Recommendation: HOLD  
Target Price until (12/31/2016): $94

1. Reasons for the Recommendation

The Rail Transportation Industry (freight) enjoyed favorable economic conditions from 2010-2014. During this time, UNP experienced year-over-year revenue growth that led to year-over-year increases in EPS culminating in 2014 with increases of 7% in volume and 6% in revenue. However, the industry and UNP ran into significant headwinds in 2015. A perfect storm of a strong dollar, low commodity prices, low energy prices, and slowing growth in China led to significant declines in rail industry share prices. Despite UNP experiencing declining year-over-year volumes and revenues in the first three quarters of 2015, the company remains a solid value and well positioned to take advantage of future increases in volume. Therefore, UNP is a strong hold.

UNP has been effective in realigning its resources to adapt to the current economic conditions after ramping up its resources to accommodate the 7% increase in 2014 volume. UNP adjusted to lower 2015 volumes by furloughing approximately 2,700 Train, Engineer, and Yard (TE&Y) employees as well as putting almost 950 locomotives into storage to align resources with lowered demand. These actions, in addition to lower diesel costs, contributed to a record quarterly low 60.3% operating ratio\(^1\) for UNP in Q3 2015 which was also an industry best when compared to the other three U.S. Class I\(^2\) railroads: BNSF (62.9%)\(^3\), CSX (68.3%)\(^4\), and Norfolk Southern (69.7%)\(^5\). Assets are being used effectively and UNP has capability to absorb increased volume on relatively short notice by reactivating furloughed TE&Y employees and bringing locomotives out of storage when economic conditions improve. The ability to quickly react to improving volumes provides significant potential upside for share value.

In addition to realigning the number of TE&Y employees and locomotives to current demand, UNP has other operational efficiencies that are being realized. In Q3 2015, UNP had record train lengths averaging approximately 6,000 feet. However, most of UNP’s rail infrastructure can accommodate lengths up to 7,200 feet and UNP is working to take advantage of the opportunity to extend train lengths. For 2016, UNP plans capital expenditures for 200 new locomotives to further increase the fuel efficiency advantage that rail enjoys over trucking. According to the American Association of Railroads, rail has an approximately four-to-one fuel efficiency per gross ton mile over truck transportation. While UNP had record volume for domestic intermodal freight in Q3 2015, higher diesel prices in the future will make rail an even more attractive alternative to truck transport. Continuing investments in growth capacity, adjustments in resources, and improvements in processes will provide an even better value to freight customers which will translate to increased shareholder value.

UNP continues its policy of returning cash to its shareholders through both dividends and cash repurchases. On February 5, 2015, UNP increased its quarterly dividend to $0.55/share from $0.50/share resulting in an annual dividend yield of approximately 2.5% for its shareholders and maintaining a 31%

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\(^1\) Operating Ratio = Operating Expenses / Operating Revenues
\(^2\) Class I railroads are those with more than approximately $463M in annual revenue ($250M in 1991 dollars adjusted for inflation).
\(^3\) Berkshire Hathaway Q3 10-Q
\(^4\) CSX Q3 10-Q
\(^5\) Norfolk Southern Q3 10-Q
dividend payout ratio. Shareholder value has also increased through UNP’s stock repurchase program. The most recent repurchase plan was approved by the Board of Directors effective January 1, 2014 for the repurchase of up to 120M common shares through December 31, 2017. In Q3 2015, UNP took advantage of low share prices and repurchased 13.8M shares during the quarter for a total of 28.7M shares repurchased in 2015 with ~59M shares remaining under the current authorization. The repurchase of shares contributed to an increase in EPS from $4.16/share in the first 9 months of 2014 to $4.19/share in the first 9 months of 2015 despite the 7% decline in revenue for the 9-month period-over-period. Overall, UNP returned $4.3B to shareholders in the first 9 months which is a 22% increase over 2014.

