

22 November 2013 | 19 pages

Railroads
North America | United States

Union Pacific Corp. (UNP)

Free Cash Flow Story at Inflection Point

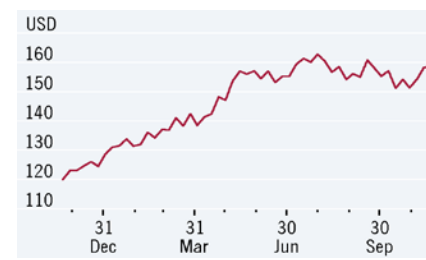
- **Larger Buyback Underpins Our Return Thesis** – Union Pacific's Board authorized a 60 million share repurchase authorization beginning January 1, 2014. The authorization replaces and augments its previous program which will end three months earlier than previously expected. The size of the authorization (60m shares over four years), builds on its previous plan for 40 million shares over three years. Further, the authorization represents 13% of the company's shares outstanding. We are encouraged by the larger buyback, as it supports and sets the stage for our view that Union Pacific is likely to steadily ramp up its annual repurchases from roughly \$1 billion over the last six years to potentially more than \$3 billion over the next four years. We reiterate our Buy rating and expect share price outperformance as this trend of greater shareholder returns becomes more widely appreciated.
- **Program Approaches Our Aggressive Target** - Assuming the company purchases its stock evenly over the four year program it would direct \$2.4 billion annually toward its buyback at its current stock price. This is within range of our target for \$3 billion + over the next several years and we wouldn't be surprised to see the company execute at a pace ahead of a simple average given recent performance.
- **Wrap Up of Old Authorization Early Implies Solid 4Q Pace** - As of September 30, 2013, Union Pacific's previous authorization had 5 million shares remaining. We don't expect the company to completely exhaust the current authorization in 4Q, as 5 million shares totals \$800 million. That said, we believe it's likely the company is trending well above our \$375 million 4Q target, likely in the \$600-\$700 million range, which could yield better EPS accretion than expected, particularly following the company's higher than expected 3Q buyback pace.
- **Reiterate Buy, \$180 Price Target** - We reiterate our Buy rating and \$180 price target, as we believe the recent pace of buybacks and its new larger authorization are signs that the company is transitioning to a focus on shareholder returns. Importantly, the power of higher returns driven by improving cash flow and low financial leverage does not appear to be fully appreciated by the Street allowing for potentially meaningful upside to EPS and P/E multiple.

EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2012A	1.79A	2.10A	2.19A	2.19A	8.28A	8.27A
2013E	2.03A	2.37A	2.48A	2.48E	9.36E	9.37E
Previous	2.03A	2.37A	2.48A	2.48E	9.36E	na
2014E	2.43E	2.68E	2.93E	2.85E	10.90E	10.71E
Previous	2.43E	2.68E	2.93E	2.85E	10.90E	na
2015E	2.76E	3.05E	3.28E	3.21E	12.30E	12.12E
Previous	2.76E	3.05E	3.28E	3.21E	12.30E	na

Source: Company Reports and dataCentral, Citi Research. FC Cons: First Call Consensus.

Buy	1
Price (21 Nov 13)	US\$160.78
Target price	US\$180.00
Expected share price return	12.0%
Expected dividend yield	1.6%
Expected total return	13.6%
Market Cap	US\$74,050M

Price Performance (RIC: UNP.N, BB: UNP US)



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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UNP.N: Fiscal year end 31-Dec						Price: US\$160.78; TP: US\$180.00; Market Cap: US\$74,050m; Recomm: Buy					
Profit & Loss (US\$m)	2011	2012	2013E	2014E	2015E	Valuation ratios	2011	2012	2013E	2014E	2015E
Sales revenue	19,557	20,926	21,912	23,365	24,692	PE (x)	23.9	19.4	17.2	14.8	13.1
Cost of sales	-6,753	-6,948	-7,078	-7,335	-7,558	PB (x)	4.2	3.8	3.3	2.6	2.1
Gross profit	12,804	13,978	14,834	16,030	17,134	EV/EBITDA (x)	11.0	9.5	8.8	7.9	7.2
Gross Margin (%)	65.5	66.8	67.7	68.6	69.4	FCF yield (%)	3.4	3.2	4.0	5.3	6.0
EBITDA (Adj)	7,341	8,505	9,191	10,227	11,124	Dividend yield (%)	1.2	1.5	1.8	2.0	2.3
EBITDA Margin (Adj) (%)	37.5	40.6	41.9	43.8	45.0	Payout ratio (%)	29	30	32	30	31
Depreciation	-1,617	-1,760	-1,775	-1,874	-1,924	ROE (%)	18.1	20.5	20.4	19.6	18.0
Amortisation	0	0	0	0	0	Cashflow (US\$m)					
EBIT (Adj)	5,724	6,745	7,416	8,353	9,200	EBITDA	7,341	8,505	9,191	10,227	11,124
EBIT Margin (Adj) (%)	29.3	32.2	33.8	35.8	37.3	Working capital	-22	-429	-285	53	-39
Net interest	-572	-535	-533	-528	-520	Other	-1,446	-1,915	-2,314	-2,582	-2,811
Associates	0	0	0	0	0	Operating cashflow	5,873	6,161	6,591	7,699	8,274
Non-op/Except	112	108	118	114	117	Capex	-3,176	-3,692	-3,618	-3,799	-3,989
Pre-tax profit	5,264	6,318	7,001	7,939	8,797	Net acq/disposals	0	0	0	0	0
Tax	-1,972	-2,375	-2,639	-2,969	-3,299	Other	57	105	0	0	0
Extraord./Min.Int./Pref.div.	0	0	0	0	0	Investing cashflow	-3,119	-3,587	-3,618	-3,799	-3,989
Reported net profit	3,292	3,943	4,361	4,970	5,498	Dividends paid	-837	-1,146	-1,374	-1,488	-1,671
Net Margin (%)	16.8	18.8	19.9	21.3	22.3	Financing cashflow	-2,623	-2,682	-3,346	-3,488	-3,671
Core NPAT	3,292	3,943	4,361	4,970	5,498	Net change in cash	131	-108	-372	412	614
Per share data						Free cashflow to s/holders	2,697	2,469	2,973	3,900	4,285
Reported EPS (\$)	6.72	8.28	9.36	10.90	12.30						
Core EPS (\$)	6.72	8.28	9.36	10.90	12.30						
DPS (\$)	1.93	2.49	2.96	3.28	3.76						
CFPS (\$)	11.99	12.93	14.14	16.88	18.51						
FCFPS (\$)	5.51	5.18	6.38	8.55	9.59						
BVPS (\$)	38.48	42.21	49.45	61.44	75.12						
Wtd avg ord shares (m)	486	473	464	454	444						
Wtd avg diluted shares (m)	490	476	466	456	447						
Growth rates											
Sales revenue (%)	15.3	7.0	4.7	6.6	5.7						
EBIT (Adj) (%)	14.9	17.8	9.9	12.6	10.1						
Core NPAT (%)	18.4	19.8	10.6	14.0	10.6						
Core EPS (%)	21.4	23.1	13.1	16.4	12.9						
Balance Sheet (US\$m)											
Cash & cash equiv.	1,217	1,063	740	1,153	1,767						
Accounts receivables	1,401	1,331	1,550	1,641	1,732						
Inventory	614	660	654	654	654						
Net fixed & other tangibles	40,194	42,280	46,536	51,448	56,684						
Goodwill & intangibles	0	0	0	0	0						
Financial & other assets	1,670	1,819	1,614	1,522	1,522						
Total assets	45,096	47,153	51,094	56,418	62,358						
Accounts payable	819	825	886	938	990						
Short-term debt	209	196	400	400	400						
Long-term debt	8,697	8,801	8,826	8,326	7,826						
Provisions & other liab	16,793	17,454	18,160	18,962	19,852						
Total liabilities	26,518	27,276	28,272	28,625	29,068						
Shareholders' equity	18,578	19,877	22,822	27,792	33,290						
Minority interests	0	0	0	0	0						
Total equity	18,578	19,877	22,822	27,792	33,290						
Net debt	7,689	7,934	8,486	7,573	6,459						
Net debt to equity (%)	41.4	39.9	37.2	27.3	19.4						

