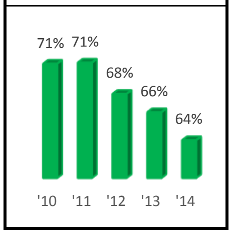
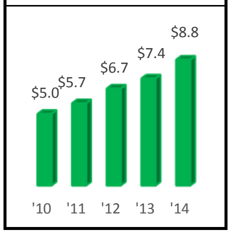
Union Pacific Corporation
June 26, 2015

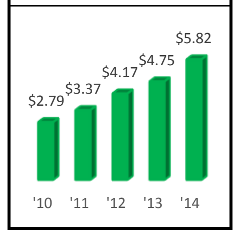
General Overview

Union Pacific Corporation (UNP) is the largest public railroad in the United States and plays a key role in the long-distance transportation of goods in the western two-thirds of the country. The company owns key assets - such as land around premier shipping ports and 31,000 miles of track – that provide a wide economic moat protecting future profits. In the last twelve months the company transported more than 1 trillion gross ton-miles[1] and earned over $5 billion dollars in profit.

Revenue	Operating Ratio	Operating Income	Owner Earnings	EPS
$23,988,000,000	63.5%	$8,753,000,000	$5,242,880,000	$5.82
5-Year CAGR = 9.0%	5-Year CAGR = -2.6%	5-Year CAGR = 15.1%	5-Year CAGR = 17.0%	5-Year CAGR = 20.2%







Purchase Logic

Our purchase of UNP was an excellent investment opportunity in this relatively difficult investment environment. With interest rates at all-time lows and stocks at relatively high prices we continue to proceed with caution. UNP has demonstrated outstanding profitability, tremendous gains in efficiency, and an insurmountable competitive position due to the ownership of critical land assets west of the Mississippi. The company has compounded earnings per share at a rate in excess of 20% for the last 10 years and it is a near certainty that the company will be more profitable 10 years from now. We purchased UNP at a 52-week low and paid roughly 15x earnings for the business – which compares favorably to the average price of an S&P 500 constituent of 18x earnings. The 20% discount relative to other businesses was due to a slight decline of freight volumes year-over-year from 2014 to 2015 (less than 3% decline for the industry as a whole); which is fully expected from time to time. The long-term competitive position, profitability, growth prospects, and tremendous cash flow of UNP remain unaffected by this short-term development.

We believe that UNP provides the correct combination of potential gain and protection of principle. In this low interest rate environment and elevated stock market, UNP pays a 2.3% dividend and repurchases a substantial amount of stock each year, which has contributed to the EPS growth of 20% per year for the last 10 years. The short-term decline in UNP's stock price was an excellent opportunity to purchase one of the best companies in the world.

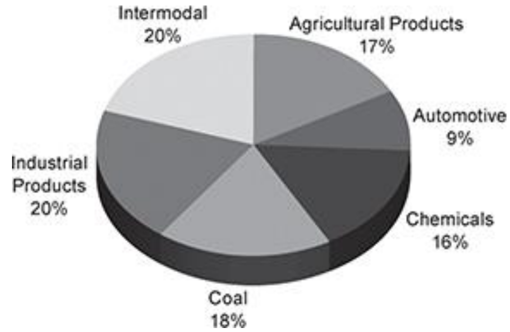
Key Metrics

The key metrics for UNP are revenue, the operating ratio, operating income, owner earnings, and EPS. The business factors that drive these metrics are described in more on the following pages.

[1] Gross Ton-Mile: Moving 2,000 lbs. of weight a distance of one-mile. Gross ton-miles include the weight of loaded and empty freight cars.

Revenue

Revenue is generated by charging customers a certain rate per ton-mile for goods transported. The company moves agricultural products, automobiles, chemicals, coal, industrial products, and intermodal goods. Each type of product category generates different rates per ton-mile – with bulk goods being generally cheaper than intermodal freight. UNP keeps track of the total number of ton-miles that generate revenue through a metric known as revenue ton-miles.[2] Revenue ton-miles and the price per ton-mile determine the overall revenue of the business. The revenue break down by product category is provided below:



Operating Ratio

The operating ratio is a measure of the efficiency of the company. It is calculated by dividing the operating expenses by the operating revenues:

$$Operating\ Ratio = \frac{Operating\ Expenses}{Operating\ Revenue}$$

The lower the operating ratio the more efficient the rail company and the larger the profits for the owners.