Economic conditions in 2015 have not been favorable for the freight transportation industry as a whole, and UNP has seen significant decreases in volume and revenue. The most significant period-over-period decline for the nine months ending September 30, 2015 for UNP was coal revenue which was down 18%. Lower demand for metallurgical coal from China drove the decline from an international perspective. Low natural gas prices drove utility companies to switch from coal to natural gas with coal’s share of electricity generation falling from 38% in Q3 2014 to 35% in Q3 2015. With natural gas futures remaining at multi-year lows and coal inventories 20 days above the five-year average, there is not much volume improvement forecasted for coal in the near future. Low oil prices have led to less drilling which, in turn, resulted in less demand for steel for drill rigs and less demand for frac sand. Until oil prices rise to encourage increased drilling, commodity prices improve, and the dollar weakens, movement of industrial products (down 16%) will not increase. Grains have been under pressure from the stronger dollar and increased foreign supply has put downward pressure on agricultural freight volume and revenue (down 4%). With low prices, farmers have put off planting and demanded less fertilizer which contributed to lower chemical movement. Low oil prices also contributed to the decline in chemical revenue (down 6%). Although economic conditions have produced disappointing 2015 numbers when compared to 2014, revenues for 2015 (projected for the full year) are higher than 2013, with the exception of coal.

Despite the challenging economic headwinds, UNP continues to improve its operating efficiencies and reinforce its position as an industry leader. It is well positioned to accommodate increases in volume and continues to return cash to shareholders through buy backs and dividends. Although UNP may not produce revenue gains in the short-term, its longer term outlook is strong and UNP will provide value to shareholders through dividends and increased share prices as it performs vital freight services to preserve our country’s economic and national security.

2. Company Analysis

UNP is a Class I railroad serving over 10,000 customers and operates on approximately 32,000 miles of tracks in 23 states across the Western two-thirds of the U.S. Their operations link the ports on the West and Gulf Coasts, the heartland, and all six ports of entry with Mexico (UNP is the only rail company servicing all six ports of entry). UNP has access to almost 90% of the North American population through its own operations and its industry partnerships. Through its wholly owned subsidiary,
Streamline, UNP can pick up and deliver freight from locations without direct rail service. In 2014, UNP was the industry leader with 29.50% share of the U.S. rail freight revenue.\(^6\)

UNP has only one reportable segment due to its integrated operations and the difficulty of segregating costs. However, UNP does break the segment down into six commodity groups to report revenues, volumes, and average revenues by carload. The commodity groups (automotive, agricultural products, chemical, coal, industrial products, and intermodal) provide a diverse commodity mix that generally contributes to stable top-line revenues.

UNP’s diverse commodity groups offer opportunities to generate stable revenue growth. Over the past five years, the individual commodity groups have experienced varying degrees of year-over-year growth and/or decline. Yet, UNP has been able to generate overall revenue growth through a mixture of volume growth and core pricing gains. For example, in 2012 and 2013 year-over-year total volume decreased slightly but total revenues increased due to pricing gains in average revenues per carload (ARC). In other years, varying combinations of pricing gains and volume changes have contributed to the increases in revenue. However, 2015 is a notable exception with five of the six commodity groups experiencing both volume and pricing declines.

UNP experienced year-over-year revenue growth from 2010 through 2014 in conjunction with a recovering domestic and global economy and the associated increased demand for rail freight transportation. During this time, it was able to improve its profitability and efficiency metrics as its revenue grew. UNP increased its operating margin from 18.41% in 2010 to 22.66% in 2014 with the increase being sequential from 2011 to 2014. Net income margin increased sequentially from 16.39% in 2010 to 21.59% in 2014. On the efficiency side, UNP experienced sequential increases in asset turnover from 0.39 times in 2010 to 0.46 times in 2014 and in ROE from 15.65% in 2010 to 24.45% in 2014. ROA increased from 24.69% in 2010 to 28.25% in 2014 while ROC increased from 39.40% in 2010 to 45.59% in 2014. As the company grew in terms of revenue from 2014-2014, it became stronger through improved profitability and efficiency.

