30 October 2013 | 20 pages

Railroads
North America

From Renaissance to Returns

Measuring US Rail Balance Sheet and Free Cash Flow Heft

- **Repurchases Have Been Important to Rail EPS Growth –** Since the North American rail industry realized pricing power in 2003-2004, the primary tenant of the long-rail thesis has been core price increases, which have driven significant margin expansion and EPS growth. That said, cash deployment in terms of stock repurchases have augmented the growth, with the big three public US rails directing $25 billion toward buybacks over the last seven years (buybacks began in 2006), reducing shares outstanding by 23.6% over the period and adding 3.8% of annual EPS growth on average. These distributions have provided roughly one quarter of the 15.1% annual EPS growth for the group, highlighting what an important source of value cash deployment has been.

- **Post Coal Correction BS/CF Strength Gap is Wide** – Over the last seven years, we've seen CSX and Norfolk Southern buyback roughly $1 billion of shares per year. However, over the last year as coal volumes have been especially hard hit in the east and have removed nearly $1 billion of annual revenue from each eastern carrier, CSX and Norfolk's buybacks have decelerated to half of that average pace. Conversely, this year Union Pacific has stepped up its pace by nearly 70% over its long term average, and based on lower financial leverage, a more stable revenue base, higher margins, and higher cash flow, the company appears poised to increase distributions going forward, potentially in a material way. This is in contrast to the potential for CSX and Norfolk to post lower distributions as bonus depreciation expires and cash flow remains muted by coal declines.

- **Union Pacific Stands Out for Future Cash Deployment** – Based on Union Pacific's lower financial leverage and higher free cash flow, we believe the company could reasonably return more than $10 billion of capital to shareholders through buybacks through 2016 (+$3.5b/year vs. $1.1b avg), representing 15% of the company's current market cap for a potential 5% annual return. CSX and Norfolk, on the other hand may return $1.5 billion each ($500m/year vs. $1.0b avg), for 2% respective annual returns. Coupled with higher fundamental earnings growth potential (low-double digit vs, high single digit), we expect relative EPS growth outperformance from Union Pacific in the coming years.

- **Multiples Don't Yet Reflect Gap in Return Potential** – Interestingly, in spite of Union Pacific's significantly more attractive cash flow profile, it trades at near parity on a P/E multiple to its eastern peers. Further, on a FCF basis Union Pacific is trading at a steep 4x multiple point discount. While recent focus has been on pricing commentary, we believe the company's focus on buybacks and dividends in the coming quarters, coupled with a stronger fundamental outlook should work to improve relative valuation. As such, we reiterate our Buy on Union Pacific.

Christian Wetherbee
+1-212-816-9051
christian.wetherbee@citi.com

Seth R Lowry
seth.r.lowry@citi.com

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

From Renaissance to Returns

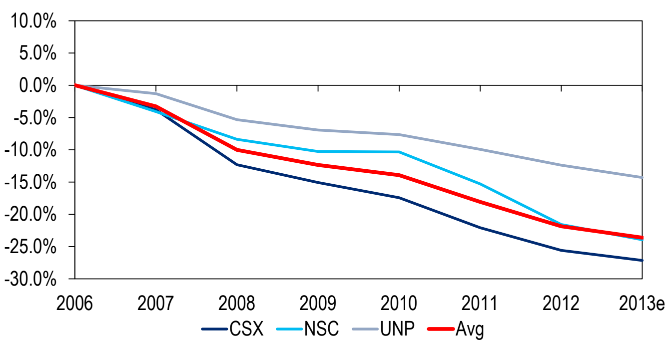
A Look Back at the Importance of Buybacks

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

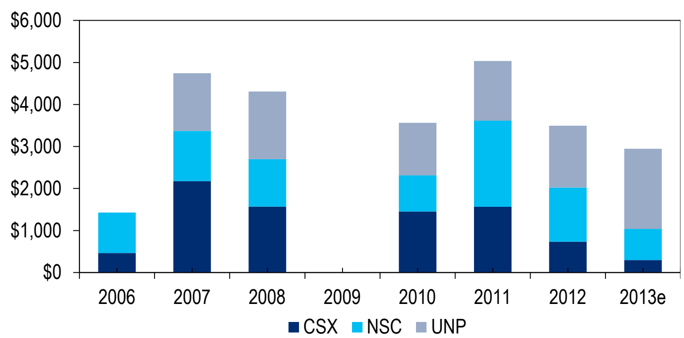
In 2006 rails began to spend incremental cash flow on share repurchases after little/no historical repurchase activity. Since 2006 (through 2013e) CSX, Norfolk Southern and Union Pacific have deployed $25.45 billion to repurchase shares, with each of the three rails averaging just over $1.0 billion annually. 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.

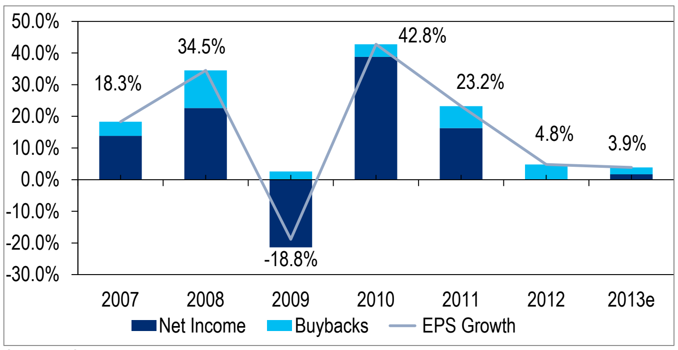
Buybacks Have Added Materially to Rails Earnings Power

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.

