THE RAILROAD WEEK IN REVIEW

October 22, 2010

“Union Pacific's earnings story is likely to show continued momentum in 2011 with room for upside versus consensus expectations and only modest sensitivity to the economy.” -- Tom Wadewitz, JP Morgan

The Union Pacific third quarter call was a delight. Whether you’re a shareholder or not (*disclosure: I’m not -- yet*), you have to be impressed with a company that can generate $4.4 billion in revenues -- a quarterly record -- and spend only $3.0 billion to do it for an operating ratio of 68.2 -- the lowest in UP’s history and the second consecutive quarter in the sub-seventies. Moreover, the operating ratio for the incremental business (year-over-year ops expense delta over year-over-year revenue delta) was a jaw-dropping 40.3 -- yes, Virginia, that’s forty-dot-three.

The quarter’s record $1.4 billion in operating income was a 46 percent improvement on the 2009 quarter as freight revenues were up 21 percent while the gain in operating expense was held to roughly half that -- 11 percent -- and ops expense ex-fuel inched up a paltry six percent. Below the line, net income jumped 51 percent to $778 million and earnings per share gained 54 percent to $1.56, thanks in part to a one-billion-dollar share buy-back, reducing the diluted share count by two percent.

Total revenue units gained 14 percent to 2.3 million units but still nine percent below the 2007 peak. Units ex-coal and intermodal increased 13 percent to 878 million units. Of the manifest commodity groups, industrial products (“IP”) led with a gain of 20 percent to 282 million units thanks to steel and scrap to support autos and drilling, aggregates (again a huge natural gas play for frack sand) and hazardous waste -- carloads of uranium tailings doubled but, due to the short haul, degraded IP’s average revenue per car down to only (!!) four percent, below the system average six percent. Construction-related commodities continue to lag.

UP is now running in the 180,000 units a week range -- a vast improvement on the low of 140,000 units reached in the 2009 second quarter -- yet still lagging the record 200,000 units achieved about this time in 2007. Chief Commercial Officer Jack Koraleski said during the call, “With no indication of any dramatic change up or down in the economy, our run rate should hold until we see the normal softening as peak season winds down and the end of year approaches.

“Tight truck supply will create opportunities not only in intermodal but our carload business as well. [*Short lines please note and play to. -- rhb*] Our industrial products business commodities have the most upside with the best opportunities in markets that are benefiting from improved auto production, increased drilling activity and hazardous waste disposal.” Also, “Fall demand for fertilizers is expected to be stronger than last year, petroleum should post gains in crude oil shipments to (St. James) and we see increased residual fuel oil moves. It also looks like industrial chemicals and soda ash are going to hold their current run rate so that will close the year stronger than a year ago.” (Transcript quotes courtesy seekingalpha.com)

At the beginning of his presentation Koraleski said, “The strength of our value proposition was reflected in our customer satisfaction scores where we set a new best-ever quarterly mark of 90. Satisfaction actually improved as we moved through the quarter even as volume grew heading into peak season. In September, we scored a 91 setting our new best ever month.”

How fitting. Two weeks ago at NEARS, UP’s Linda Brandl, VP for the National Customer Service Center, was on my Class I “Customer Satisfaction” panel to talk specifically about how UP creates, measures and improves customer satisfaction; to have these “best-ever” numbers now only reinforces the point. And the point short lines need to take away comes from Lance Fritz, EVP Operations.

In his part of the call, he showed how meeting customer requirements in industry spot and pull goes directly to customer satisfaction with UP performance. It is important to note that the UP surveys go directly to and seek feedback from the very folks that see UP crews every day. He concludes, “Quality service is also cost efficient. In the third quarter we leveraged volume through our transportation plant, increasing car loadings faster than crew-starts.” As noted above, volumes grew 14 percent; Lance said crew-starts increased only eight percent.