For definitions of the items in this table, please click [here](#).

From Renaissance to Returns

The following is an excerpt from our October 30 note "From Renaissance to Returns"

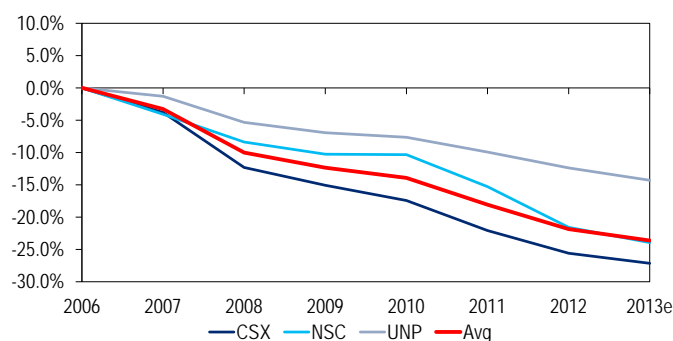
A Look Back at the Importance of Buybacks

While pricing has been the most important driver of the rail renaissance to date, it is hard to ignore the incremental earnings power boost provided by share buybacks over the better part of the last decade. Beginning in 2003, pricing power was realized for the rails and within three years the US rail industry had gained enough confidence in its earnings trajectory and had deleveraged sufficiently to begin share repurchase programs which previously had not existed. While capex has remained elevated as a percent of revenue, cash flow generation has been sufficient to drive solid dividend increases and buybacks in every year since 2006, except 2009. In this note, we more closely examine the history and future potential of cash allocation and shareholder distributions with a focus on the seemingly large divergence between eastern carriers and Union Pacific. A divergence which could see Union Pacific materially enhance shareholder returns through dividends and buybacks, while the eastern carriers may see cash flow more pressured from the decline of coal.

Big 3 Public US Rails Have Spent \$25 billion on Buybacks

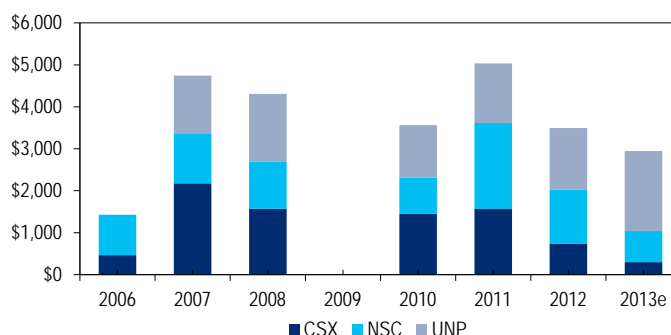
In 2006 rails began to spend incremental cash flow on share repurchases after little/no historical repurchase activity. Since 2006 (through 2013e) CSX, Norfolk Southern and Union Pacific have deployed \$25.45 billion to repurchase shares, with each of the three rails averaging just over \$1.0 billion annually. Over this time, diluted shares outstanding for these companies have declined by 23.6%, with an average annual decline of 3.8%. CSX has led the group with its share count declining by 27.1% in total or 4.4% annually since 2006. Norfolk Southern follows with a 23.9% total share decline and a 3.8% annual rate, while Union Pacific has lagged, with its shares declining 14.3% in total and 2.2% per year since 2006.

Figure 1. US Rail Shares Outstanding Have Decline 14-27% Since 2006



Source: Citi Research

Figure 2. Total Capital Directed to Repurchases Exceeds \$25 Billion



Source: Citi Research, \$ mil.

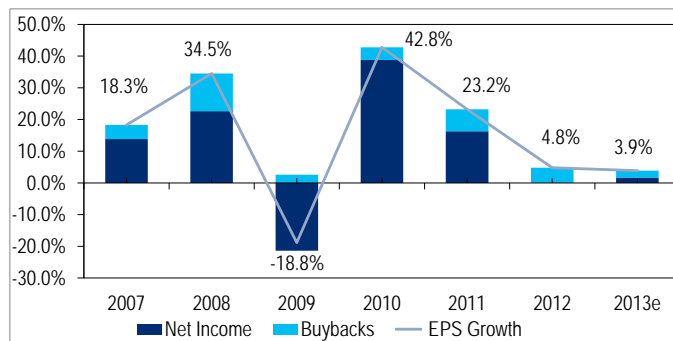
Buybacks Have Added Materially to Rails Earnings Power

Looking at the group's above average annual earnings power of 15.1% over the last seven years, it's interesting to note that approximately 25% of the growth has been driven by accretion from share repurchases. So while pricing power, which has driven margin expansion has been the single most important driver of the industry's robust earnings growth, buybacks have clearly augmented the growth. The eastern rails, in particular, have seen a larger percentage of annual earnings growth come from buybacks than Union Pacific has.

Earnings power at CSX has benefitted the most from buybacks, while Union Pacific has benefitted the least.

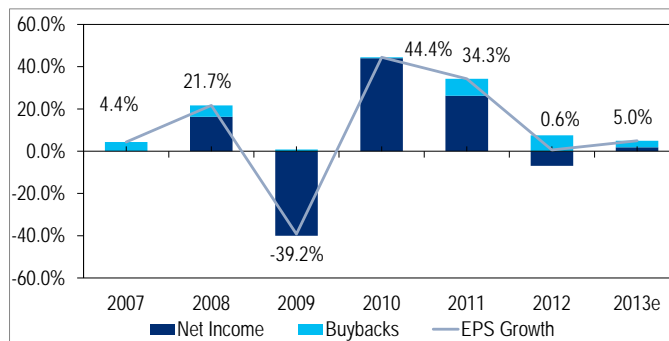
- Since 2007 CSX has posted an impressive 15.5% annual EPS growth, while net income has grown 10.3% per year and the company has averaged a 4.4% annual buyback.
- Norfolk Southern has posted a 10.2% annual EPS growth, while net income has grown 5.9% per year and the company has averaged a 3.8% annual buyback.
- Finally, Union Pacific has posted a stellar 19.9% annual EPS growth, while net income has grown 17.3% per year and the company has averaged a 2.2% annual buyback.