Operating Income

Operating income is the total profits before interest and taxes. This metric is important because it is a measure of profitability before financing is consider. Railroads are unique relative to other businesses in that they have very stable revenues due to the ownership of irreplaceable assets, such as land next to dense population centers, and these assets afford UNP strong pricing power. Due to the stability in operating income most railroads operate with slightly more debt than our typical investment, but in this particular industry the moderate debt levels are both intelligent and prudent.

Owner Earnings

Owner earnings is a calculation of the cash flow available to owners after all expenses are paid – including interest and taxes. It is important to carefully consider the depreciation charges for UNP because of the capital intensive nature of the business. The company spends several billion dollars per year maintaining their track networks, transfer stations, and rail cars. The owner earnings represent the cash available for payment of dividends, share repurchases, and business growth after all maintenance capital expenditures have been considered. This metric is the ultimate driver of value for the owners of the business.

[2] Revenue Ton-Mile: Moving 2,000 lbs. of weight a distance of 1 mile and receiving revenue from clients for this service. Empty freight cars do not count as revenue ton-miles.

EPS

UNP has historically utilized approximately 44% of all owner earnings to repurchase shares. Due to the strong repurchase program the share count has declined for the last 10 years and EPS has increased at a rate faster than owner earnings. We fully anticipate UNP to continue the strong repurchase program and for our portion of the business to increase annually with no further investment on our part. By repurchasing shares the company is eliminating the number of business partners and increasing our stake.

Historical Performance of Key Metrics

Year	'10	'11	'12	'13	'14
Total Revenue	$16,965,000,000	$19,557,000,000	$20,926,000,000	$21,963,000,000	$23,988,000,000
Revenue Ton-Miles	520,400,000,000	544,400,000,000	521,100,000,000	514,300,000,000	549,000,000,000
Operating Ratio	70.6%	70.7%	67.8%	66.1%	63.5%
Operating Profit	$4,981,000,000	$5,724,000,000	$6,745,000,000	$7,446,000,000	$8,753,000,000
Owner Earnings	$2,802,560,000	$3,297,280,000	$3,974,400,000	$4,428,800,000	$5,242,880,000
EPS	$2.79	$3.37	$4.17	$4.75	$5.82

Revenue

In the last 5 years UNP has been able to compound revenue at a rate of 9.0% per year with relatively flat revenue ton-miles. The increase in revenue from $16.9 billion to $23.9 billion is largely attributed to the company's ability to increase prices every year. UNP owns key locations around the fastest growing U.S. population centers and many of the major West Coast and Gulf Coast ports. This pricing power is a clear demonstration of the economic moat surrounding UNP's business. We believe the revenue for UNP will fluctuate between -10% to +15% depending on the overall level of economic activity in the United States. We expect an average increase in revenue of 5% per year from a combination of price increases and gains in revenue ton-miles over the next 10 years.

Operating Ratio

The combination of pricing power and increased efficiency has allowed UNP to consistently improve the company's operating ratio for the last 10 years. Just 5-years ago the company had roughly $70 of operating expenses for every $100 of revenue – today the expenses are only $63 per $100 of revenue. We expect the operating ratio to continue to decline as the company transports more revenue ton-miles of freight for customers with less employees and more efficient operations. Despite being unionized it is evident that wages are not increasing proportionally to revenue:

Time Frame	1-Year Ago	3-Years Ago	5-Years Ago	10-Years Ago
Revenue	$23.9 Billion	$20.9 Billion	$16.9 Billion	$13.5 Billion
Salaries	$5.1 Billion	$4.6 Billion	$4.3 Billion	$4.3 Billion
Employees	47,201	45,923	42,884	49,747
Revenue Per Employee	$508,000	$456,000	$396,000	$273,000

Operating Income

Due to increasing efficiency and strong operating leverage the operating income has increased at a rate of 15.1% per year – significantly faster than the 9.0% gains in revenue. Technological advances in locomotives should allow UNP to gain additional efficiencies in fuel savings, and software development for train operations will reduce labor costs as UNP accomplishes more with less. We expect the growth in operating income to continue to outpace the growth in revenue due to these gains in efficiency and UNP's pricing power. We anticipate operating income to fluctuate between -15% and +20% per year with a 10-year average of 9% per year.

Owner Earnings

In the last 5 years owner earnings have increased at a slightly faster rate than owner earnings, 17.0% per year, due to a change in UNP's financial structure. In 2005 the company has $1.8 billion in operating income, $7 billion in debt, and an interest coverage ratio of ~4:1. Today the company has less financial leverage with operating income of $8.7 billion, $11 billion in debt, and an interest coverage ratio of ~15:1. We believe that UNP could borrow significantly more and still be financed in a safe and prudent manner. If borrowings were to increase, owner earnings may grow at a slightly lower rate than operating income, but the borrowings could be allocated to share repurchases and buy back a substantial portion of the business – greatly bolstering EPS. We do not know if UNP will increase financial leverage in the next 10 years and would be content if the company does not, but in the event UNP borrows to repurchase shares it could be very lucrative for the owners of the business. It is our expectation that owner earnings will fluctuate proportional to operating income – with the potential for slight deviations in the event leverage increases.

EPS

In the last 5 years EPS has compounded at a rate of 20.2% - outpacing revenue, operating income, and owner earnings. The incredible growth in EPS is a byproduct of strong operating performance and substantial share repurchases. UNP has allocated roughly 44% of all owner earnings to share repurchases, 21% to dividend payments, and retained 35% for growth. We anticipate UNP to continue similar capital allocation practices in the future, and in turn, EPS should grow faster than revenue, operating income, and owner earnings for the next 10 years. In the event that UNP elects to borrow and repurchase shares the EPS growth will accelerate even more. We expect EPS to fluctuate annually between -12% and +25% with a 10-year average of 11% per year.

Summary of Key Metrics

Metric	Expectations
Revenue	Fluctuating between -10% to 15% per year Average of 5% over 10 years
Operating Ratio	Fluctuating between -15% and 20% Average of 9% over 10 years
Operating Income	Fluctuating between -15% and 20% Average of 9% over 10 years
Owner Earnings	Growth proportional to operating income Additional borrowings would slightly lower owner earnings
EPS	Fluctuating between -12% and 25% per year Average of 11% over 10 years

The Moat Around The Metrics

The economic moat surrounding UNP's competitive position is both deep and wide. The company owns 31,000 miles of track around the United States – much of which was purchased more than 100 years ago. The key assets now owned by UNP were originally acquired on a first come, first serve basis, at the origins of the rail road industry. The infrastructure around key population centers and the world's largest industrial ports is no longer available, and this is a competitive advantage that is nearly impossible to duplicate. The company owns ports around San Francisco, Los Angles, Houston, and New Orleans. These are critical locations for the receipt of shipments from China and imports that travel through the Gulf. In addition to these critical ports UNP also owns transfer stations in Chicago, Seattle, San Antonio, Denver, Minneapolis, Milwaukee, St. Louis, Salt Lake City, Omaha, Reno, Las Vegas, Fresno, and Portland– to name a few. The largest competitor of UNP is Warren Buffet's Burlington Northern Santa Fe, which owns parallel routes at some of UNP's key locations. In the last 10 years these two companies have been steadily increasing prices on their respective routes due to increased demand. It is highly likely that UNP and BNSF will be able to continue to flex their competitive strength by gradually increasing prices over the next 10 years, which will disproportionately increase profitability. We firmly believe the moat surrounding UNP is one of the widest in the world.

Risks

There are many different types of risk associated with investing – both market risk and business risk. Market risk is the risk that the price of a stock will fluctuate in the short-term due movements in the general stock market. This type of risk is unavoidable and as long-term investors we do not worry about market risk. The second type of risk is business risk - or the risk that the business we've purchased will not perform well in the future. As long-term investors this is the risk we attempt to minimize. We believe that if our businesses succeed over long periods of time our investments will prove highly profitable. Below is a list of the short-term and long-term business risks we've assumed as owners of UNP.