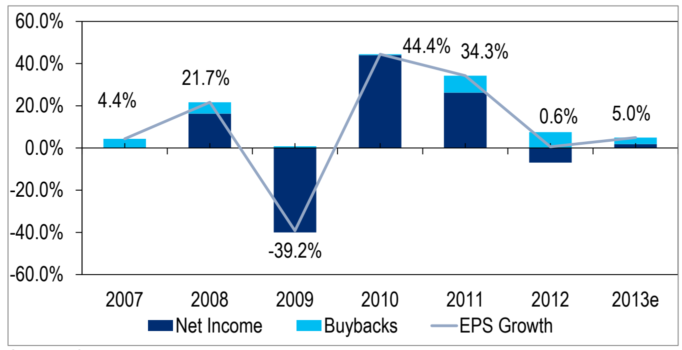
- Since 2007 CSX has posted an impressive 15.5% annual EPS growth, while net income has grown 10.3% per year and the company has averaged a 4.4% annual buyback.
- Norfolk Southern has posted a 10.2% annual EPS growth, while net income has grown 5.9% per year and the company has averaged a 3.8% annual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



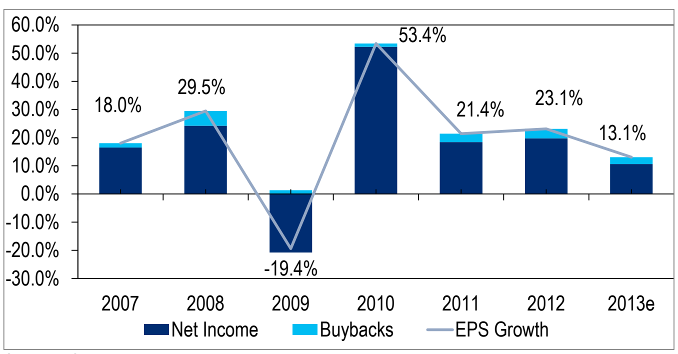
Source: Citi Research

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



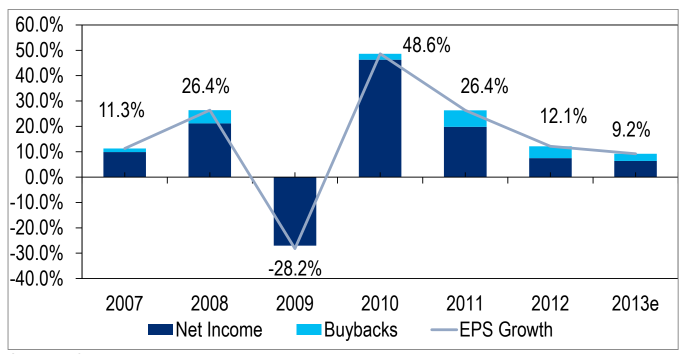
Source: Citi Research

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



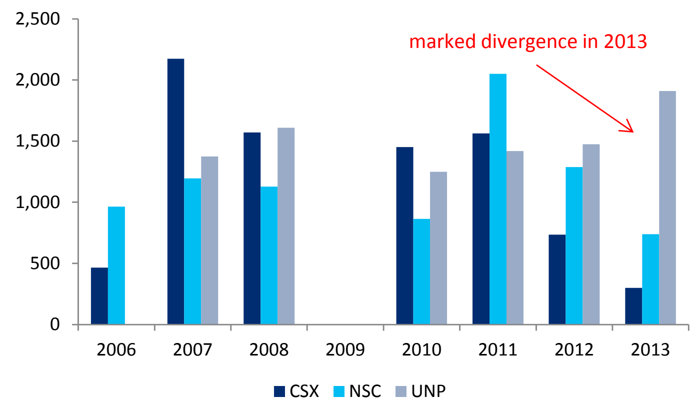
Source: Citi Research

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 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 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

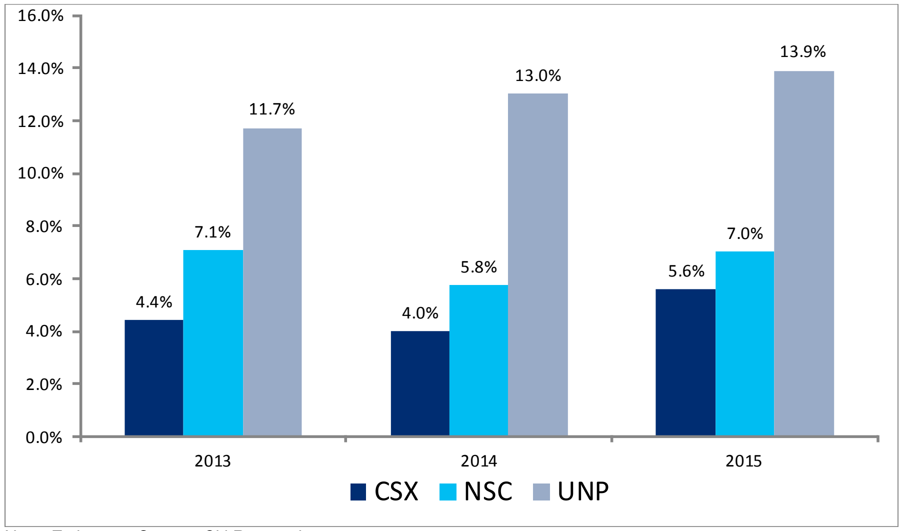
There are several reasons for the expected divergence, but principally, we believe it comes down to two points: 1) weaker coal volumes could persist and will dampen revenue and net income growth and thus free cash flow, as capex remains within recent ranges (17-19% of revenues), and 2) both CSX and Norfolk 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 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 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 Acceleration for UNP, Widening the Gap with CSX and NSC