Figure 3. CSX EPS Growth Has Averaged 15.5%, with 4.4% Buybacks



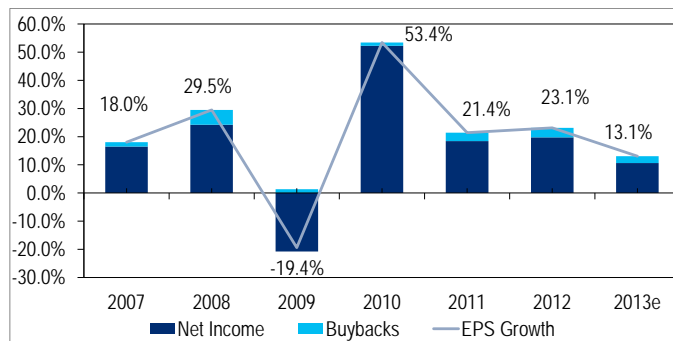
Source: Citi Research

Figure 4. NSC EPS Growth Has Averaged 10.2%, with 3.8% Buybacks



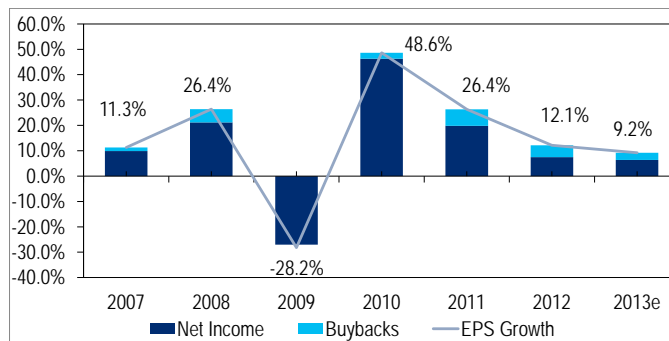
Source: Citi Research

Figure 5. UNP EPS Growth Has Averaged 19.9%, with 2.2% Buybacks



Source: Citi Research

Figure 6. Group EPS Growth Has Averaged 15.1%, with 3.8% Buybacks



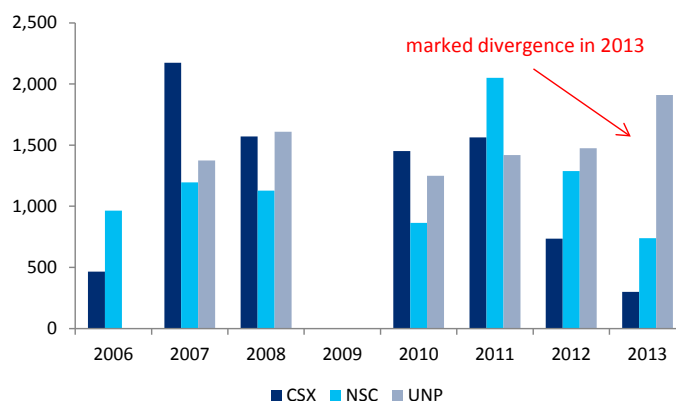
Source: Citi Research

Recent Trends Suggest Divergence in 2013 and Beyond

As the charts above highlight, CSX and Norfolk Southern have generated a material amount of 2012 and 2013 EPS growth from share repurchase accretion, as core net income growth has been pressured by declining coal revenues. We actually believe both companies have done a very good job of maintaining margins and earnings in the face of a severe coal decline, which has reduced annualized commodity revenue for both carriers by nearly \$1 billion over the last two years. That said, the pace of buybacks has meaningfully decelerated in 2013 as cash flow has been pressured by declining coal revenue. For 2013 CSX has decelerated its pace of buybacks significantly to a Citi estimated \$300 million, partly due to not having a current buyback authorization in place during 1Q13. This level would represent ~30% of its \$1.0 billion seven-year average. Norfolk Southern has also decelerated buybacks to a Citi estimated \$700 million pace in 2013, approximately 70% of its \$1.0 billion seven-year average and below the \$1.7 billion averaged in 2011 and 2012. This is in contrast to Union Pacific, which has underperformed on its relative

buyback over the seven-year historical period, but this year is on pace for a \$1.9 billion repurchase in 2013, nearly 70% above its previous \$1.1 billion seven-year average and above the \$1.4 billion spent on average in 2011 and 2012. Further, given relative margins and free cash flow expectations, we would expect Union Pacific to grow distributions over the next few years.

Figure 7. Buyback Totals Diverge in 2013



Source: Citi Research

A Look Forward to Future Cash Distributions

Looking forward over the next three years, it appears that differences between the rails' cash flow generation and financial leverage will drive a divergence of cash distributions. We believe dividend growth will continue to be the priority for all three rails, with payout ratio targets running in the low-to-mid 30% range. However, post dividends and capex, we believe CSX and Norfolk may need to keep the pace of buybacks well below their \$1.0 billion respective annual run rates. On the other hand, we believe Union Pacific will increase buybacks, potentially to levels well above its \$1.1 billion average annual pace.

Future cash distributions are likely to be driven by the impact of coal on free cash flow and financial leverage

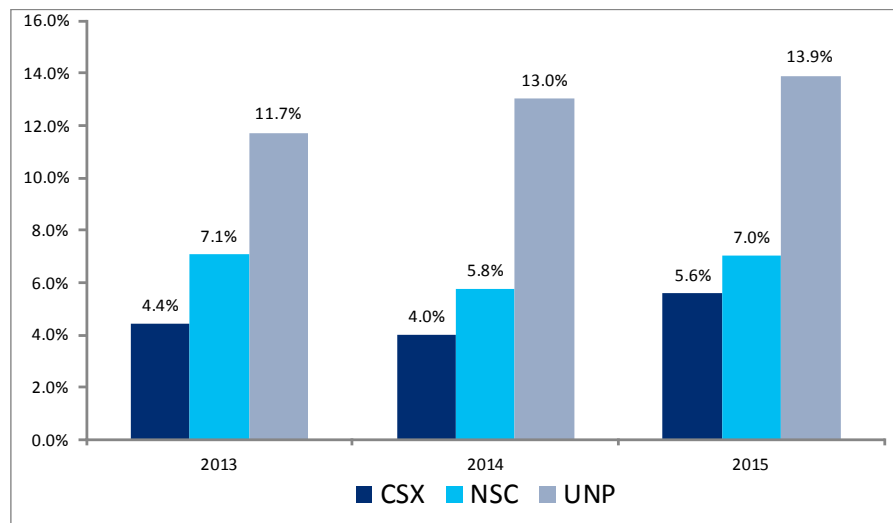
There are several reasons for the expected divergence, but principally, we believe it comes down to two main points: 1) weaker coal volumes could persist and will dampen revenue and net income growth and thus free cash flow, as capex remains within recent ranges (17-19% of revenues), and 2) both CSX and Norfolk Southern have higher financial leverage than Union Pacific, leaving less borrowing flexibility assuming maintenance of investment grade status.

