

Railroads Keep Chugging Along

The recent action by Berkshire Hathaway to purchase Burlington Northern Santa Fe has brought attention to the railroad industry. In this article, we discuss the importance of the industry to the U.S. economy and the advantages of shipping by rail. Overall, we like the long term characteristics of the railroad industry and would recommend investors buy senior unsecured bonds issued by the large investment grade operators.

On November 3, 2009, Warren Buffett, considered by many as the greatest investor in history, made the largest bet of his lifetime. His company, Berkshire Hathaway, announced plans to acquire Burlington Northern Santa Fe for \$44 billion. Mr. Buffett has been intimate with the railroad industry for some time given major investments in Union Pacific, Norfolk Southern, and Burlington Northern. He has now placed all his eggs in one basket as Mr. Buffett will be forced to sell his other railroad holdings. There is no doubt that Mr. Buffett has a very good understanding of the industry and its prospects for the future. This investment is as much a bet on the economy as it is on the sector and the company. Here is a couple of quotes from Mr. Buffett regarding his recent purchase:

“Our country’s future prosperity depends on its having an efficient and well-maintained rail system.”

“Conversely, America must grow and prosper for railroads to do well”

“Most of all, however, it’s an all-in wager on the economic future of the United States”

We would like to go into some mechanics of the rail industry including the interaction with the economy. This should go a long way towards explaining Mr. Buffett’s investment and the reason why we like the industry from a longer term bondholder perspective.

The transfer of goods across the United States is very reliant on the railroad industry. In turn, the health of the economy depends on the smooth operation of the rail system which includes a 140,000 mile network and over 550 railroad companies. Railroads move everything from the coal that is used to generate electricity to the grain that is used to make the cereal you eat every morning. In fact, railroads move about 70% of the coal in the U.S. used to generate about

50% of the electricity in the U.S.¹ In an average year, rails ship 1.7 million car loads of agricultural products and another 1.5 million car loads of finished food products.² Railroads have the number one position in the shipping industry with a 43% share.³ We have seen an improving trend in railroad traffic as some economic trends have turned positive or at least stabilized (**Exhibit 1**). Rail freight volume can be considered a leading indicator of economic activity as businesses begin to build inventories ahead of expected growth.

Exhibit 1:



Shipping by rail is the most cost effective way to move goods. Post the Staggers Rail Act of 1980, which ended regulation of the industry, productivity has greatly improved. In 2008, U.S. railroads moved one ton of freight 457 miles per gallon of fuel.⁴ This makes railroads two to three times more efficient than trucks. Much of the productivity enhancement was reflected in lower pricing which was passed on to the customer. Railroad rates have increased at a much

¹ “The Economic Impact of America’s Freight Railroads,” [Association of American Railroads – Policy and Economics Department](#) (September 2009):1.

² “The Economic Impact of America’s Freight Railroads,” 1.

³ “The Economic Impact of America’s Freight Railroads,” 1.

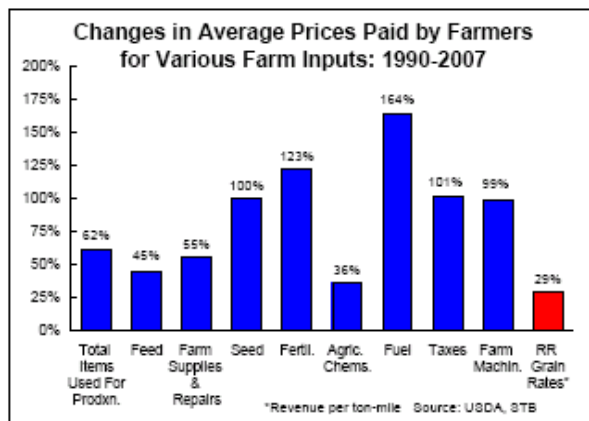
⁴ “The Economic Impact of America’s Freight Railroads,” 3.

AAM THOUGHT LEADERSHIP

Railroads Keep Chugging Along

slower rate versus other costs assumed by the customer. For example, **Exhibit 2** compares the increased cost for railroad services to other costs borne by the typical farmer. Using revenue per ton mile, average U.S. rail rates were down 49% from 1981 to 2008.⁵ That means the typical shipper can move twice the amount of goods at the same price it paid 25 years ago.⁶

Exhibit 2:



Over the past couple of years, contracts have been renegotiated at higher prices for several reasons including improved service, strong value versus other forms of freight, and historically low rates. Going forward, we would expect low-to-mid single digit price increases. One reason is the value proposition versus truck. The per mile rates for railroads is 20-40% below that of trucks.⁷ Also, the large capital needs of the industry necessitate a certain economic return and therefore reduces the likelihood that one major railroad substantially lowers its price to gain share. Finally, fuel cost/volatility is almost entirely passed through to the customer and is not part of the negotiated cost of the contract. This makes the contract price a better representation of true cost to the railroad.

