, it perhaps

illuminates other factors in Buffett's thinking. While Berkshire has issued debt in the past, it has typically been done to finance loan portfolios, and as Matt points out, the durations have been matched. In Buffett's New York Times op-ed pieces he has further warned about the risks of price increases, or inflation, coming at some point in the future. And if he truly believes that inflation is a major risk, it would make sense to issue debt—some of it fixed rate—to finance the deal, as the burden of those debt payments would decline over time if inflation were to heat-up. In addition, any capital expenditures that Burlington makes today will be cheaper than they would in the future if inflation were to heat-up. Finally, as Matt pointed out to me, since Burlington is guaranteed a decent return on capital, it may be shielded from future inflationary pressures since it would be able to pass on price increases to keep earning its return. Think of this as utility type earnings.

All of these characteristics—including the inflationary ones—may explain why Berkshire was willing to pay-up so much to buy Burlington. Not only could one argue that the absolute price of the acquisition was on the higher side, but Buffett himself indicated that in his view he was using modestly undervalued stock as currency to complete the deal. Furthermore, given Buffett's historical views on stock splits, it seems odd that he would agree to one now unless he really wanted to bring Burlington into the Berkshire umbrella. Given all of this, Matt probably put it best, when he said that not only is Buffett's purchase of Burlington an all-in bet on the United States, but so is it an all-in bet on future inflation.

Please do send me any questions or comments you may have, and my thanks to Matt Nellans for his contributions to this article.

You might also be interested to know that this blog was featured in a Crain's article, which I have liked [here](#).

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