Buffett buy may trigger interest in Canadian Pacific

(The following story by Scott Deveau appeared on the Financial Post website on November 4, 2009.)

OTTAWA — Shares in Canadian railways jumped yesterday on news Warren Buffett plans to acquire Burlington Northern Santa Fe Corp., renewing speculation a smaller sector-al player such as Canadian Pacific Railway Ltd. might be on the radar of would-be buyers.

The US$34-billion Buffett bid yesterday served as justification for the notion of buying railways and a boost of confidence that the economy is clawing out of recession, said Fadi Chamoun, a UBS analyst.

"It's really a play on the economy and a play on the rail business model," he said in an interview. "I don't see a lot of M&A [mergers and acquistions] in this sector.

"This is a unique situation with Berkshire privatizing BNSF. I don't think there are a lot of US$40-billion guys waiting to buy up railroads."

But he acknowledged that CP, the smallest of the North American Class 1 railways, might attract some attention based on its size.

While Mr. Buffett has expressed admiration for the railway's larger domestic rival, Canadian National Railway Co., investors are only allowed to own 15% of the former Crown corporation. CP has none of the same restrictions, making it the only real play among Canadian railways.

Two years ago, when the so-called rail renaissance was at its peak, Toronto investment house Brookfield Asset Management Inc. was one of a handful of private-equity firms to look at CP when its shares were trading above $70. A deal at the time was estimated to be worth more than $15-billion.

But CP management rebuffed Brookfield and others, and in ensuing months acquired Dakota, Minnesota & Eastern Railroad for nearly $1.5-billion in what was then deemed a defensive move against future offers.

Ironically, the DM&E acquisition might make CP even more attractive.

While the DM&E increased CP's exposure to the ethanol trade, the gem in the deal was the rights the railway had to build into the thermal-coal-rich region of the Powder River Basin, which straddles the Montana and Wyoming border. The basin is only served by BNSF and Union Pacific.

Berkshire already owns Mid American Energy Holdings Co., and the BNSF offer is viewed by some analysts as a way of vertically integrating the U.S. expansion into coal-fired electricity production.

"Apart from a bet on the broad U.S. recovery, Berkshire may also be looking for an indirect exposure to coal, specifically Powder River Basin coal," said David Newman, National Bank Financial analyst. "While demand for thermal coal has moderated due to high stockpiles and reduced electricity generation, longer term, the prospects remain favourable."

About a quarter of BNSF's sales last year were from coal shipments, of which 90% came from the Powder River Basin.

CP has yet to decide whether it will push ahead with development of the Powder River Basin line; it come with a substantial price tag. Not only is the whole project expected to cost about $4-billion, but CP would have to pay an additional $1-billion to former DM&E owners if it starts moving coal before 2025 as set out in its purchase agreement.

Still, even without the Powder River Basin project, CP might prove a shrewd acquisition at the 18 times projected 2010 earnings per share that Mr. Buffett offered for BNSF yesterday. With indicators suggesting freight-volume declines are on the mend, that multiple may actually be 12 or 13 times actual earnings, Mr. Newman said.