Fuel surcharges have provided a significant source of revenue for UNP. In 2007, almost identical anti-trust lawsuits were filed by 20 rail shippers against UNP and four other Class I railroads in the U.S. alleging price fixing by the railroads due to common fuel surcharges for certain rail traffic. The lawsuit has since been joined by 10 other shippers for a total of 30, but one of the Class I Railroads was dropped from the suit. The suit is on hold pending the outcome of the U.S. Supreme Court case, *Tyson Foods v. Bouaphakeo*, scheduled to be heard on November 10, 2015 which could impact the UNP case. In 2011, Oxbow Carbon & Minerals LLC filed a similar complaint against UNP and one other Class I Railroad seeking over $30M in damages. The suit also alleged price-fixing and monopolistic practices in setting fuel surcharges and pricing of certain commodities, including coal and petroleum coke. The parties commenced discovery on March 24, 2015. If the courts find in favor of the complainants, a significant source of flexibility--surcharges providing a partial cost reimbursement pricing mechanism--for revenue generation may no longer be available.

\(^{6}\) IBISWorld
In January 2010, the Federal Railroad Administration (FRA) issued initial rules for the implementation of Positive Train Control (PTC) by the end of 2015. The final regulation came out in August 2014. The purpose of PTC is to avoid accidents due to human and mechanical mistakes such as train-to-train and overspeed accidents, misaligned switch derailments, and unauthorized entry to work zones. UNP estimates that costs will exceed those assumed by the FRA. Through 2014, UNP has invested about $1.6B into the technology and plans an additional $400M in 2015, but it will not be ready by the end of 2015 (other railroads will not meet the deadline either). On September 30, 2015, the House Transportation and Infrastructure Committee’s leadership introduced the Positive Train Control Enforcement Act of 2015 which will extend the deadline to the end of 2018 with a possible extension of an additional two years to 2020. However, if the Act is not passed by December 31, 2015 there could be significant disruptions throughout the network because UNP (and other railroads) will have to embargo trains transporting Toxic Inhalation Hazard cargo and could extend the shutdown to shipments of all freight on those lines. The American Chemistry Council estimates that “nearly $350 billion of annualized economic activity would be suspended” and more than 590,000 employees would need to file for unemployment insurance “as a substantial cost to taxpayers.” With a potential economic impact of that magnitude, it is unlikely that the congress will fail to pass the legislation.

Although UNP is an industry leader, has strong financials, and enjoys efficiency advantages, its business depends on the demand from its customers driven by the overall economic environment which UNP does not control. It is difficult for UNP to generate demand for its services or ensure consistency in demand. To paraphrase UNP’s CFO, Rob Knight, volume is always their friend. The perfect scenario is about 1.5% to 2% volume growth each year and that growth rate is a “railroader’s best friend.” The unprecedented increase of 7% volume growth in 2014 followed by the 5% decline in 2015 causes significant problems for a railroader in maintaining efficiencies. UNP will continue to improve in areas under its control and adapt to the economic environment that it cannot control.

3. Industry Analysis

UNP is part of the Rail Transportation industry that generates its revenue ($84B in 2014), mostly from rail freight services transporting bulk and intermodal shipments (the exception being Amtrak which generates most of its revenues from passengers). Bulk shipments, consisting of large quantities of unpackaged commodity cargo (e.g. oil, grain, or coal), account for 51.8% of revenue and intermodal shipments, containers such as trailers or shipping containers, account for 42.7% of industry revenue. Coal is the most widely transported commodity comprising 38.8% of all rail freight shipped in the U.S. Recently, there has been a global trend towards door-to-door logistics services in addition to rail transport service. Rail companies are now providing total life cycle logistics for shipments to include packaging shipments and forwarding them to their rail pick-up points for rail movement or even by ship/barge, air, or rail.

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8 As of UNP Q3 2015 10-Q.
10 Data from IBISWorld
The nation’s rails provide a network to transport goods between cities and ports in addition to connecting production facilities to distribution centers and consumption destinations. The network provides a land bridge between the West, East, and Gulf Coasts. The container ports in Los Angeles, Long Beach, and Oakland handle an estimated 25% of imported goods, mostly from Asia. Using rail from these California ports to the East Coast can save a week over the 25-day trip through the Panama Canal for container ship freight originating in Asia destined for the East Coast.