Short-Term Risks

In the short-term there are many risks we've assumed as owners of UNP. As a railroad company the revenue generated by UNP will fluctuate based on how the United States economy is performing as a whole. When certain macro-economic factors change it is often difficult to forecast the impact it will have on the rail industry. For example, when oil prices decline the production of oil decreases and shipments of oil using rail declines reducing demand for UNP's services. However, the decrease in oil prices saves consumers money at the gas pump and increases demand for other household items which are imported from China, which increases the demand for UNP's services. It is possible the increase in imports could more than of set the decline in oil revenues for UNP. Typically, these fluctuations in demand are short-term in nature, and over long periods of time the total volume of goods shipped across the United States has increased. We view this type of risk as very low and would ignore decreases in demand that are caused by the typical ebbs and flows of the US economy.

In addition to macro-economic risks, UNP also could face large expenses in the event that one of their rail cars derails and hazardous waste is spilled along transportation routes. This risk is unavoidable, but should be minimized through sound operations. In the event an accident did occur it would cause a large one-time expense for UNP that would likely impact the stock price in the short-term. This risk is best minimized by maintaining the highest quality routes and having a focus on safety. Historically, UNP has had the largest capital expenditure programs in the world to maintain the quality of the track it owns, and, also boast one of the best safety track records in the industry.

Another short-term risk is increased wages due to the highly unionized nature of the railroad industry. The company has ~47,000 employees and 85% of these employees are part of unions that negotiate their wages periodically. It is possible that unfavorable negotiations may occur, or a strike could ensure, both of which would impact profits in the short-term. We do not view this risk as having a material impact on the long-term prospects of the business due to the trends we've seen in the industry for the last 80 years. The rail industry has continued to gain efficiencies from technological advances and is accomplishing far more today with 85% less workers than they did shortly after WWII. Wages and salaries at UNP have been stable for the last 10 years, even as revenue has doubled. We believe the risk posed by unionized workers is limited in this particular industry.

Long-Term Risks

The portfolio of critical land assets owned by UNP is very impressive. We believe that ownership of land around high population areas has allowed UNP to increase prices steadily for the last 10 years. Historically, the rail industry has been heavily regulated and recent deregulation has benefited UNP. In the event that regulators step in with price controls or other obligatory mandates, such as the recently passed Positive Train Controls, profitability would decline. Due to the dominant market position of UNP we view regulatory risk as the largest risk in the long-term. We do not know what regulations may develop in the next 10 years, but believe that the sensational purchase price, strong competitive position, and outstanding profitability of UNP merited assuming this regulatory risk. Overall, we view the risk associated with ownership of UNP to be very low relative to the vast majority of businesses for sale in the United States. We are excited about the future prospects of the company.

Conclusion

UNP is the largest public railroad in the United States and plays a key role in the long-distance transportation of goods in the western two-thirds of the country. The company has one of the widest economic moats of any business in the world stemming from the ownership of key assets - such as land around premier shipping ports and 31,000 miles of track connecting major cities. We purchased UNP at a 52-week low and paid roughly 15x earnings for the business – which compares favorably to the average price of an S&P 500 constituent of 18x earnings. The 20% discount relative to other businesses was due to a slight decline in freight volumes year-over-year from 2014 to 2015. This type of decline from time to time is fully expected in the industry. The key metrics for the business are revenue, the operating ratio, operating income, owner earnings, and EPS. We believe that UNP provides the correct combination of potential gain and protection of principle in this difficult investment environment. In the last 10 years UNP has compounded EPS at a rate of 20% per year through outstanding cost controls and sustainable pricing power. We anticipate UNP to yield approximately 10% per year during our holding period.

Works Cited

1) *UNP Annual Report - SEC Filing 10-K.* EDGAR, 2014.
2) *Industry Analysis – The Transportation Industry: Airlines, Trucking and Railroads.* AIMR Publications, 1992.

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