Free Cash Flow Ramps Up for Union Pacific

As [we first highlighted in June](#), Union Pacific appears poised to double free cash flow per share over the next four years from \$4.50 per share to \$9.85 per share, as capex as a percent of revenue decelerates modestly and margins continue to expand. With no material M&A activity likely, we would expect that most of the cash flow generated will be returned to shareholders through dividends and buybacks. Dividends will be the first priority for management in our view and we would expect to see the company maintain a low 30% payout ratio. That said, we expect total free cash flow conversion to accelerate from an already US industry leading position. Looking at free cash flow simplistically defined as net income plus depreciation less capex, we expect the company to grow its free cash conversion (FCF/revenues) from 11.7% in 2013 to 13.9% in 2015. We are forecasting operating cash flow (before changes in working capital) to grow 30% to \$7.4 billion

for Union Pacific from 2012, while its capex is set to grow only 6.7%. The eastern carriers are more challenged to generate free cash flow in our model given further declines in coal volumes, which while offset by growth in non-coal commodities, appears likely to mute potential margin expansion.

Figure 8. FCF Conversion Will Accelerate for UNP, Widening the Gap with CSX and NSC



Source: Citi Research

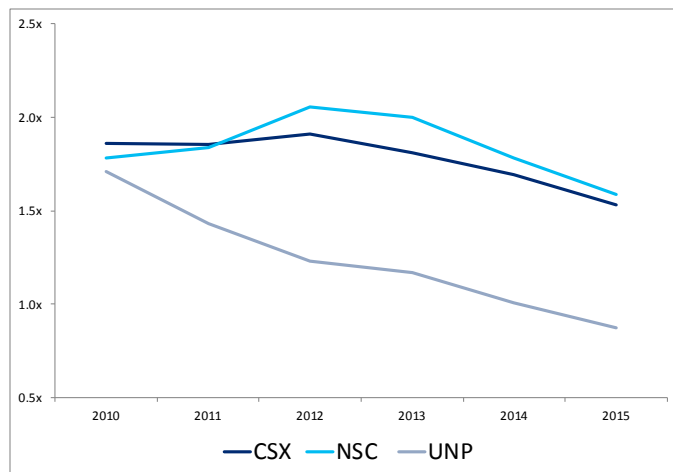
Financial Leverage Should Play a Factor in Distributions

While we are not advocates for blindly leveraging up to pay one time dividends and fund oversized buybacks, we believe responsible management of financial leverage could be a driver of higher shareholder distributions at Union Pacific in the coming years.

We note that in 2010, exiting the recession, leverage metrics among the large U.S. Class I rails were relatively similar with net debt to EBITDA ranging from 1.7-1.9x and adjusted debt to total capitalization from 40-50%. However, as returns for Union Pacific have improved, with its EBITDA set to grow 42% from 2010 to our 2013 forecast, compared to 15% average growth for CSX and Norfolk Southern, Union Pacific has attained an additional potential driver of both earnings and shareholder returns through its ability to tap the debt markets. For 2013 we estimate full year net debt to EBITDA to be 1.2x for Union Pacific, while CSX and Norfolk's leverage is more elevated at 1.8x and 2.0x, respectively. Neither level presents undue concern about over-leverage, but we believe it will keep debt maintenance/de-leveraging as a financial priority, likely limiting future flexibility. We forecast Union Pacific to attain a 0.7x net debt to EBITDA ratio by 2015 and an adjusted debt to total capitalization of only 26%, or 14% lower than its targeted 40%, assuming no further borrowings.

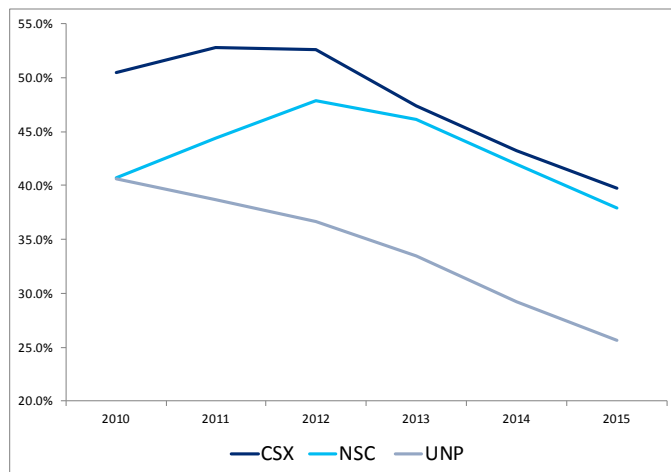
It is important to note, that maintaining an investment grade credit rating is highly important to each of the US rails and as such, we would expect debt maintenance to be consistent with that goal. That said, we believe maintaining leverage of 1.5x-2.0x and debt to capitalization levels up to 50% is in line with investment grade standards for large industrial companies.

Figure 9. Historical and Forward Net Debt to EBITDA



Source: Citi Research

Figure 10. Historical and Forward Adjusted Debt to Total Capital



Source: Citi Research

Combo of FCF and Leverage = Big Potential for UNP

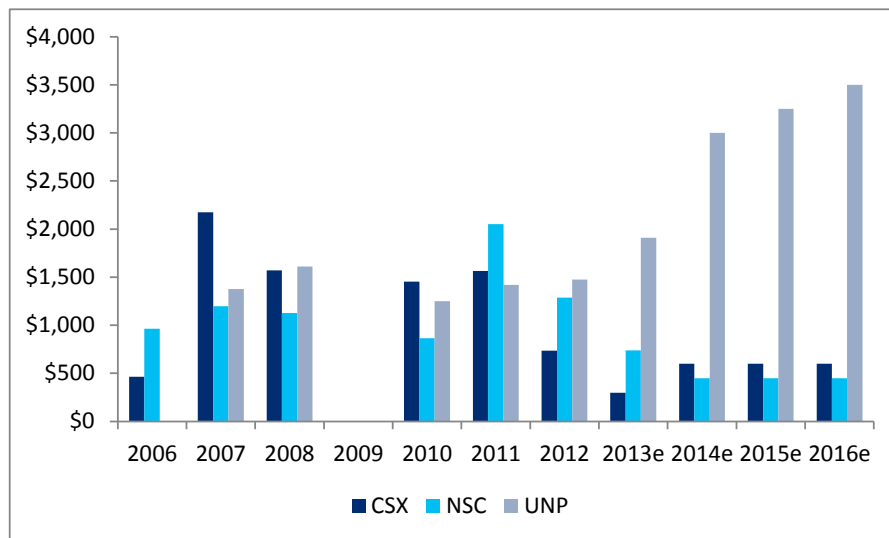
Putting together the company's robust free cash flow profile and its low leverage we believe Union Pacific can fund meaningful cash distributions to shareholders in the coming years. Through the 2014-2016 forecast period, we believe Union Pacific will generate \$10.9 billion of cumulative free cash flow to use towards dividends and buybacks, or 15% of its current equity market capitalization. This compares to \$2.8 billion, or 10% of market cap at CSX and \$3.0 billion, or 12% of market cap at Norfolk Southern. CSX and Norfolk Southern are ahead of Union Pacific in terms of dividends, which we project will consume 72% and 69% of free cash generation in 2014 through 2016, respectively. For Union Pacific, we expect steady dividend increases to consume only 46% of free cash flow. Further, we believe Union Pacific can responsibly increase debt by as much as \$12.5 billion, while still maintaining a solid investment grade standing over the three year period.

