

## >: Analyzing Buffett's Largest Stock Purchase in Years

Tuesday, May 8, 2007 / Dylan Jovine

HE'S ARROGANT. NARCISSISTIC. A KNOW-IT-ALL. A MOMMA'S BOY. A TOTAL LOSER.

At least, that's the reaction I've steeled myself to hear from some of you upon finishing this article.

Well, I'll say to you the same thing I said to the little bullies (i.e. the "in crowd" I yearned so desperately to be part of) in kindergarten:

*"Stocks and bonds will make me rich one day, but your words (especially ones sent to me via internet or email) will NEVER hurt me."*

Has it finally happened? Have I officially lost my mind? Not quite.

Let me explain:

Recently it was announced (amidst much fanfare) that billionaire investor Warren Buffett went "Old School" (Will Ferrell-style, not Andy Rooney-style) and made his largest fractional stock purchase in years.

The stock he bought was Burlington Northern Santa Fe Railroad (SYM: BNI). And from what I've gathered (i.e. read in the press), it was his largest stock purchase in years (39 million shares) in the \$80/share range.

The reason I'm planning on getting attacked from those among us who are Buffett fanatics (you know who you are; and yes, you do need a new hobby) is because I'm going to disagree with many of you as to why he made the purchase.

First, let me speak to what we CAN agree on.

Yes, Buffett is a genius. Without a doubt, he is the single greatest investor to ever live (for those of you who don't agree, you simply haven't thought hard enough about the subject).

But contrary to popular belief, his purchase of Burlington Northern was not "visionary."

Indeed, it was ordinary. Quite ordinary for Buffett in fact (and that, ladies and gentlemen, is what his true genius really is - an incredible dedication to the ordinary).

### **Baby, You Can Ride My Car**

But unlike typical Buffett copy-cat investors, I don't follow Buffett to find out what stocks he's buying. For starters, large investors like him have to buy large cap stocks just to move the needle on the performance of their portfolio.

Many analysts and Buffett watchers have been asking why he's become bullish on the railroad industry.

But that's the wrong question to ask.

You see, Buffett didn't become bullish on the entire railroad industry. He's become bullish on a single company, Burlington Northern.

But the reasons he's become bullish on BNI may suggest an underlying strength in the railroad industry that I explored with readers of *Fallen Angel Stocks* in our most recent issue, released last Friday.

Indeed, the move is reminiscent of the decision he made to buy MidAtlantic Energy in 2000 when oil was still between \$10 and \$20 per barrel.

Let me explain.

Railroads, once proverbial for an industry in disarray, have now begun to compete effectively with (and work with) the trucking industry. After a long series of bankruptcies, mergers, and acquisitions, there are now four significant US railroads. They are:

- ? The Union Pacific
- ? The Burlington Northern Santa Fe
- ? The CSX
- ? The Norfolk Southern

The Union Pacific and BN Santa Fe dominate the West, while the CSX and Norfolk Southern dominate the East. All of these companies have

developed intermodal capacities, with the ability to shift freight from railroad companies to trucks to ships and barges. The railways have become, overall, transportation giants that handle freight door to door.

How they've grown into dominant positions is a story created over centuries. What is important is that the industry is experiencing underlying strength that is improving overall returns-on-capital.

That means companies like BNI are able to get higher returns for the same capital investment.

As you can see from the example below, BNI has increased its return-on-capital by 44% during the past three years (sorry for the fuzziness of the chart ... didn't have time to get a graphic artist on the case):

### **Burlington Northern Santa Fe Railroad Return-on-Capital Analysis**

| Return on<br>Invested Capital<br>Reconciliation                          | 2006      | 2005      | 2004                |
|--|-----------|-----------|---------------------|
| Average Capitalization (a)   | \$ 21,199 | \$ 19,831 | \$ 19,069 Operating |
| Income   | \$ 3,517  | \$ 2,922  | \$ 1,686            |
| Other Expense  | (40)      | (37)      | (4)                 |
| Financing Charges (b)  | 370       | 305       | 274                 |
| Exclude 2004 Charge for Change<br>in Environmental and Asbestos Estimate | —         | —         | 465                 |
| Taxes (c)  | (1,438)   | (1,196)   | (917)               |
| After-Tax Income Excluding<br>Financing Charges and 2004 Charge          | \$ 2,409  | \$ 1,994  | \$ 1,504            |
| Return on Invested Capital (d)   | 11.4%     | 10.1%     | 7.9%                |

As you can see above, in 2006 BNI received 44% more for every dollar it spent than it did in 2004 (11.4% versus 7.9%).

If the company were able to increase its ROIC to 15%, that would have increased earnings in 2006 to \$3.179 billion.

At the same price/earnings multiple that BNI carries today of 14, the stock would automatically increase by 40% to \$125 per share.

### **Why This is a PERFECT Lesson on Warren Buffett's Investing Style**

Many people (myself included) believe that BNI is well positioned on the west coast to take advantage of the long-term trend in imports, especially those from Asia; there should be strong demand for BNI's services for the foreseeable future.

After entering U.S. ports, many of these goods are then shipped by rail, as this is typically cheaper than using trucks for long-haul routes.

But it's neither imports from Asia, housing starts nor car sales ? traditional drivers of revenue growth among railroads ? that will propel BNI going forward.

The big driver of growth will likely be ethanol.

President Bush's recent State of the Union address aside, the need for alternative fuels - especially ethanol ? is likely real and here to stay.

And ethanol fuel cannot be shipped in traditional pipelines, because it picks up corrosive water and other chemicals.

Therefore, it must be shipped by other methods, notably rail. As ethanol becomes more mainstream and widely used, there will be a substantial increase in the demand for rail services from alternative fuel producers and refiners.

And it is that, more than any other long-term driver, that will likely portend a generational shift in the economics of the rail industry.

But all of those factors probably had very little weighting to Buffett when he made his purchase of BNI.

The fact is that the company - from both internal and external efforts - is increasing its return on capital (the amount it makes in relation to what it spends).

Buffett's real genius is that he focuses on the facts instead of hard-to-predict futuristic reasons as to WHY the company is accomplishing this.

In other words, the fact that the company is increasing its ROIC is proof enough that business is going well.