

Investors hear whistle of railroad profit

(The following story by Brendan Case and Eric Torbenson appeared on The Dallas Morning News website on November 8, 2009.)

DALLAS, Texas — In the shipping battle of trucks vs. trains, Warren Buffett's wager is on rail.

The next economic uptick – just getting started in some areas – will call Buffett's bet on whether railroads can deliver big earnings.

His \$44 billion gamble on Burlington Northern Santa Fe Corp. suggests he thinks three decades of deregulation, consolidation and infrastructure investment have built the engine for the next chapter in the so-called railroad renaissance.

The recession put an emergency brake on demand over the last two years. But with freight volumes set to recover if the economy gains steam, the nation still needs coal and an efficient way to move everything from cars to clothes to corn.

And energy prices are expected to rise, a trend that would favor railroads because they're more fuel-efficient than trucks.

"I think the railroads have market share opportunities," said Anthony Hatch, a railroad analyst in New York. "We expect fuel prices to go higher, which makes them cheaper. And in terms of carbon footprint, they use a lot less fuel, so they have a lot less emissions and a lot less cost."

To be sure, it's easy to exaggerate the rivalry between trucks and trains. The two sides fight over some shipments, but they work together to handle others.

Trucks boast speed and flexibility, and they have a strong advantage over distances of about 500 miles or less. Trains are competitive over long hauls, and they're also a more economical choice for bulk goods such as farm crops and coal.

So-called intermodal traffic – in which a train handles long hauls while trucks handle pickup and delivery – has grown smartly. Three of BNSF's top 10 customers are trucking companies, says Matthew Rose, the railroad's chairman and chief executive.

"We love the compelling vision of being able to work with trucking companies to take trucks off the highway, improve our fuel efficiency as a society, take carbon out of the air, take trucks off of I-35," Rose said. "That will be the same vision for the next 10 years."

But railroads need to improve their reliability if they hope to gain market share, says Bruce Allen, director of the Wharton transportation program at the University of Pennsylvania. During the last boom, railroads turned in a strong financial performance but sometimes struggled to avoid service delays and gridlock.

In 2007, railroads handled about 15 percent of freight tonnage, compared with nearly 70 percent for trucks, Allen said. Intermodal truck-rail traffic accounted for about 1.6 percent.

"At a time period when fuel prices are likely to go up, the advantage of railroads is likely to get bigger and bigger," Allen said. "But I've learned over the years, you never count out the resiliency of these truckers. It's amazing what they're able to do."

BNSF grows

Since 2000, the U.S. railroad industry has invested billions of dollars expanding track, buying locomotives and building freight yards. Even amid the industry's transformation, BNSF stood out.

After Rose took over in late 2000, revenue nearly doubled between 2001 and 2008, beating the 50 percent increase registered by rival Union Pacific Corp.

With sales of \$18 billion last year, BNSF nosed ahead of Union Pacific as the nation's largest railroad.

Freight haulers of all stripes have seen business dry up during the U.S. recession. As the economy recovers,

however, analysts and investors see railroads as valuable prizes.

"Stop and think: Do you think we'll ever have any new railroads?" asks Don Hodges, co-manager of the Dallas-based Hodges Fund.

Hodges began buying BNSF shares in 2004, when they were hovering around \$35 each. He sold last week, after the stock jumped to a few dollars shy of \$100 when Buffett announced his deal.

He still sees a bright financial future for railroads.

"The supply is constrained by lack of new competition," he said. "It's the most efficient method of shipping by a factor of about three, when you look at consumption of fuel. Highways are overloaded, and trucks spew forth a lot of carbon into the air."

It's far from clear how quickly the nascent economic recovery will boost freight volumes. But Rose says the railroads will be ready as demand revives, thanks to the industry's increased capacity.

"I think we've proven that it's actually easier to expand the railroads than it is to expand the public highways, because we own the majority of the land," he said.

"And we don't have the same regulatory restrictions to lay down track as you have to lay down new highway."

Better competition

But can railroads use their advantages to snatch more business?

"There's no question that rail has been taking an aggressive posture in public as holding itself out to be more fuel-efficient and more eco-friendly," said Bruce Carlton, president of the National Industrial Transportation League, which represents shippers.

That's a handy argument at a time when Congress is considering legislation that could toughen federal regulation of the industry. But there are signs that railroads are competing more effectively with trucks.

Some shippers are picking rail for trips as short as 500 miles, Carlton said.

"Railroads are making some incursions there," he said.

Not so fast, said Clayton Boyce, a spokesman for the American Trucking Associations. Plenty of communities have no rail freight service. Trucks can go anywhere roads go – and they typically offer speedier, more reliable service than trains.

"You still cannot get beyond all the limitations of rail," Boyce said. "Very, very little freight goes directly from a source to a destination without going on a truck."

Like Rose, however, Boyce notes that the two industries often work hand in hand. BNSF's growth depends on doing more of that.

"We work with them very closely," Rose said, referring to trucking companies. "They still participate by providing the pickup and delivery, and we do the middle to long-haul stuff, which is exactly what public policy should want. Get the trucks off the highway, get them to the railroad."