What this means for the group, is that while we believe Union Pacific can ramp up buy backs to \$3-4 billion annually without the aid of modest debt, CSX and Norfolk Southern are likely to see buybacks drop toward \$500 million annually.

Collectively, we believe this means after dividends Union Pacific can direct more than \$18 billion of capital, or 26% of its market cap toward share repurchases over the next two years without disturbing its financial stability. For CSX we estimate this post dividend number to be just \$3.8 billion, or 14% of market cap and for Norfolk Southern we estimate the ability to return \$3.5 billion post dividends, or 14% of market cap. What this means for the group, is that while we believe Union Pacific can ramp up buy backs to \$3-4 billion annually with the aid of modest debt, CSX and Norfolk Southern are likely to see buybacks drop toward \$500 million annually.

Inclusive of our dividend estimates, we calculate potential total shareholder returns for the three rails over the next two years to be \$14.4 billion or 20% for Union Pacific, \$2.2 billion or 8% for CSX and \$2.1 billion or 9% for Norfolk Southern.

Figure 11. The Divergence of Buyback Potential is Material in 2014-2016

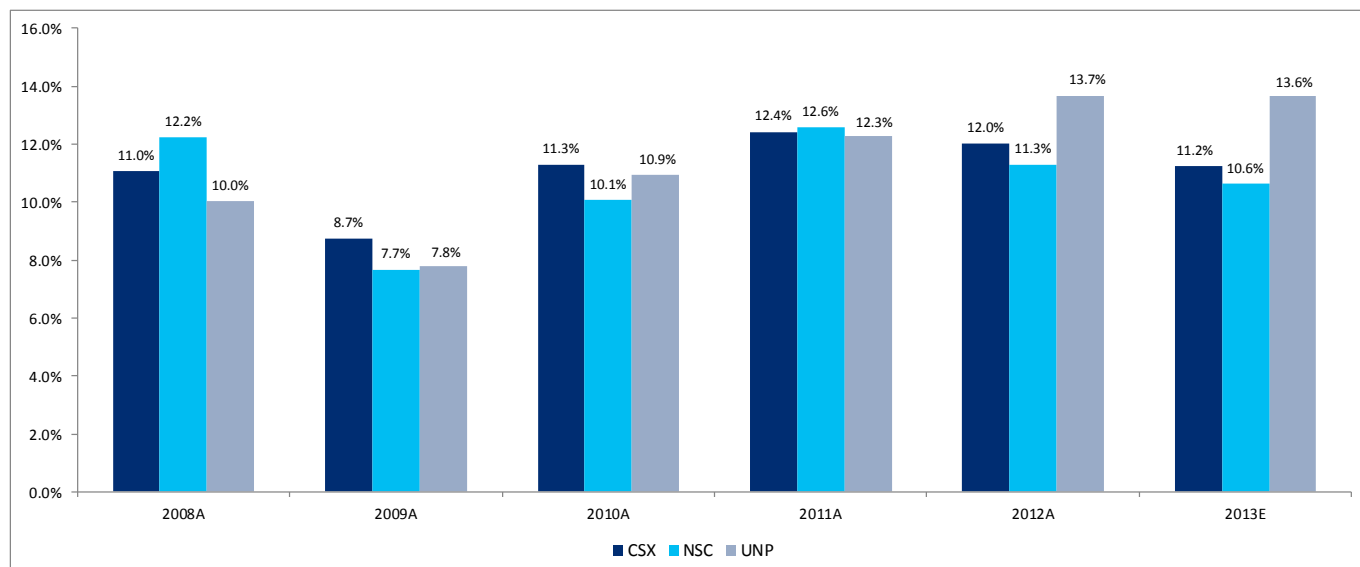


Source: Citi Research, \$ mil.

Multiple Parity Does Not Reflect FCF/Return Divergence

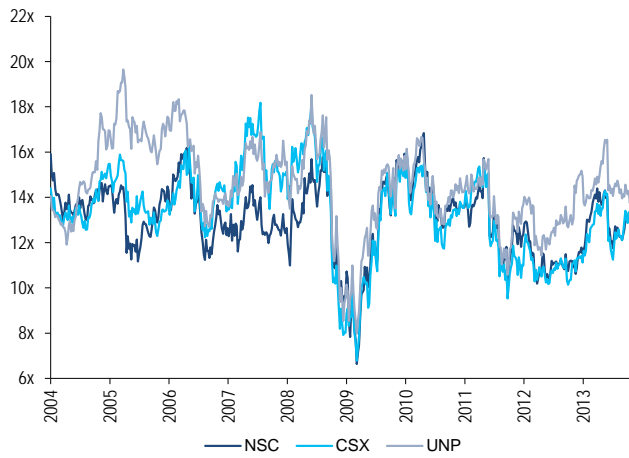
Union Pacific is an outlier within Transportation, as it remains one of the few companies which has not seen material multiple expansion over the course of the last six months. In fact, exiting 3Q13 earnings, Union Pacific is trading in line to slightly lower than CSX and Norfolk Southern on a forward multiple basis for only the fourth time in 10 years. On a FCF/share basis, Union Pacific is trading at a steep 4x multiple discount. While we are not looking for multiple expansion beyond historical bands over the next two years as free cash flow builds, we believe it is possible to see upside toward the high end of historical forward P/E valuation ranges, particularly as Union Pacific's EPS and free cash flow growth profile is captured in its ROIC performance, which remains well ahead of peers.

Figure 12. Union Pacific's ROIC Outperformance Has Been Pronounced in 2012 and 2013