Note: Estimates; Source: Citi Research

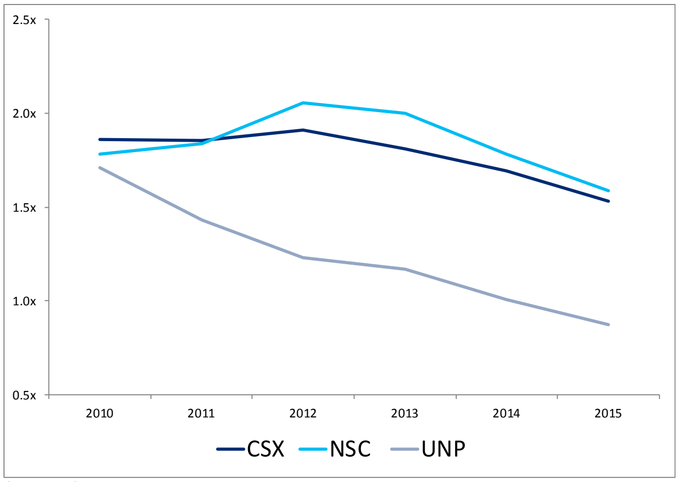
Financial Leverage Should Play a Factor in Distributions

While we are not advocates for blindly levering 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.

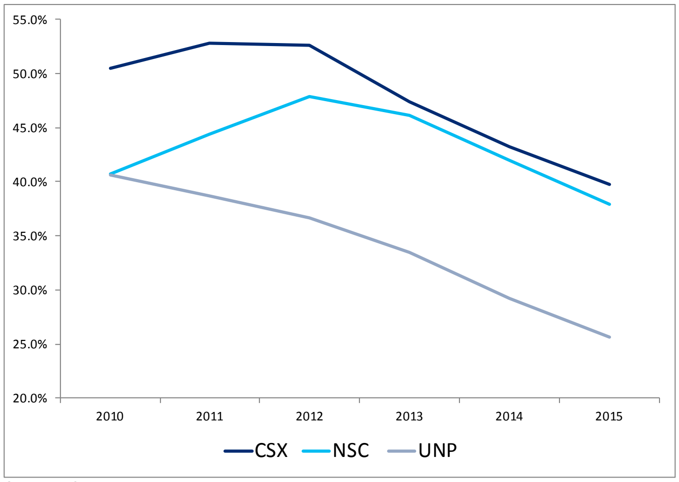
It is important to note, that maintaining an investment grade credit rating is highly important to each of the US rails and as such, we expect debt maintenance to be consistent with that goal. That said, we believe maintaining leverage of 1.5x-2.0x and debt to capitalization levels up to 50% is in line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

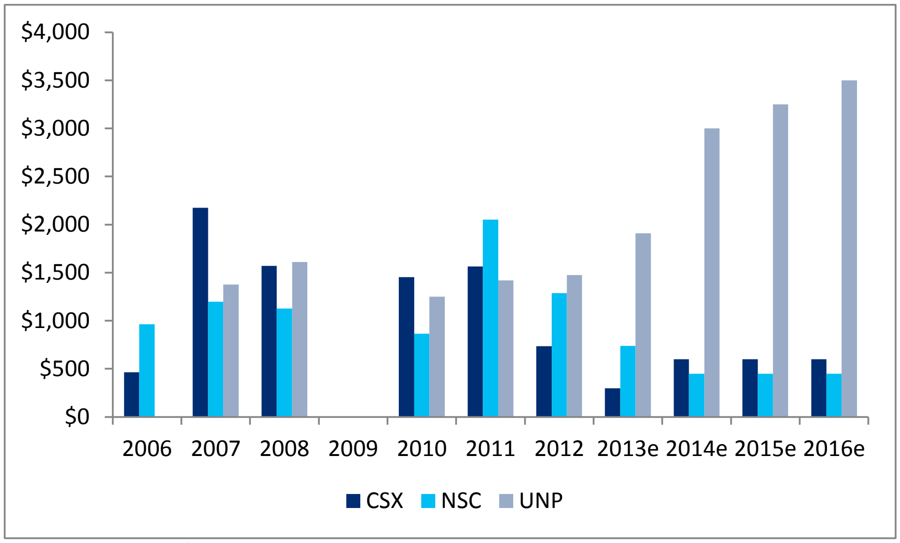
Putting together the company's robust free cash flow profile and its low leverage we believe Union Pacific can fund meaningful cash distributions to shareholders in the coming years. Through the 2014-2016 forecast period, we believe Union Pacific will generate $10.9 billion of cumulative free cash flow 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