The railroad industry is not without its risks and challenges. First, about 15% of railroad revenue is spent on the maintenance and improvement of rail infrastructure. This is important to keep service levels strong as growth picks up. The capital intense nature of this industry means that the

large rail companies need access to the capital markets, in particular, the unsecured fixed income markets. Despite the latest deep economic recession, all of the major rails have had no trouble issuing unsecured bonds over the last couple of years, including Baa3/BBB- rated CSX. The investment grade railroad industry has issued \$3.9 billion of unsecured U.S. bonds to date in 2009, \$5.3 billion in 2008, and \$5.8 billion in 2007. Second, as pointed out earlier, railroad revenues are tied to the health of the economy. Almost 40% of railroad revenue has low economic sensitivity.⁸ Therefore, the remaining revenues are tied to economic volatility which can be significant depending on which part of the cycle the economy is in. Lastly, new federal legislation is a risk since it could result in more government oversight and possibly more control with rates that would favor shippers.

Given the importance of the railroad industry to the economy, we would be somewhat surprised with government action that challenged the industry's ability to earn a reasonable economic return and invest in its infrastructure. Weak service levels, poor maintenance, and lack of capacity growth could slow U.S. economic growth. Also, we believe that the industry will be shielded from especially negative legislature given Mr. Buffett's strong ties to President Obama, support out of Washington for expansion of the rail network, and public benefits for rails versus trucks (e.g., greenhouse gas emissions, highway congestion, pollution).

We believe that investments in railroad bonds represent a good value versus other sectors of the Corporate index. For example, in **Exhibit 3** you can clearly see that the railroad industry has outperformed the consumer cyclical segment of the Barclays Capital Corporate Index, which includes such industries as automotive, retail, and lodging. Currently, the difference in spreads between the two sectors is small. We see better value in the rail sector versus consumer cyclicals given lower volatility in the rail sector and more stable fundamental characteristics. In addition, the railroad sector has produced better excess returns than the broader Corporate and Industrial categories of the Index for 2008 and year to date 2009.

⁵ "Overview of America's Freight Railroads," [Association of American Railroads – Policy and Economics Department](#) (September 2009): 1.

⁶ "Overview of America's Freight Railroads," 1.

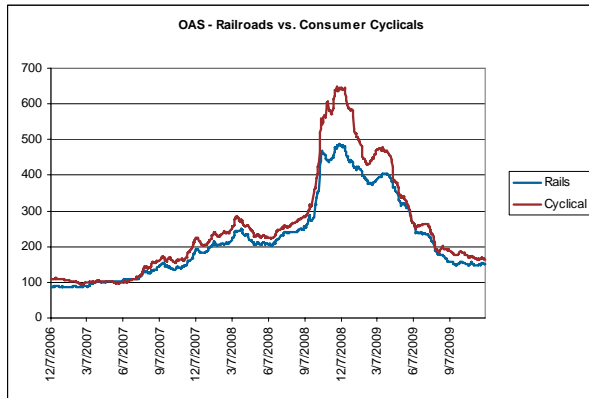
⁷ Matthew Troy, Bascome Majors, CPA, Ben Hopkins, "Railroads: It Was the Best of Times...Initiating Coverage on the North American Railroads," [Citigroup Global Markets](#) (March 5, 2009): 16.

⁸ William J. Greene, CFA, "Freight Transportation – 2Q09 Review: Solid Play on Volume Recovery," [Morgan Stanley Research North America](#), (August 3, 2009): 51.

AAM THOUGHT LEADERSHIP

Railroads Keep Chugging Along

Exhibit 3:



Source: Barclays Capital

In summary, we are constructive on the long term outlook for the railroad industry. Clearly, this industry plays a key role in helping boost economic growth

Written by:

Michael J. Ashley
Vice President, Corporate Credit

For more information, contact:

Joel B. Cramer, CFA, *Director of Sales and Marketing*
joel.cramer@aamcompany.com

Greg Curran, CFA, *VP, Business Development*
greg.curran@aamcompany.com

30 North LaSalle Street
Suite 3500
Chicago, IL 60602
312.263.2900
www.aamcompany.com

This information was developed using publicly available information, internally developed data and outside sources believed to be reliable. While all reasonable care has been taken to ensure that the facts stated and the opinions given are accurate, complete and reasonable, liability is expressly disclaimed by AAM and any affiliates (collectively known as 'AAM'), and their respective officers and employees. Any opinions and/or recommendations expressed are subject to change without notice.

This information is distributed to recipients including AAM, any of which may have acted on the basis of the information, or may have an ownership interest in securities to which the information relates. It may also be distributed to clients of AAM, as well as to other recipients with whom no such client relationship exists. Providing this information does not, in and of itself, constitute a recommendation by AAM, nor does it imply that the purchase or sale of any security is suitable for the recipient.