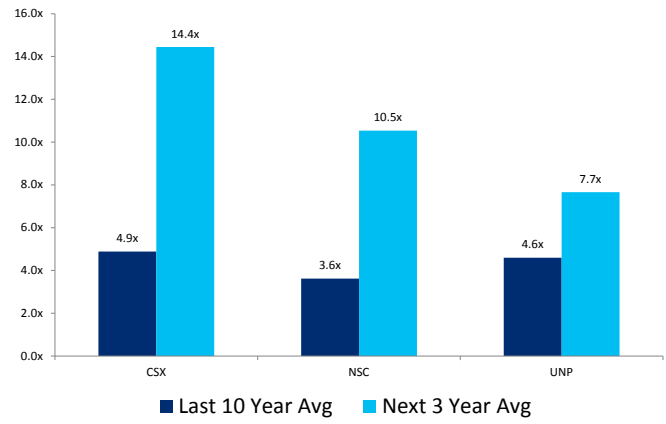
Source: Citi Research; FactSet

Figure 13. Forward US Rail Earnings Multiples Have Converged



Source: Citi Research

Figure 14. UNP is Trading at a Steep Discount on Forward P/FCF



Source: Citi Research

Figure 15. Union Pacific Corp. Earnings Model

	2010A	2011A	2012A	2013E	2014E	2015E	1Q12A	2Q12A	3Q12A	4Q12A	2012A	1Q13A	2Q13A	3Q13A	4Q13E	2013E
OPERATING REVENUES																
Agricultural	3,018	3,324	3,280	3,203	3,470	3,654	858	854	783	785	3,280	784	784	771	864	3,203
Automotive	1,271	1,510	1,807	2,065	2,210	2,321	430	475	436	466	1,807	487	534	512	532	2,065
Chemicals	2,425	2,815	3,238	3,527	3,805	4,115	768	795	841	834	3,238	873	890	883	881	3,527
Coal	3,489	4,084	3,912	4,004	4,118	4,221	995	869	1,058	990	3,912	936	975	1,082	1,011	4,004
Industrial Products	2,639	3,166	3,494	3,784	4,072	4,362	863	917	879	835	3,494	916	977	975	916	3,784
Intermodal	3,227	3,602	3,955	4,058	4,379	4,668	909	1,003	1,022	1,021	3,955	988	993	1,027	1,050	4,058
Total Freight Revenues	16,069	18,508	19,686	20,641	22,054	23,341	4,823	4,913	5,019	4,931	19,686	4,984	5,153	5,250	5,254	20,641
Other Revenues	896	1,049	1,240	1,271	1,311	1,351	289	308	324	319	1,240	306	317	323	325	1,271
Total Operating Revenues	16,965	19,557	20,926	21,912	23,365	24,692	5,112	5,221	5,343	5,250	20,926	5,290	5,470	5,573	5,579	21,912
OPERATING EXPENSES																
Compensation & Benefits	4,314	4,681	4,685	4,772	4,910	5,085	1,211	1,151	1,188	1,135	4,685	1,216	1,185	1,196	1,175	4,772
Fuel	2,486	3,581	3,608	3,543	3,697	3,800	926	882	880	920	3,608	900	863	866	914	3,543
Purchased Services & Materials	1,836	2,005	2,143	2,299	2,359	2,444	526	542	542	533	2,143	557	585	588	569	2,299
Depreciation	1,487	1,617	1,760	1,775	1,874	1,924	427	433	447	453	1,760	434	438	447	456	1,775
Equipment & Other Rents	1,142	1,167	1,197	1,236	1,278	1,314	296	299	300	302	1,197	313	302	309	312	1,236
Other	719	782	788	871	893	925	216	190	200	182	788	237	219	205	210	871
Total Operating Expenses	11,984	13,833	14,181	14,497	15,012	15,493	3,602	3,497	3,557	3,525	14,181	3,657	3,592	3,611	3,637	14,497
Operating Income	4,981	5,724	6,745	7,416	8,353	9,200	1,510	1,724	1,786	1,725	6,745	1,633	1,878	1,962	1,943	7,416
Interest Expense	602	572	535	533	528	520	135	135	137	128	535	128	133	138	134	533
Other Expense (Income)	(54)	(112)	(108)	(118)	(114)	(117)	(16)	(21)	(28)	(43)	(108)	(40)	(23)	(28)	(27)	(118)
Income Before Income Taxes	4,433	5,264	6,318	7,001	7,939	8,797	1,391	1,610	1,677	1,640	6,318	1,545	1,768	1,852	1,836	7,001
Income Taxes	1,653	1,972	2,375	2,639	2,969	3,299	528	608	635	604	2,375	588	662	701	688	2,639
Adjusted Net Income	2,780	3,292	3,943	4,361	4,970	5,498	863	1,002	1,042	1,036	3,943	957	1,106	1,151	1,147	4,361
Extraordinary Charge	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
GAAP Net Income	2,780	3,292	3,943	4,361	4,970	5,498	863	1,002	1,042	1,036	3,943	957	1,106	1,151	1,147	4,361
Adjusted Earnings Per Share (EPS)	5.53	6.72	8.28	9.36	10.90	12.30	1.79	2.10	2.19	2.19	8.28	2.03	2.37	2.48	2.48	9.36
GAAP Earnings Per Share (EPS)	5.53	6.72	8.28	9.36	10.90	12.30	1.79	2.10	2.19	2.19	8.28	2.03	2.37	2.48	2.48	9.36
Fully Diluted Shares	502.3	489.8	476.5	466.1	456.1	446.9	481.4	477.2	475.2	472.0	476.5	470.5	467.6	464.2	461.9	466.1
Dividends Per Share	1.31	1.93	2.49	2.96	3.28	3.76	0.60	0.60	0.60	0.69	2.49	0.69	0.69	0.79	0.79	2.96
EBITDAR																
EBITDAR	7,610	8,508	9,702	10,427	11,505	12,438	2,233	2,456	2,533	2,480	9,702	2,380	2,618	2,718	2,711	10,427
EBITDA	6,468	7,341	8,505	9,191	10,227	11,124	1,937	2,157	2,233	2,178	8,505	2,067	2,316	2,409	2,399	9,191
Operating Ratio	70.6%	70.7%	67.8%	66.2%	64.2%	62.7%	70.5%	67.0%	66.6%	67.1%	67.8%	69.1%	65.7%	64.8%	65.2%	66.2%
EBITDA Margin	38.1%	37.5%	40.6%	41.9%	43.8%	45.0%	37.9%	41.3%	41.8%	41.5%	40.6%	39.1%	42.3%	43.2%	43.0%	41.9%
REVENUE GROWTH																
Freight Revenues	20.2%	15.2%	6.4%	4.9%	6.8%	5.8%	13.5%	6.9%	3.8%	2.1%	6.4%	3.3%	4.9%	4.6%	6.6%	4.9%
Other Revenues	16.4%	17.1%	18.2%	2.5%	3.1%	3.1%	19.4%	17.1%	22.3%	14.3%	18.2%	5.9%	2.9%	-0.3%	1.9%	2.5%
Total Operating Revenues	20.0%	15.3%	7.0%	4.7%	6.6%	5.7%	13.9%	7.5%	4.7%	2.8%	7.0%	3.5%	4.8%	4.3%	6.3%	4.7%
EXPENSE MARGINS																
Compensation & Benefits	25.4%	23.9%	22.4%	21.8%	21.0%	20.6%	23.7%	22.0%	22.2%	21.6%	22.4%	23.0%	21.7%	21.5%	21.1%	21.8%
Fuel	14.7%	18.3%	17.2%	16.2%	15.8%	15.4%	18.1%	16.9%	16.5%	17.5%	17.2%	17.0%	15.8%	15.5%	16.4%	16.2%
Purchased Services & Materials	10.8%	10.3%	10.2%	10.5%	10.1%	9.9%	10.3%	10.4%	10.1%	10.2%	10.2%	10.5%	10.7%	10.6%	10.2%	10.5%
Other	4.2%	4.0%	3.8%	4.0%	3.8%	3.7%	4.2%	3.6%	3.7%	3.5%	3.8%	4.5%	4.0%	3.7%	3.8%	4.0%
Equipment & Other Rents	6.7%	6.0%	5.7%	5.6%	5.5%	5.3%	5.8%	5.7%	5.6%	5.8%	5.7%	5.9%	5.5%	5.5%	5.6%	5.6%
Depreciation & Amortization	8.8%	8.3%	8.4%	8.1%	8.0%	7.8%	8.4%	8.3%	8.4%	8.6%	8.4%	8.2%	8.0%	8.0%	8.2%	8.1%
Total Operating Expenses	70.6%	70.7%	67.8%	66.2%	64.2%	62.7%	70.5%	67.0%	66.6%	67.1%	67.8%	69.1%	65.7%	64.8%	65.2%	66.2%
EPS Growth (YOY)	53.4%	21.4%	23.1%	13.1%	16.4%	12.9%	38.6%	31.7%	18.4%	10.4%	23.1%	13.5%	12.6%	13.1%	13.2%	13.1%
Dividend Payout Ratio	23.7%	28.7%	30.1%	31.6%	30.1%	30.6%	33.5%	28.6%	27.4%	31.4%	30.1%	33.9%	29.2%	31.9%	31.8%	31.6%

Source: Citi Investment Research and Analysis, Company filings

Union Pacific Corp.