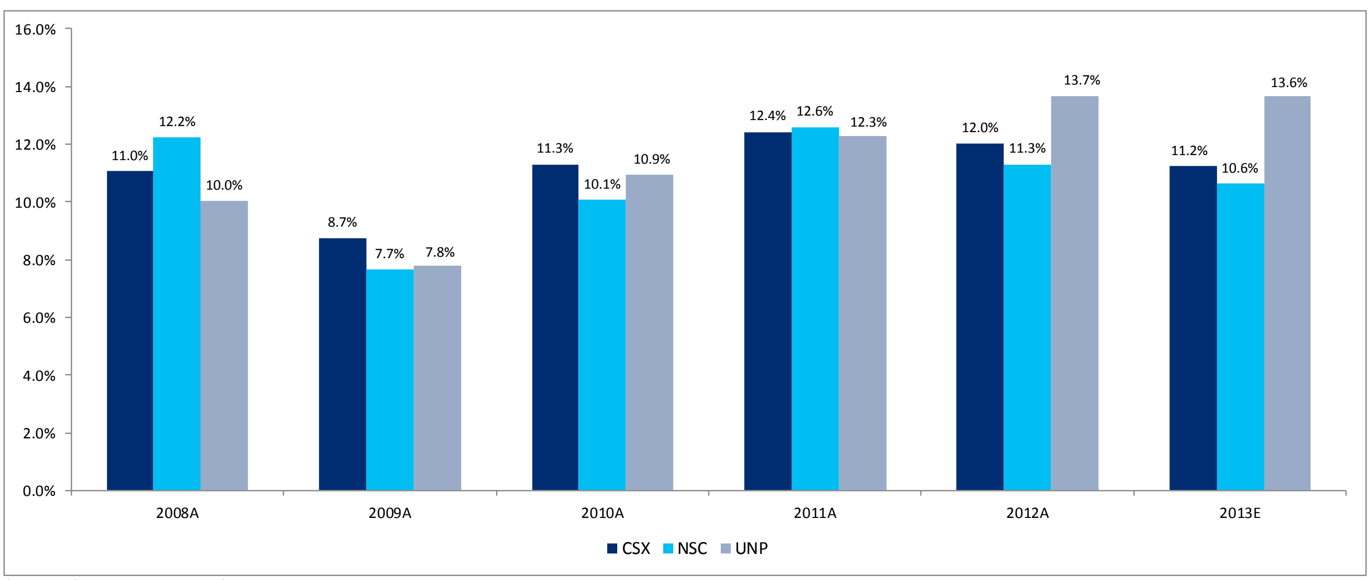


Source: Citi Research, $ mil.

Multiple Parity Does Not Reflect FCF/Return Divergence

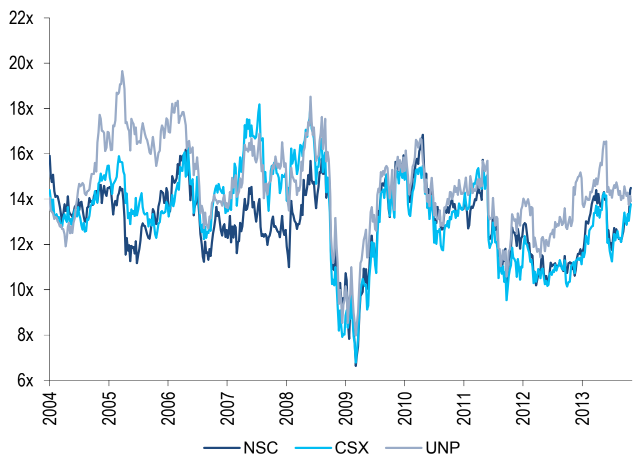
Union Pacific is an outlier within Transportation, as it remains one of the few companies which has not seen material multiple expansion over the course of the last six months. Exiting 3Q13 earnings, Union Pacific is trading in line to slightly lower than CSX and Norfolk Southern on a forward multiple 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



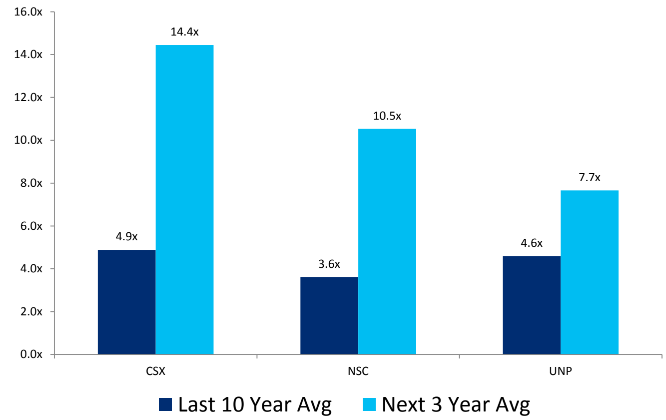
Source: Citi Research; FactSet

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

Earnings Models

Figure 15. CSX Corp. Earnings Model

	2010A	2011A	2012A	2013E	2014E	2015E	1Q12A	2Q12A	3Q12A	4Q12A	2012A	1Q13A	2Q13A	3Q13A	4Q13E	2013E
REVENUES																
Total Merchandise	5,786	6,302	6,656	6,980	7,479	7,998	1,675	1,711	1,609	1,661	6,656	1,717	1,782	1,719	1,762	6,980
Coal, Coke, and Iron Ore	3,267	3,709	3,190	2,879	2,656	2,628	832	820	791	747	3,190	726	770	720	663	2,879
Intermodal	1,295	1,452	1,594	1,690	1,816	2,001	389	408	399	398	1,594	404	425	431	430	1,690
Other	288	280	316	417	362	382	70	73	95	78	316	111	92	129	85	417
Total Surface Transportation	10,636	11,743	11,756	11,966	12,313	13,010	2,966	3,012	2,894	2,884	11,756	2,958	3,069	2,999	2,940	11,966
Eliminations/Other	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Total Revenues	10,636	11,743	11,756	11,966	12,313	13,010	2,966	3,012	2,894	2,884	11,756	2,958	3,069	2,999	2,940	11,966
EXPENSES																
Labor & Fringe	2,957	3,073	3,020	3,119	3,212	3,363	770	744	754	752	3,020	767	777	791	784	3,119
Materials, Supplies, & Other	1,979	2,229	2,156	2,229	2,268	2,355	542	550	525	539	2,156	507	582	576	564	2,229
Fuel	1,212	1,668	1,672	1,644	1,682	1,755	444	410	397	421	1,672	444	397	407	396	1,644
Inland Transportation	63	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Depreciation	948	976	1,059	1,102	1,142	1,189	257	263	268	271	1,059	270	276	277	279	1,102
Equipment & Other Rents	374	379	392	385	388	407	97	102	96	97	392	95	96	94	100	385
Total Operating Expenses	7,533	8,325	8,299	8,479	8,692	9,068	2,110	2,069	2,040	2,080	8,299	2,083	2,128	2,145	2,123	8,479
Operating Income	3,103	3,418	3,457	3,486	3,621	3,941	856	943	854	804	3,457	875	941	854	816	3,486
Interest Expense	557	552	566	559	544	544	144	139	138	145	566	147	140	136	136	559
Other Income, Net	32	22	16	16	27	16	4	5	5	2	16	(3)	9	5	5	16
Earnings Before Income Taxes	2,578	2,888	2,907	2,943	3,104	3,413	716	809	721	661	2,907	725	810	723	685	2,943
Income Tax Expense	1,011	1,066	1,084	1,089	1,164	1,280	267	297	266	254	1,084	266	306	260	258	1,089
Adjusted Net Income	1,567	1,822	1,823	1,854	1,940	2,133	449	512	455	407	1,823	459	504	463	428	1,854
Extraordinary Charge	3	-	(36)	(31)	-	-	-	-	-	(36)	(36)	-	(31)	-	-	(31)
GAAP Net Income	1,564	1,822	1,859	1,885	1,940	2,133	449	512	455	443	1,859	459	535	463	428	1,885
Adjusted Earnings Per Share (EPS)	1.36	1.67	1.75	1.82	1.95	2.20	0.43	0.49	0.44	0.40	1.75	0.45	0.49	0.46	0.42	1.82
GAAP Earnings Per Share (EPS)	1.36	1.67	1.79	1.85	1.95	2.20	0.43	0.49	0.44	0.43	1.79	0.45	0.52	0.46	0.42	1.85
Fully Diluted Shares	1,154.0	1,089.2	1,040.0	1,018.4	997.3	968.8	1,049.0	1,043.0	1,040.0	1,028.0	1,040.0	1,023.0	1,023.0	1,017.5	1,010.0	1,018.4
Dividends Per Share	0.33	0.45	0.54	0.59	0.63	0.67	0.12	0.14	0.14	0.14	0.54	0.14	0.15	0.15	0.15	0.59
Dividend Payout Ratio	24%	27%	30%	32%	32%	30%	28%	29%	32%	32%	30%	31%	29%	33%	35%	32%
EBITDA	4,051	4,394	4,516	4,588	4,763	5,130	1,113	1,206	1,122	1,075	4,516	1,145	1,217	1,131	1,095	4,588
EBITDAR	4,425	4,773	4,908	4,973	5,151	5,537	1,210	1,308	1,218	1,172	4,908	1,240	1,313	1,225	1,195	4,973
CSX Operating Ratio	*70.8%*	*70.9%*	*70.6%*	*70.9%*	*70.6%*	*69.7%*	*71.1%*	*68.7%*	*70.5%*	*72.1%*	*70.6%*	*70.4%*	*69.3%*	*71.5%*	*72.2%*	*70.9%*
Revenue Growth																
Total Merchandise	18.7%	8.9%	5.6%	4.9%	7.2%	6.9%	9.8%	6.1%	2.8%	3.9%	5.6%	2.5%	4.1%	6.8%	6.1%	4.9%
Coal, Coke, and Iron Ore	19.8%	13.5%	-14.0%	-9.8%	-7.7%	-1.1%	-5.3%	-14.4%	-17.3%	-18.4%	-14.0%	-12.7%	-6.1%	-9.0%	-11.3%	-9.8%
Intermodal	7.6%	12.1%	9.8%	6.0%	7.4%	10.2%	17.2%	8.5%	8.1%	6.1%	9.8%	3.9%	4.2%	8.0%	8.1%	6.0%
Other	22.6%	-2.8%	12.9%	32.0%	-13.2%	5.5%	-4.1%	0.0%	31.9%	25.8%	12.9%	58.6%	26.0%	35.8%	9.0%	32.0%
Total Surface Transportation	17.6%	10.4%	0.1%	1.8%	2.9%	5.7%	5.6%	-0.2%	-2.3%	-2.3%	0.1%	-0.3%	1.9%	3.6%	1.9%	1.8%
Revenue Growth	*70.8%*	*70.9%*	*70.6%*	*70.9%*	*70.6%*	*69.7%*	*71.1%*	*68.7%*	*70.5%*	*72.1%*	*70.6%*	*70.4%*	*69.3%*	*71.5%*	*72.2%*	*70.9%*
Operating Expense Growth																
Labor & Fringe	27.8%	26.2%	25.7%	26.1%	26.1%	25.8%	26.0%	24.7%	26.1%	26.1%	25.7%	25.9%	25.3%	26.4%	26.7%	26.1%
Materials, Supplies, & Other	18.6%	19.0%	18.3%	18.6%	18.4%	18.1%	18.3%	18.3%	18.1%	18.7%	18.3%	17.1%	19.0%	19.2%	19.2%	18.6%
Conrail Oper. Fees, Rents & Svcs	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Inland Transportation	0.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Fuel	11.4%	14.2%	14.2%	13.7%	13.7%	13.5%	15.0%	13.6%	13.7%	14.6%	14.2%	15.0%	12.9%	13.6%	13.5%	13.7%
Equipment & Other Rents	3.5%	3.2%	3.3%	3.2%	3.2%	3.1%	3.3%	3.4%	3.3%	3.4%	3.3%	3.2%	3.1%	3.1%	3.4%	3.2%
Depreciation	8.9%	8.3%	9.0%	9.2%	9.3%	9.1%	8.7%	8.7%	9.3%	9.4%	9.0%	9.1%	9.0%	9.2%	9.5%	9.2%
Total Operating Expenses	29.2%	29.1%	29.4%	29.1%	29.4%	30.3%	28.9%	31.3%	29.5%	27.9%	29.4%	29.6%	30.7%	28.5%	27.8%	29.1%
EPS Growth	42.8%	23.2%	4.8%	3.9%	6.9%	13.2%	20.8%	7.6%	1.5%	-8.5%	4.8%	4.8%	0.4%	4.0%	6.9%	3.9%
Dividend Payout Ratio	24.1%	26.7%	30.2%	31.9%	32.4%	30.4%	28.0%	28.5%	32.0%	32.5%	30.2%	31.2%	28.7%	33.0%	35.4%	31.9%

