Buffett's Burlington Deal

On Melbourne Cup day, Berkshire Hathaway produced a shock of its own. Warren Buffett's company announced it had made an 'all-in wager on the economic future of the US'. Berkshire has agreed to buy the 77.4% of Burlington Santa Fe railway group that it didn't already own for US$100 per share in cash and stock - a 31% premium to the 2 November closing price.

The price - equating to an equity valuation of $US34bn and a price-to-earnings multiple of about 18 times - could hardly be considered cheap. Particularly when judged against Buffett's historical standards. But you can draw one of three conclusions from the deal.

Firstly, in a world of rising inflation and rising energy prices, Buffett believes rail is going to be the big winner: 'Burlington Northern Santa Fe last year moved, on average, a ton of goods 470 miles on a single gallon (3.8 litres) of diesel, and society has an enormous interest in using less oil to transport goods'. He went on to say that 'Each train displaces 280 trucks on the road. When it comes to spewing pollutants there is nothing more efficient than trains.'

The second conclusion you could draw is that he thinks Berkshire's own stock is overvalued. A significant portion, 40%, of the purchase price will be paid for with Berkshire shares. The last time Buffett made such a large scrip acquisition was the US$16bn, 1998 purchase of General Reinsurance. At the time, much of Berkshire's $US60,000 share price comprised of overpriced (by Buffett's own admission) equity investments. Many of his long-term holdings, such as Coca Cola and American Express, are still trading below their 1998 levels more than 10 years later. Berkshire itself looks more reasonably priced today, but perhaps Buffett knows something we don't.

Finally, while I don't want to upset the Buffett world again by suggesting the Oracle may have lost his marbles, he may simply be preparing Berkshire for a post-Buffett world. Burlington mightn't be the cheapest investment he's ever made but there's every chance it will still be around and profitable in 50 years' time. Perhaps that gives him a lot more confidence in the future of his estate than leaving behind a large pile of cash for someone else to manage.