Company description

Union Pacific Corporation is a diversified transport company that provides rail freight transportation over a network of approximately 32,100 route miles located in 23 states in the western two-thirds of the U.S.

Investment strategy

We believe Union Pacific is arguably the best total package in the rail sector. The company has a big opportunity from renewing its legacy contracts, which could drive \$1 billion in incremental operating income potentially driving most of the progress to its long-term operating ratio goal. As such we rate the shares Buy.

Valuation

Our \$180 price target is based on a 16.5x multiple of our 2014 EPS estimate, which is above the company's historical average forward P/E multiple of 15.0x.

Risks

For Union Pacific, we highlight the following risks to achieving our price target and earnings forecasts:

- **Economic cyclicality.** The transportation industry is subject to cyclical factors, including economic conditions, customers' business conditions, credit markets, and seasonal patterns, which may adversely affect customer shipping volumes and industry freight demand. Conversely, if the economy is stronger than we anticipate, the shares could exceed our target price.
- **Competitive market.** Freight rates may be subject to significant competitive pricing pressures from other transportation providers, including other modal providers, which may limit growth opportunity and adversely affect operating results. As a result, Union Pacific may not be able to translate its legacy contract renewals into as large a revenue opportunity as we currently forecast.
- **Highly regulated industry.** The railroad industry is subject to various laws and regulations that govern industry-related and environmental activities. Changes or violations of these laws or regulations could adversely affect operations. In addition, Union Pacific could become subject to a shipper rate case, which if lost, may result in a rate reduction potentially impacting revenue and EPS projections.
- **Unionized work force.** Most of Union Pacific's employees are represented by labor unions and are covered by collective bargaining agreements. Inability to negotiate acceptable agreements may result in loss of business and increased operating costs from higher wages or benefits paid to union members.
- **Volatile fuel prices.** Fluctuating fuel prices may adversely affect operating results, as increases in fuel-surge revenue may not offset increases in fuel costs, and increases in freight revenue may not offset reductions in fuel-surge revenue caused by lower fuel prices. Furthermore, because Union Pacific's fuel surcharges operate on a lag, volatility in fuel prices may result in the inability to closely match the timing of fuel expenses to fuel surcharge collection.

CSX Corp.

(CSX.N; US\$27.05; 2)

Valuation

Our \$27 price target is based on a 14x multiple of our 2014 EPS estimate, which is above its historical average forward P/E multiple of 13.2x as we believe operating execution will continue improve, which coupled with core pricing strength should help offset weakness in Coal volumes.

Risks

For CSX, we highlight the following risks to achieving our price target and earnings forecasts:

- **Economic cyclicality.** CSX's volumes are subject to cyclical factors, including economic conditions, customers' business conditions, credit markets, and seasonal patterns, which may adversely affect freight volumes. Conversely, if the economy is stronger than we anticipate, the shares could exceed our target price.
- **Competitive market.** Freight rates may be subject to significant competitive pricing pressures from other transportation providers, including other modal providers, which may limit growth opportunity and adversely affect operating results.
- **Highly regulated industry.** The railroad industry is subject to various laws and regulations that govern industry-related and environmental activities. Changes or violations of these laws or regulations could adversely affect operations.
- **Unionized workforce.** Most of CSX's employees are represented by labor unions and are covered by collective bargaining agreements. Inability to negotiate acceptable agreements may result in loss of business and increased operating costs from higher wages or benefits paid to union members.
- **Volatile fuel prices.** Fluctuating fuel prices may adversely affect operating results, as increases in fuel surcharge revenue may not offset increases in fuel costs, and increases in freight revenue may not offset reductions in fuel-surcharge revenue caused by lower fuel prices. Furthermore, because rail fuel surcharges operate on a lag ranging between two weeks and two months, volatility in fuel prices may result in the inability to closely match the timing of fuel expenses to fuel surcharge collection.

Norfolk Southern Corp.

(NSC.N; US\$86.82; 2)

Valuation

Our \$86 price target is based on a 14x multiple of our 2014 EPS estimate, as the company is doing a better job on the cost/productivity front, aiding modest margin expansion.

Risks

For Norfolk Southern, we highlight the following risks to achieving our price target and earnings forecasts:

- **Economic cyclical.** Norfolk Southern's volumes are subject to cyclical factors, including economic conditions, customers' business conditions, credit markets, and seasonal patterns, which may adversely affect freight volumes. Conversely, if the economy is stronger than we anticipate, the shares could exceed our target price.
- **Competitive market.** Freight rates may be subject to significant competitive pricing pressures from other transportation providers, including other modal providers, which may limit growth opportunity and adversely affect operating results.
- **Highly regulated industry.** The railroad industry is subject to various laws and regulations that govern industry-related and environmental activities. Changes or violations of these laws or regulations could adversely affect operations.
- **Unionized workforce.** Most of Norfolk Southern's employees are represented by labor unions and are covered by collective bargaining agreements. Inability to negotiate acceptable agreements may result in loss of business and increased operating costs from higher wages or benefits paid to union members.
- **Volatile fuel prices.** Fluctuating fuel prices may adversely affect operating results, as increases in fuel surcharge revenue may not offset increases in fuel costs, and increases in freight revenue may not offset reductions in fuel-surcharge revenue caused by lower fuel prices. Furthermore, because Norfolk Southern's fuel surcharges operate on a lag ranging between two weeks and two months, volatility in fuel prices may result in the inability to closely match the timing of fuel expenses to fuel surcharge collection.