Rail transportation has a competitive advantage over other modes of transportation such as trucking and air for transporting large volumes of freight over long distances (UNP defined as 500 miles). When compared to road transportation on the basis of fuel efficiency in 2013, the Association of American Railroads estimated rail transport to be four times more fuel efficient per ton moved per mile and to emit 75% less in greenhouse gases than road transportation.

There are eleven Class I rail companies in North America, seven of which operate in the US. The industry is extremely concentrated with UNP (29.5%), BNSF (28.5%), CSX (15.2%), and Norfolk Southern (14.4%) accounting for 87.6% of the $84B in 2014 industry revenues. The remaining seven Class I companies and approximately 500 Class II and III rail companies have a combined U.S. market share of only 12%. Concentration of market share among the top four carriers signifies the dominance of Class I carriers and the economies of scale from their extensive and efficient operations.

BNSF is UNP’s nearest direct competitor and operates in the western two-thirds of the U.S. serving many of the same locations as UNP. However, BNSF covers 28 states (as opposed to UNP’s 23) and operates in two Canadian provinces. Like UNP, BNSF carries coal, grain, intermodal containers and trailers, chemicals, metals, minerals, timber, vehicles, and consumer goods. Consumer products and industrial products make up almost 60% of BNSF’s revenues. Like UNP, BNSF transports coal from Wyoming’s Powder River Basin accounting for 90% of BNSF’s coal movements. The other U.S. Class I rail companies, CSX and Norfolk Southern, operate mostly east of the Mississippi River in the same commodity groups.

IBISWorld places the Rail Transportation industry in the Growth Cycle with revenues growing faster than the economy and the industry has a positive outlook. According to IBISWorld, the Rail Transportation industry will realize annual revenue gains of 3.0% over the next five years and generate total annual industry revenues of $97.2B in 2020. The Department of Transportation has estimated that demand for rail transportation, based on tonnage moved, will increase 88% over 2002 numbers by 2035. Both cite the improving economy and population growth as the basis of growth in the Rail Transportation industry. Since rail is more fuel efficient and emits less greenhouse emissions than over-the-road transport, rail should benefit from the increased demand for freight movement.

According to IBISWorld, market segments such as agricultural products, coal, and chemicals sensitive to global demand will account for more than 40% of industry revenue, in part due to the land bridge provided by rail from the West Coast to the East Coast that will get Asian products to East Coast customers faster than container ships traveling through the Panama Canal. However, it does not appear that IBISWorld has updated their forecasts with the recent information regarding China’s slowing economy, devaluation of the renminbi, or the decline in the Chinese equity markets.
IBISWorld expects to see larger rail companies continue to expand through acquisitions of smaller regional railroads. In addition to acquiring smaller rail lines, larger companies are expected to increase their capabilities through acquisition of or partnership with companies that can help provide door-to-door services. These companies could be local trucking lines, packing companies, or even barge operators. Any industry that could help facilitate the movement of a customer’s freight via rail will be in play. Despite high barriers to entrance, the forecasted revenue growth and respectable profit margins may bring in new companies that have access to large amounts of capital. IBIS world anticipates the number of rail operators to increase by 1.3% annually through 2020 to a total of 623 companies and the number of industry employees to increase 2.9% annually to total 199,575 rail industry personnel.

Past and expected future capital reinvestment expenditures are a factor in IBISWorld’s projection of increased profit margins to 18.6% by 2020 in the Rail Transportation industry. The industry should realize increased productivity from investments replacing old locomotives with new, more fuel efficient and powerful locomotives, upgrading equipment, and installing new rail. While public spending on road improvements has been stagnant and falling behind making truck transport less efficient, the Rail Transportation industry relies on its own private investments in infrastructure. The industry consistently implements those capital investments on an annual basis and will need to continue investing to meet expanding demand that will result in rail being a more attractive alternative for customers freight transportation needs.
Appendix: Inputs into valuation using multiples

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*Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance*