Recommendation: Hold **Target Stock Price (12/31/2016): $120**

1. Reasons for the Recommendation

My recommendation is to hold Union Pacific Corporation (UNP) because my forecast shows that the stock is currently fairly valued and should rise over 10% by the end of 2016 for an estimated total return of 15.83%. The forecast is conservative as it does not include the impact of authorized share repurchases on the future stock price.

Positives

UNP is a leader in the railroad industry and provides diverse transportation services in the agricultural, automotive, chemicals, energy, industrial products and intermodal segments. UNP has a well-known brand and strong franchise. UNP has an A credit rating from Standard & Poor. IBISWorld forecasts that all six segments making up UNP's business will continue to grow in the future. The agriculture segment shipments are forecasted to increase due to higher farming efficiency and better demand for agricultural products and services as the economy improves. Agricultural exports are forecast to grow at an annualized rate of 4.8% to $211.5 billion from 2015 to 2019. The automotive segment is forecasted to increase because increased credit access and disposable income will allow consumers to purchase new vehicles. Also, IBISWorld forecasts that automobile exports will grow due to emerging economies, like China, improving their highway infrastructure increasing demand for cars in their markets. Further, IBISWorld forecasts that the number of vehicles imported into the U.S. will increase at an average annual rate of 1.2% to $169.3 billion from 2015 to 2020 because US dollar appreciation will give U.S consumers more purchasing power in foreign markets. The chemical segment is forecasted to grow at annualized rate of 1.0% to $48.4 billion from 2015 to 2019. Chemical exports are forecasted to grow at an annualized rate of 0.6% to $9.0 billion from 2016 to 2020 while imported chemical products are forecasted to grow at annualized rate of 1.3% to $5.1 billion from over the same period. The energy segment is forecasted to grow because of energy needs of expanding existing business and new business openings as economy continues to grow. Industrial products are forecasted to grow at an average annual rate of 3.4% to $94.0 billion from 2015 to 2019 because of increasing U.S. population, increasing imports, and improving economy and labor market. The intermodal segment is forecasted to grow from 2015 to 2019 because of being more efficient at transporting finished goods and a positive business mix (Rivera, Edward. 2014.)

UNP operates in all major fastest-growing population centers from the West Coast to the Gulf Coast ports. UNP supports the global supply chain and UNP is the only railroad to service all six major Mexican gateways. UNP will continue to increase its Mexican revenue because it recently began construction of a $400 million rail terminal in New Mexico. Furthermore, imported agricultural foods from Asia, especially China, will increase shipments from the west coast ports. An improving economic environment and labor market, new home construction, home repair and remodeling will increase demand for industrial products such as lumber from the Pacific Northwest and Western Canada. As a result, consumers will spend more, and manufacturing will increase and rail transportation will increase to meet greater demand (10-K, 2014.)

IBISWorld states the outlook for rail industry is positive in the long term, and railroads have a competitive advantage over other methods for large distance freight because it is cost effective. The barriers to entry in the rail industry are high with a steady trend due to the huge amount of capital investment required. IBISWorld predicts that rail industry revenue will grow at an average annual rate of 3.4% to 94.0 billion from 2014 to 2019. The rail transportation industry's life cycle is in a growth phase and will grow at an annualized rate of 5.2% through 2019 (Rivera, Edward. 2014.)

Negatives

On the negative side, energy markets will continue to be volatile. Lower fuel prices can be a negative because of reduced competitive advantage of rail over trucking. Truck transportation's flexibility in routes will be increasingly attractive to customers if fuel prices continue to drop. Another negative is that major railroads have already reduced oil train speeds to no more than 40 mph in "high threat" urban areas in accordance with Transportation Secretary Anthony Foxx's regulation last year. The Department of Transportation recently announced an emergency order requiring trains hauling oil and other flammable liquids to slow down when passing through highly populated areas and announced other measures to improve rail safety. As a result, UNP will spend more time to deliver goods to customers and costs will increase. The regulation will put UNP at a disadvantage compared to truck competitors (Rivera, Edward and DEF, 14A, 2014.)

The rail industry will face big challenges because railroads depend heavily on expensive infrastructure and capacity constraints will limit rapid industry growth. As a result, there is less potential upside compared to more nimble industries (Rivera, Edward. 2014.)