Source: Citi Investment Research and Analysis, Company filings

Figure 16. Norfolk Southern Corp. Earnings Model

	2008A	2009A	2010A	2011A	2012A	2013E	2014E	2015E	1Q12A	2Q12A	3Q12A	4Q12A	2012A	1Q13A	2Q13A	3Q13A	4Q13E	2013E
REVENUES																		
Coal	3,111	2,264	2,719	3,458	2,879	2,530	2,405	2,321	766	755	701	657	2,879	635	626	641	628	2,530
General Merchandise	5,492	4,175	5,001	5,584	5,920	6,251	6,640	7,042	1,496	1,556	1,425	1,443	5,920	1,530	1,588	1,578	1,555	6,251
Intermodal	2,058	1,530	1,796	2,130	2,241	2,384	2,537	2,692	527	563	567	584	2,241	573	588	605	618	2,384
Total Railway Operating Revenues	10,661	7,969	9,516	11,172	11,040	11,165	11,583	12,054	2,789	2,874	2,693	2,684	11,040	2,738	2,802	2,824	2,801	11,165
EXPENSES																		
Compensation & Benefits	2,684	2,401	2,708	2,974	2,960	2,967	3,047	3,182	786	724	724	726	2,960	780	726	735	726	2,967
Purchased Services	1,242	1,087	1,151	1,272	1,321	1,363	1,355	1,374	318	320	333	350	1,321	321	343	349	350	1,363
Equipment Rents	357	316	326	338	283	274	287	292	73	72	70	68	283	72	67	71	64	274
Fuel	1,638	725	1,079	1,589	1,577	1,614	1,668	1,694	413	390	379	395	1,577	429	391	390	404	1,614
Depreciation	804	837	819	862	916	916	947	981	224	229	230	233	916	227	226	230	233	916
Materials	380	309	346	408	408	418	417	425	112	95	109	92	408	101	116	100	101	418
Casualties & Other Claims	167	102	142	158	130	112	124	139	38	30	33	29	130	35	20	23	34	112
Other	292	230	269	300	321	320	348	355	80	80	84	77	321	82	77	77	84	320
Total Operating Expenses	7,564	6,007	6,840	7,901	7,916	7,984	8,193	8,442	2,044	1,940	1,962	1,970	7,916	2,047	1,966	1,975	1,996	7,984
Income from Railway Operations	3,097	1,962	2,676	3,271	3,124	3,181	3,390	3,612	745	934	731	714	3,124	691	836	849	805	3,181
Other Income, Net	110	127	153	160	129	126	116	120	29	31	33	36	129	38	29	30	30	126
Interest Expense on Debt	444	467	462	455	495	517	508	502	120	122	124	129	495	129	128	131	129	517
Income Before Income Taxes	2,763	1,622	2,367	2,976	2,758	2,790	2,998	3,230	654	843	640	621	2,758	600	737	748	706	2,790
Income Taxes - Current	749	250	533	507	642	794	1,118	1,205	156	269	96	121	642	136	203	194	261	794
Income Taxes - Deferred	290	338	346	590	367	215	-	-	88	50	142	87	367	74	69	72	-	215
Total Income Taxes	1,039	588	879	1,097	1,009	1,009	1,118	1,205	244	319	238	208	1,009	210	272	266	261	1,009
Adjusted Net Income	1,724	1,034	1,489	1,879	1,749	1,781	1,880	2,025	410	524	402	413	1,749	389	465	482	445	1,781
Extraordinary Charge	(8)	-	7	37	-	60	-	-	-	-	-	-	-	60	-	-	-	60
GAAP Net Income	1,716	1,034	1,496	1,916	1,749	1,841	1,880	2,025	410	524	402	413	1,749	450	465	482	445	1,841
Adjusted Earnings Per Share (EPS)	4.54	2.76	3.98	5.35	5.38	5.64	6.10	6.70	1.23	1.60	1.25	1.30	5.38	1.22	1.46	1.53	1.43	5.64
GAAP Earnings Per Share (EPS)	4.52	2.76	4.00	5.45	5.38	5.84	6.10	6.70	1.23	1.60	1.25	1.30	5.38	1.41	1.46	1.53	1.43	5.84
Fully Diluted Shares Outstanding	380.0	372.1	371.8	351.4	325.2	315.4	308.2	302.2	332.9	327.5	321.8	318.6	325.2	318.1	317.8	313.9	311.9	315.4
Dividends Per Share	1.22	1.36	1.42	1.66	1.94	2.06	2.17	2.20	0.47	0.47	0.50	0.50	1.94	0.50	0.52	0.52	0.52	2.06
Operating Income (EBIT)	3,097	1,962	2,676	3,271	3,124	3,181	3,390	3,612	745	934	731	714	3,124	691	836	849	805	3,181
EBITDAR	4,258	3,115	3,821	4,471	4,323	4,371	4,624	4,886	1,042	1,235	1,031	1,015	4,323	990	1,129	1,150	1,102	4,371
EBITDA	3,901	2,799	3,495	4,133	4,040	4,097	4,337	4,593	969	1,163	961	947	4,040	918	1,062	1,079	1,038	4,097
Operating Ratio	*71.0%*	*75.4%*	*71.9%*	*70.7%*	*71.7%*	*71.5%*	*70.7%*	*70.0%*	*73.3%*	*67.5%*	*72.9%*	*73.4%*	*71.7%*	*74.8%*	*70.2%*	*69.9%*	*71.3%*	*71.5%*
Revenue Growth																		
Coal	*34.4%*	*-27.2%*	*20.1%*	*27.2%*	*-16.7%*	*-12.1%*	*-4.9%*	*-3.5%*	*-6.1%*	*-15.5%*	*-22.0%*	*-22.7%*	*-16.7%*	*-17.1%*	*-17.1%*	*-8.6%*	*-4.4%*	*-12.1%*
General Merchandise	*5.7%*	*-24.0%*	*19.8%*	*11.7%*	*6.0%*	*5.6%*	*6.2%*	*6.0%*	*13.4%*	*8.6%*	*-1.0%*	*3.6%*	*6.0%*	*2.3%*	*2.1%*	*10.7%*	*7.8%*	*5.6%*
Intermodal	*7.1%*	*-25.7%*	*17.4%*	*18.6%*	*5.2%*	*6.4%*	*6.4%*	*6.1%*	*8.7%*	*4.3%*	*2.9%*	*5.4%*	*5.2%*	*8.7%*	*4.4%*	*6.7%*	*5.8%*	*6.4%*
Total Revenues	*13.0%*	*-25.3%*	*19.4%*	*17.4%*	*-1.2%*	*1.1%*	*3.7%*	*4.1%*	*6.5%*	*0.3%*	*-6.8%*	*-4.0%*	*-1.2%*	*-1.8%*	*-2.5%*	*4.9%*	*4.4%*	*1.1%*
Expense Margins																		
Compensation & Benefits	25.2%	30.1%	28.5%	26.6%	26.8%	26.6%	26.3%	26.4%	28.2%	25.2%	26.9%	27.0%	26.8%	28.5%	25.9%	26.0%	25.9%	26.6%
Purchased Services	11.6%	13.6%	12.1%	11.4%	12.0%	12.2%	11.7%	11.4%	11.4%	11.1%	12.4%	13.0%	12.0%	11.7%	12.2%	12.4%	12.5%	12.2%
Equipment Rents	3.3%	4.0%	3.4%	3.0%	2.6%	2.5%	2.5%	2.4%	2.6%	2.5%	2.6%	2.5%	2.6%	2.6%	2.4%	2.5%	2.3%	2.5%
Fuel	15.4%	9.1%	11.3%	14.2%	14.3%	14.5%	14.4%	14.1%	14.8%	13.6%	14.1%	14.7%	14.3%	15.7%	14.0%	13.8%	14.4%	14.5%
Depreciation	7.5%	10.5%	8.6%	7.7%	8.3%	8.2%	8.2%	8.1%	8.0%	8.0%	8.5%	8.7%	8.3%	8.3%	8.1%	8.1%	8.3%	8.2%
Materials	3.6%	3.9%	3.6%	3.7%	3.7%	3.7%	3.6%	3.5%	4.0%	3.3%	4.0%	3.4%	3.7%	3.7%	4.1%	3.5%	3.6%	3.7%
Casualties & Other Claims	1.6%	1.3%	1.5%	1.4%	1.2%	1.0%	1.1%	1.1%	1.4%	1.0%	1.2%	1.1%	1.2%	1.3%	0.7%	0.8%	1.2%	1.0%
Other	2.7%	2.9%	2.8%	2.7%	2.9%	2.9%	3.0%	2.9%	2.9%	2.8%	3.1%	2.9%	2.9%	3.0%	2.7%	2.7%	3.0%	2.9%
Depreciation	7.5%	10.5%	8.6%	7.7%	8.3%	8.2%	8.2%	8.1%	8.0%	8.0%	8.5%	8.7%	8.3%	8.3%	8.1%	8.1%	8.3%	8.2%
Total Operating Expenses	71.0%	75.4%	71.9%	70.7%	71.7%	71.5%	70.7%	70.0%	73.3%	67.5%	72.9%	73.4%	71.7%	74.8%	70.2%	69.9%	71.3%	71.5%
EPS Growth	21.7%	-39.2%	44.4%	34.3%	0.6%	5.0%	8.1%	9.9%	22.8%	15.7%	-21.3%	-6.4%	0.6%	-0.6%	-8.6%	22.8%	10.0%	5.0%
Payout Ratio	26.9%	49.3%	35.7%	31.0%	36.1%	36.5%	35.6%	32.8%	38.2%	29.4%	40.0%	38.6%	36.1%	40.9%	35.5%	33.9%	36.5%	36.5%

