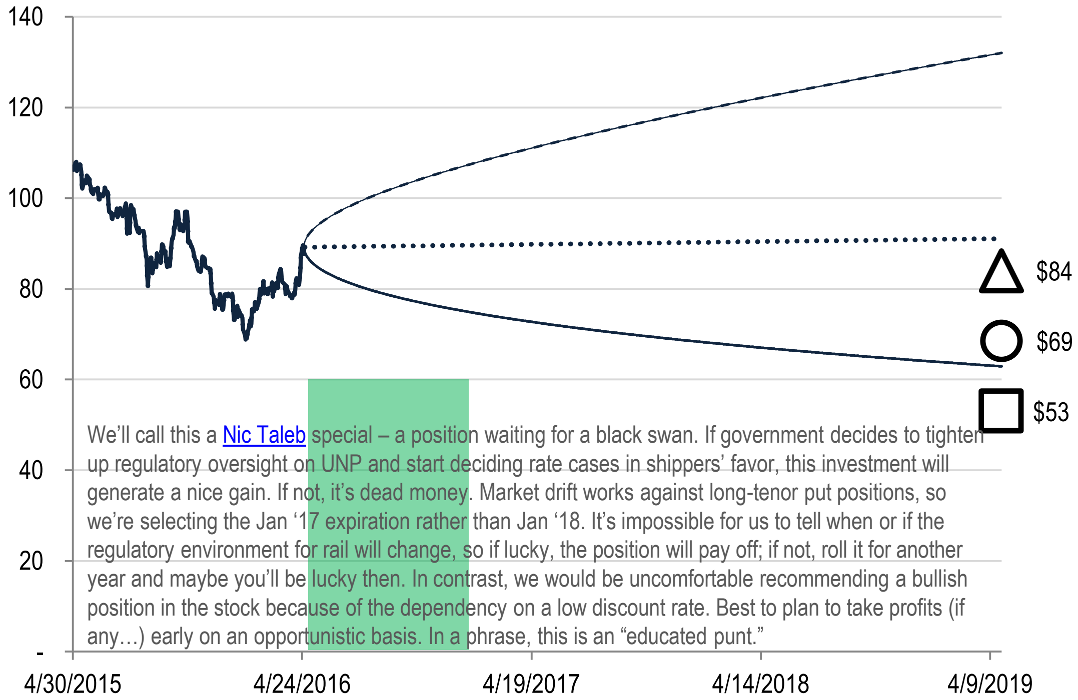
IOI Tear Sheet : Union Pacific (UNP)

Speculative Bearish Put (Low Conviction)

B / S	P / C / S	Strike	Exp.	Premium
Buy	Put	60	JAN '18	($0.93)



We'll call this a Nic Taleb special – a position waiting for a black swan. If government decides to tighten up regulatory oversight on UNP and start deciding rate cases in shippers' favor, this investment will generate a nice gain. If not, it's dead money. Market drift works against long-tenor put positions, so we're selecting the Jan '17 expiration rather than Jan '18. It's impossible for us to tell when or if the regulatory environment for rail will change, so if lucky, the position will pay off; if not, roll it for another year and maybe you'll be lucky then. In contrast, we would be uncomfortable recommending a bullish position in the stock because of the dependency on a low discount rate. Best to plan to take profits (if any…) early on an opportunistic basis. In a phrase, this is an "educated punt."

IOI's Take

Data as of 27 April, 2016

Railroads are institutional investor darlings (Buffet & BNSF, Ackman & CP), but if you didn't invest when they did (2010 & 2011, respectively), these trains have probably left the station. UNP operates as a monopoly or cozy duopoly partner to BNSF and is lightly regulated, meaning it has almost unrestrained pricing power thanks to implicit government support. Most increases from repricing have already been seen, meaning profit growth in future will slow. For most large cap cos, we use 10% discount rates; UNP is overvalued by this yardstick. Using a 9% discount rate (duopoly discount), UNP is fairly valued. 8% and it's a screaming buy. Value is dependent on gov't fiat.

Drivers

Revenues	Coal volumes in secular decline. Intermodal vols at risk from Panama canal. All else cyclical or steady. Proj: +5% (Best), 0% (Worst) thanks to continuing pricing power.
Profitability	Phenomenal! Mid- to High 20% OCP margin levels. Better than some tech firms…(ahem, IBM). Proj: 27% (B), 23% (W)
Investment Level / Eff.	45% of profits spent on cap improvements. Highly effective over last 5 years, less effective going forward. Proj (med-term growth): 7% (B), 5% (W)
Balance Sheet	Regulatory leniency adds billions or tens of billions to its value. This position can reverse, tho' hard to judge problty.

Valuation & Return

Valuation Uncertainty: High

	Low	Likely	High
Stock Fair Value ($)	53	69	84
Stock Return (%)	-40	-23	-6
Option Period Return (%)	653	-100	-100
Option Annual Return (%)	1479	-100	-100

Historical Metrics

	Historical Median	
	5-year	10-year
Revenue Growth (%)	7	7
Profit Margin (%)	23	21
Med-term Growth	High	High

Market Risk

Coal volumes are heading down, Intermodal may too. If revenues fall off, the $40 range possible using historical PSR as a guide (lowest decile). Lowest quartile PSR generates implied low end of $50 – in line with our lowest value estimate.

Case / Scenario	Value
PSR Implied Low	39
0% | 23% | 5%	53
0% | 23% | 7%	57
0% | 27% | 5%	63
0% | 27% | 7%	67
5% | 23% | 5%	67
5% | 23% | 7%	72
252-day Low	69
5% | 27% | 5%	78
5% | 27% | 7%	84
252-day High	108
PSR Implied High	113

Scenarios Key
ST Rev Growth | ST OCP Margin | Med-Term Growth