Finally, UNP is dependent on only a few key suppliers of their high-technology locomotives because high barriers of entry due to the capital intensive nature and highly advance technology of the business. If trouble hits the suppliers, such as insolvency or bankruptcy, UNP would see a significant rise in costs and operational difficulties (Rivera, Edward. 2014.)

2. Company Analysis

The Union Pacific Corporation's (UNP) operates on 31,838 miles of track, with 26,009 miles owned by the railroad. UPR covers 23 states in the western two-thirds of the U.S. UNP is a diverse railroad business including agricultural products making up 17% of the Railroad's freight revenue, automotive making up 9% of revenue, chemicals making up 16% of revenue, coal (coal and petroleum coke) accounting for 18% of the freight revenue, industrial products with 20% of total freight revenue and intermodal freight (international and domestic) accounting for 20% of freight revenue. UNP operates in all major fastest-growing population centers from the West Coast to the Gulf Coast ports. UNP connects with Canada's rail systems and Mexican gateways. UNP has about 10,000 customers and delivers products with safe, reliable, fuel-efficient and environmentally friendly trains (10-K, 2014.)

SWOT Analysis

Strengths

IBISWorld states that UNP is first in the U.S. with a market share with 29.6%. UNP is one of the largest railroads in North America. UNP makes significant capital investments to improve infrastructure and network capacity in order to be more efficient and handle volume growth. UNP intend to spend $4.3 billion in 2015 on upgrading infrastructure, replaced and improved existing capital assets like locomotives to more fuel-efficient models and improving the safety of their network with new rails. UNP has made large technology investments, such as $450 million for Positive Train Control (PTC), in order to increase network and terminal capacity (10-K, 2014.)

UNP has repurchased 237 million shares of common stock, worth $11.7 billion since 2007. UNP's stock repurchase indicates UNP's managers believe that UNP's stock has been undervalued. The stock repurchases demonstrate that management is confident in future performance and rewards shareholders with added capital gains because the repurchase program will increase UNP's stock price (10-K, 2014.)

Weakness

West Coast ports shut down in February 2015 because of a labor conflict. The shutdown cost the U.S. economy $1B/day. About 85% of UNP's 47,201 full time employees are from 14 major rail unions. If UNP has trouble negotiating with the unions, it will have a potential strike. As a result, UNP will suffer huge costs which will drag the revenue down. Also, union demands could raise compensation and benefit for 85% of UNP's employees (DEF, 14A, 2014.)

Opportunities

Coal and natural gas growth will offer an opportunity for UNP in the future. IBISWorld forecasts that the coal and natural gas will grow because of improving market conditions from 2015 to 2019. Revenues from coal and natural gas are forecasted to rise at an annualized rate of 3.4% to $118.6 billion from 2015 to 2019. Fuel was 23% of operating expenses in 2014. Lower fuel prices will bring opportunity to UNP. Lower fuel prices will have a positive impact on the economy because consumers will have more discretionary income to spend on various products that UNP transports (Rivera, Edward, 2014).

IBISWorld forecasts a grow the rate of 2.5% to $121.0 billion in Car and Automobile Manufacturing from 2015 to 2019 due to strengthening economic environment with the Consumer Confidence Index (CCI) rising at an annualized rate of 11.1% from 2015 to 2019. The strengthened economic environment will give an opportunity to UNP (Rivera, Edward, 2014.)

Biofuel is a large part of the agriculture business revenue. IBISWorld forecasts biofuel to grow because more ethanol manufacturers will enter the market from 2015 to 2019. Also, the federal government has set a target of 36.0 billion gallons of biofuel, especially ethanol and biodiesel for transportation uses, by 2022 (Rivera, Edward, 2014.) Biofuels continue to be an opportunity for UNP to grow the agriculture segment.

Threats

The agricultural segment is volatile because of the effects of weather, which can reduce crop yield. Also, weather can effect freight operations, such as the severe flooding and washouts in Colorado in 2013. Winter weather is a big challenge because UNP operates though the mountainous west (Rivera, Edward. 2014.)

Truck transportation's flexibility in routes can be more attractive to customers because trucks can provide door to door service. Roads are much more prevalent than train tracks because road infrastructure costs less than railroad infrastructure. Water transportation continues to threaten rail transportations with safe and reliable service. Furthermore, there have been two U.S. and two Canadian's oil train fires this year. UNP will have a potential risk carrying flammable chemical (10-K and DEF, 14A, 2014.)

3. Industry Analysis

IBISWorld states that the rail transportation industry's revenue mainly comes from freight services, 54.1% from bulk and 41.3% from intermodal freight. Passenger service is only a small portion at 2.9%. Coal is the most widely transported commodity, making up 41.0% of freight by weight. The industry mainly carries coal, grain products, intermodal containers and trailers, chemicals, forest products, metals, minerals, automobiles and consumer goods. Amtrak mainly provides passenger services have operated at a loss since the 1970s (Rivera, Edward. 2014.)

The industry's major players are the Burlington Northern Santa Fe Corporation (BNSF), which is second behind UNP with a market share of 28.3%; CSX Corporation is third with market share at 15.6%; Norfolk Southern Corporation (Norfolk) is fourth with a market share of 14.8% and other companies which have much smaller portions of the market such as Grand Trunk Corporation with a 4.4% market share, Soo Line Railroad Company with 2.3% market share, and Kansas City Southern with a 1.7% market share (Rivera, Edward. 2014.)

IBISWorld states that competition within the rail industry is medium. The non-passenger rail freight service mainly competes on price, transit time and reliability. Competition outside the rail industry arises from other transportation industries such as road, ocean and air transportation. However, railroads have a competitive advantage over other methods for large distance freight because it is cost effective (Rivera, Edward. 2014.)

Freight rail has a capital expenditure to revenue ratio of 19%, much larger than the 3% for manufacturing. Class I railroads dominate the industry due to acquisitions of small railroads, and acquisitions will become increasingly common in the future. Even though barriers to entry are high, increasing demand for rail services will attract new entrants (Rivera, Edward. 2014.)

IBISWorld states that rail industry business mainly comes from the U.S. The Southeast accounts for 26.6% of industry revenue, including the port of Southern Louisiana. The west with the largest container ports represents 25.0% of imported goods, including Los Angeles, Long Beach and Oakland. Southeast lines mainly carry lumber, gravel, stone, cement and steel products. The great Lakes region accounts for 18.3% of the rail industry revenue. The Southwest lines mainly carry chemicals and petroleum products. Texas is a major rail sector with 9.2% of the industry total and 5.5% of the national total (Rivera, Edward. 2014.)

The globalization of the industry is at a low level and the trend is increasing. Most of the Class I railroads operate in the U.S. only and 85.7% of industry revenue comes from the U.S. A small portion (7.1%) of the revenue comes from Canada, mainly from the combined Grand Trunk Corporation and Soo Line Railroad Company, both wholly owned subsidiaries of Canadian railroads. The rest (5.4%) of revenue comes from Mexico, with Kansas City Southern, accounting for 48.0% of Mexican revenue (Rivera, Edward. 2014.)

The rail industry has completely recovered from the recession of 2009. By taking advantage of increasing fuel efficiency and a lower carbon footprint, the rail transportation industry's services have increased to meet greater demand for freight transportation. As the economy and labor market improve, consumers will spend more, manufacturing will increase and rail transportation will increase to meet demand. Also, IBISWorld estimates that the U.S. population will increase to 333.4 million by 2019, increasing demand for goods and freight services to ship those goods (Rivera, Edward. 2014.)

Mergers and acquisitions within the rail industry will likely continue to improve concentration of services in the future. Also, offering door to door delivery services will be a global trend in the future (Rivera, Edward. 2014.)

Appendix: Inputs into Valuation Using Multiples

	2009A	2010A	2011A	2012A	2013A	2014A	2015F	2016F	2017F
Stock Price	63.90	92.66	105.94	125.72	168.00	119.13	109.30	119.60	125.41
EPS (basic)	3.76	5.58	6.78	8.33	9.47	5.77	6.39	6.99	7.33
Sales (millions)	14,143.00	16,965.00	19,557.00	20,926.00	21,963.00	23,988.00	26,018.49	27,982.51	29,955.12
Sales Per Share (basic)	28.12	34.05	40.27	44.23	47.41	26.74	29.00	31.19	33.39
P/E	16.99	16.61	15.63	15.09	17.74	20.65	17.12	17.12	17.12
P/S	2.27	2.72	2.63	2.84	3.54	4.46	3.08	3.08	3.08

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