Source: Citi Investment Research and Analysis, Company filings

Figure 17. 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	3,609	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 Frieght 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	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.

(UNP.N; US$150.57; 1)

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-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 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.

Norfolk Southern Corp.

(NSC.N; US$87.99; 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 cyclicality.** 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.

CSX Corp.

(CSX.N; US$26.66; 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.

Appendix A-1

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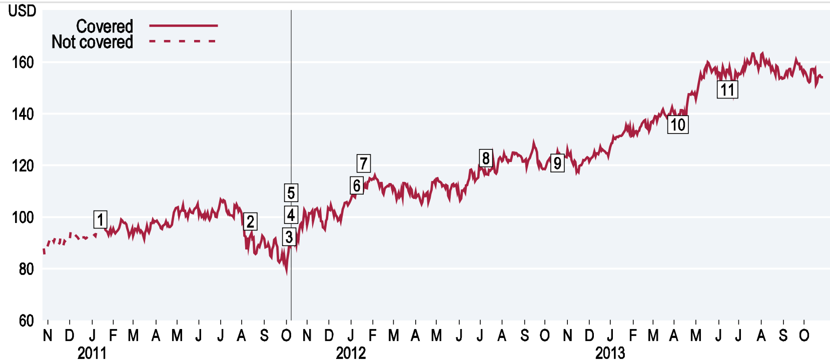
Union Pacific Corp. (UNP)

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	*106.00	89.53
4	8-Oct-11	Stock rating system changed		
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
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