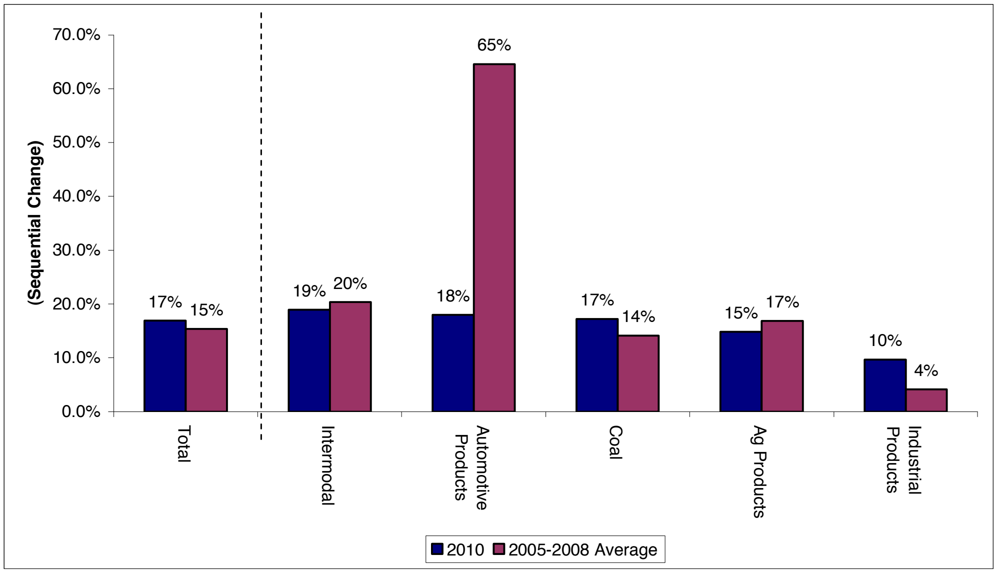
In, conclusion, I think JPM’s Wadewitz says it best: “We expect some of the acceleration in pricing through 2010 to carry into 2011 and we also note that a tight truck market should provide support for rail pricing gains.” And given the strength of UP’s traditional merchandise carload franchise, short lines that connect with UP ought to do well going forward.

A note this week from Chris Ceraso at Credit Suisse says the four-week average year-over-year revenue-unit increase through week 40 was running 12 percent ahead of last year. He then compares fourth quarter to the preceding third quarter in 2010 with the average Q3-Q4 delta for the 2005-2008 period and the result are encouraging. Total 2010 unit counts lead the prior periods 17 percent to 15 percent. The winners are coal (17 percent to 14 percent) and industrial products (10 percent to 4 percent). Somewhat surprisingly 2010 intermodal lags, however slightly (20 percent to 19 percent), and ag products are down (17 percent to 15 percent). The auto spread was the biggest drop of all, to an 18 percent delta from 65 percent in the earlier period. See his chart reproduced on the next page.

Ceraso doesn’t share his thoughts on what happened but I will share mine. As for auto, we had 10 percent more people working and many of them up to their eyeballs in debt for new cars and new everything else. Jack Koraleski said on the UP call they’re looking at an 11-million unit run-rate for new-car production this year (JD Power says 11.5 million but we won’t quibble). That’s against Global Insight’s 2007 US auto production of 10.5 million.

I suspect there are two reasons for the drop. First, the Big Three US car makers depended largely on distant parts suppliers that used box cars to send parts to Detroit. That’s pretty much dried up as the transplants make their own axles and doors in-house or use intermodal. Second, we’re tending toward more Toyota Corollas and fewer Chevy Tahoes. That means more vehicles per auto rack. The September, 2010, *Railway Age* tells us UP is building 90-foot auto rack cars that can be two or three levels, meaning more finished vehicles per rail car and lower auto volume car-counts for the same number of vehicles.

Exhibit 5: QTD Sequential Change by Commodity vs 4-Year Average



Source: AAR

Continuing with the Ceraso note, it looks to me like coal is up because we have more people running air conditioners and movie theaters. Industrial products are up because the rails are flat doing a better job of moving the goods. The share may still stink but there are still people buying consumer staples if not discretionary items, and raw materials for everything from P&G soap to Toyota dashboards are here -- in the chemicals group.

The AAR's latest *Rail Time Indicators* report came out October 11. If you're part of the railroad business you really need to be reading it because it's "a non-technical summary of many of the key economic indicators of potential interest" to railroaders -- particularly shortliners who don't see the analyst notes or the trade press. It's a free PDF and it's easy to get on the e-mail distribution list. E-mail your name and company to Beth Eagney at beagney@aar.org.

For example, you've seen the weekly carload commodity comments here. The source data for the September, 2010, numbers is on page 7. But then the report drills down into weekly data for coal, chemicals, grain, primary metals, waste & scrap and so on. You can see on page 12, for example, that average weekly US+Canada loads of aggregates are about where they were a year ago and still lag 2006-7 by roughly 10,000 units. There remain 17 more pages of goodies. Get it.