Appendix A-1

Analyst Certification

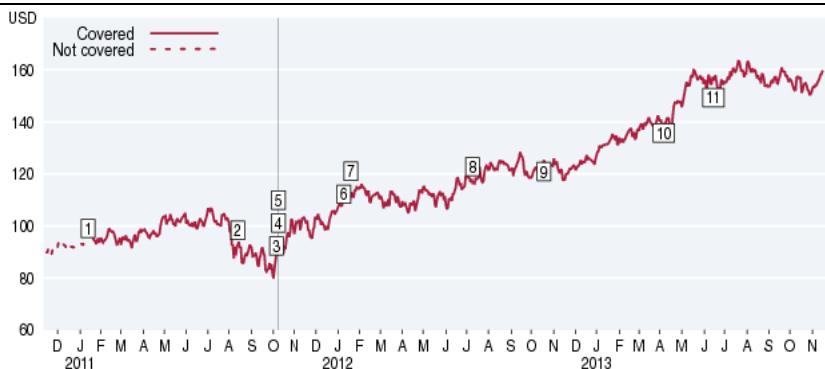
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IMPORTANT DISCLOSURES

Union Pacific Corp. (UNP)

Ratings and Target Price History Fundamental Research

Analyst: Christian Wetherbee
Covered since January 13 2011



	Date	Rating	Target Price	Closing Price
1	13-Jan-11	*1M	*112.00	99.02
2	12-Aug-11	1M	*110.00	92.72
3	6-Oct-11	1M	*108.00	89.53
4	8-Oct-11	Stock rating system changed		

* Indicates change

	Date	Rating	Target Price	Closing Price
5	8-Oct-11	*1	106.00	88.80
6	10-Jan-12	1	*124.00	111.36
7	19-Jan-12	1	*128.00	112.18
8	10-Jul-12	1	*135.00	116.46

	Date	Rating	Target Price	Closing Price
9	18-Oct-12	1	*143.00	125.34
10	5-Apr-13	1	*160.00	138.54
11	14-Jun-13	1	*180.00	157.02

Rating/target price changes above reflect Eastern Standard Time

Union Pacific Corp. (UNP)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Christian Wetherbee
Covered since January 13 2011



	Date	Rating	Target Price	Closing Price
1	9-Dec-11	*ADD MP	-	101.75

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Norfolk Southern Corp. (NSC)

Ratings and Target Price History Fundamental Research

Analyst: Christian Wetherbee
Covered since January 13 2011



	Date	Rating	Target Price	Closing Price
1	13-Jan-11	1M	*76.00	65.68
2	27-Apr-11	1M	*80.00	68.41
3	27-Jul-11	1M	*85.00	76.12
4	12-Aug-11	1M	*81.00	68.17
5	6-Oct-11	1M	*76.00	65.45

* Indicates change

	Date	Rating	Target Price	Closing Price
6	8-Oct-11	Stock rating system changed		
7	8-Oct-11	*1	76.00	64.87
8	10-Jan-12	1	*87.00	77.72
9	25-Jan-12	1	*85.00	75.17
10	21-Sep-12	1	*78.00	65.00

	Date	Rating	Target Price	Closing Price
11	24-Oct-12	*2	*86.00	61.09
12	5-Apr-13	2	*80.00	74.52
13	24-Jul-13	2	*78.00	74.66
14	23-Oct-13	2	*86.00	86.06

Rating/target price changes above reflect Eastern Standard Time

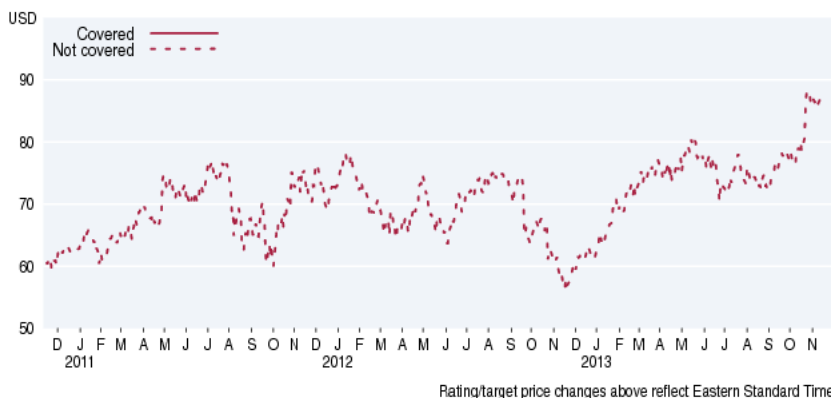
Norfolk Southern Corp. (NSC)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Christian Wetherbee
Covered since January 13 2011



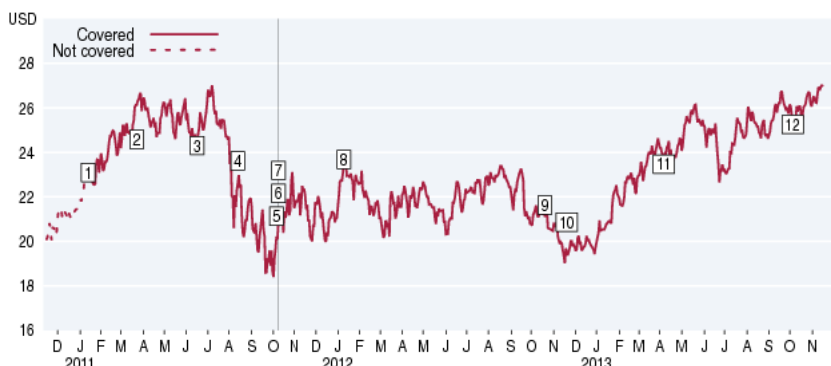
* Indicates change

CSX Corp. (CSX)

Ratings and Target Price History

Fundamental Research

Analyst: Christian Wetherbee
Covered since January 13 2011



	Date	Rating	Target Price	Closing Price
1	13-Jan-11	*1M	*26.67	23.09
2	23-Mar-11	1M	*28.33	26.12
3	16-Jun-11	1M	*28.00	24.30
4	12-Aug-11	1M	*27.00	22.60

* Indicates change

	Date	Rating	Target Price	Closing Price
5	6-Oct-11	1M	*25.00	20.21
6	8-Oct-11	Stock rating system changed		
7	8-Oct-11	*1	25.00	20.09
8	10-Jan-12	1	*27.00	23.53

	Date	Rating	Target Price	Closing Price
9	19-Oct-12	1	*24.00	21.10
10	20-Nov-12	1	*22.00	19.52
11	5-Apr-13	1	*27.00	23.84
12	4-Oct-13	*2	27.00	25.88

Rating/target price changes above reflect Eastern Standard Time

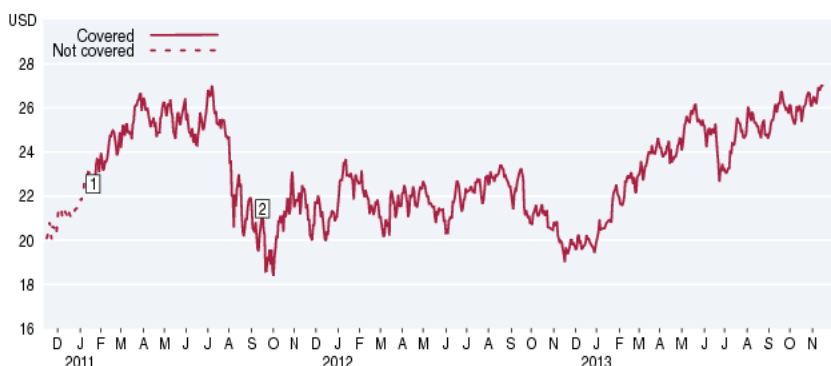
CSX Corp. (CSX)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Christian Wetherbee
Covered since January 13 2011



	Date	Rating	Target Price	Closing Price
1	20-Jan-11	*ADD MP	-	22.58

* Indicates change

	Date	Rating	Target Price	Closing Price
2	16-Sep-11	*REM MP	-	21.43

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Sep 2013

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
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Christian Wetherbee; Seth R Lowry

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