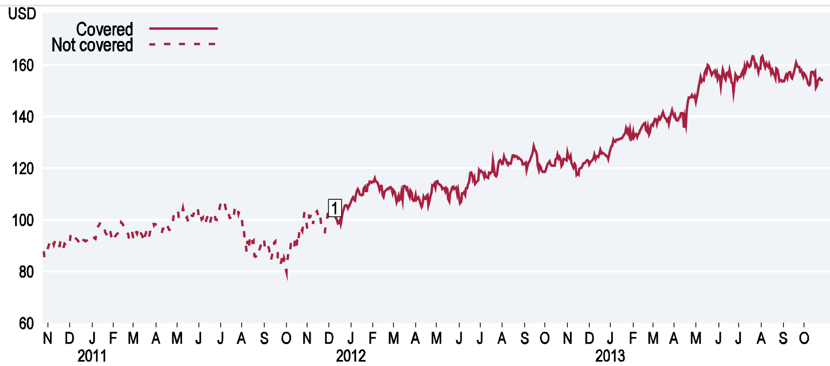
* Indicates change

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

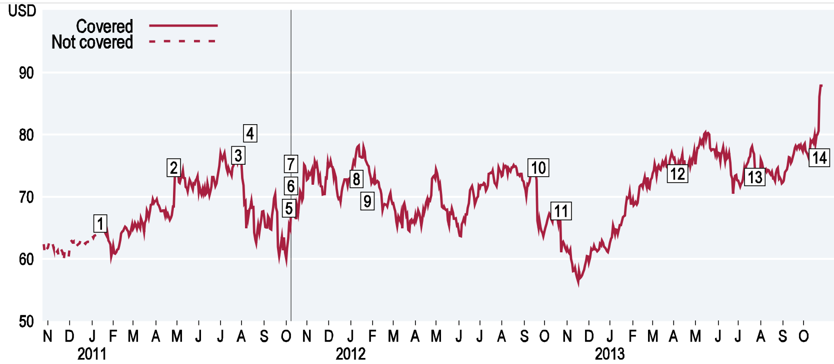
* Indicates change

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
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
11	24-Oct-12	*2	*68.00	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

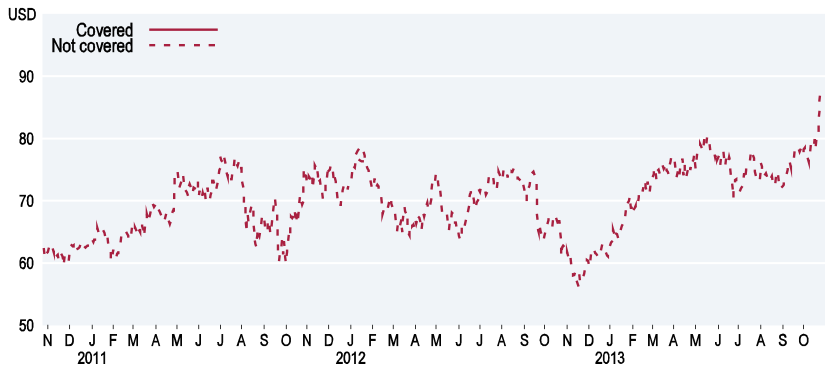
* Indicates change

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



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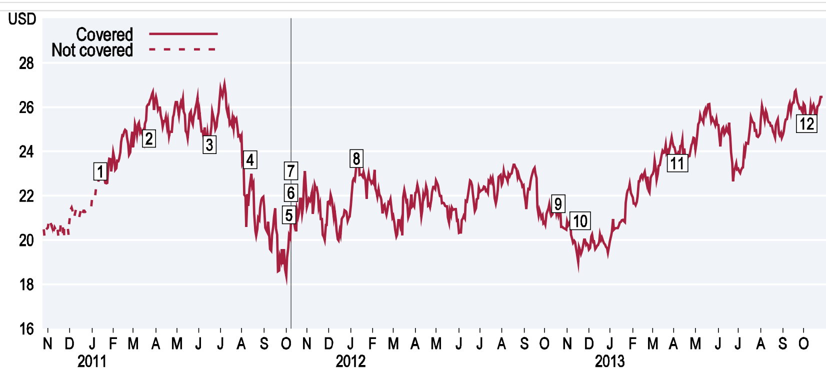
Rating/target price changes above reflect Eastern Standard Time

CSX Corp. (CSX)

Ratings and Target Price History
Fundamental Research

Analyst: Christian Wetherbee
Covered since January 13 2011

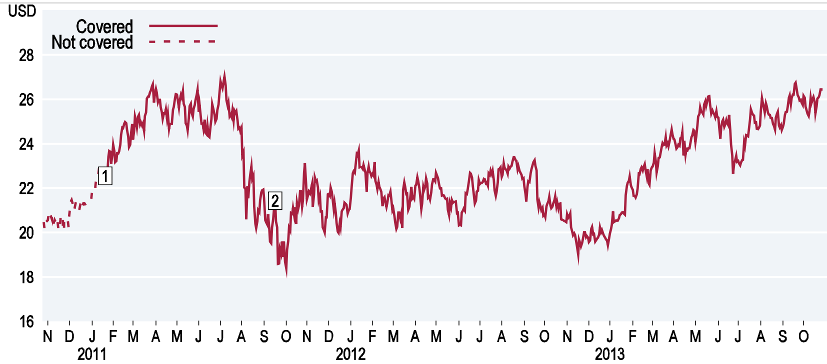


	Date	Rating	Target Price	Closing Price
1	13-Jan-11	*1M	*26.67	23.09
2	23-Mar-11	1M	*28.33	26.12
3	16-Jun-11	1M	*28.00	24.30
4	12-Aug-11	1M	*27.00	22.60
5	6-Oct-11	1M	*25.00	20.21
6	8-Oct-11	Stock rating system changed		
7	8-Oct-11	*1	25.00	20.09
8	10-Jan-12	1	*27.00	23.53
9	19-Oct-12	1	*24.00	21.10
10	20-Nov-12	1	*22.00	19.52
11	5-Apr-13	1	*27.00	23.84
12	4-Oct-13	*2	27.00	25.68

* Indicates change

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
2	16-Sep-11	*REM MP	-	21.43

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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