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Union Pacific Corp. (UNP)

Credit Suisse Industrials Conference

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Analyst, Credit Suisse Securities (USA) LLC

MANAGEMENT DISCUSSION SECTION

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Okay. Great. Good morning, everyone. Happy to kick off our 10th Annual Credit Suisse Industrials Conference. Couldn't think of a better person to start our conference than Jennifer Hamann, who's the CFO of Union Pacific. Jennifer has been CFO for about three years, I believe. And has been with Union Pacific for close to 30 years, which is quite remarkable. So, obviously someone who knows the company very well.

And Jennifer has a couple of opening comments that she'd like to make, and then, we'll get into some Q&A.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

All right. Well, thanks, Ari. Good morning, everyone. We don't have any slides to show you today. We do have an updated pitchbook that's out on our Investors website. It's by the link for the webcast for this event. So you can look at that for a little bit of updated information. Obviously, want to remind everyone we may be making some forward-looking statements today. Those statements are subject to risks and uncertainties. So please refer to the Investors website and our SEC filings for information about those risks.

Want to give you a quick update on three things this morning, our operations, our volumes, and then just a couple of thoughts to 2023. So operationally, we have taken a bit of a step back. You've seen that in our metrics here in the month of November. We'll be posting new numbers here today from a freight car velocity standpoint, that'll be 186 miles per day. From an operating inventory standpoint, it's about 194,000 carloads. And when you juxtapose that against the seven-day carloadings coming out of the Thanksgiving holiday, you definitely see some distortions there. Thanksgiving is a time when you do give us the ability to work on our network. And I think Eric and his team really did a good job taking advantage of this opportunity where volumes are a little bit lighter. Moving trains off the network, helping reduce the operating inventory. And so when I look at our seven-day numbers today, that freight car velocity is closer to 190 miles a day and the operating inventory is closer to 185,000 carloads. So, good progress, obviously work to be done.

We knew as we started on this journey of improving our overall network performance, it wasn't going to be a straight line, there was going to be some fits and starts. So this is obviously something we're experiencing. The number one constraint that we have had in terms of improving our overall fluidity of the network has been crews, and we've been talking to you about that much of the year. We came in to this event saying that we needed to hire about 1,400 people. So between training and hiring about 1,400 people this year, right now we're at about 1,500. So we've got about 1,000 that have graduated, call it, 500 or so that are still in training. We're also working with select customers in certain geographic areas where we still have some of that crew tightness to help try to control some of that operating inventory that has come onto our network. And so, having the dialogue with our customers to try to [indiscernible] (00:03:01) a little bit of their volume to help us again with restoration of that fluidity.

And then, I think it's also important to note that when you look at metrics besides just the freight car velocity in particular on the intermodal side of our business, if you look at our trip plan compliance, which essentially is your on time delivery metric, that's actually in the mid-70 percentile. So we've seen some really good improvement there. And Intermodal obviously is one of our most service sensitive parts of our business. And when you look beyond the crew resources feel good about our locomotive supply. We still have 2,000 locomotives that are parked. We're going to have about 80 sidings that we've turned over into service by the end of this year, over the last four years. And that helps both from a productivity standpoint as well as just overall capacity.

So then, if I turn and I look at our volumes, our volumes right now are up about 3%. So they have come back a tiny bit over the course of the last few weeks. Part of that is related to our operational fluidity. As our network slows down, that does have an impact on our carloadings. We're also seeing a bit of economic softness in a few places. So if you look at the three different groups that we have, and I just look at my notes just to make sure I get all these numbers right, but our Bulk is flat right now. And so when you look at the Bulk items of our commodities, coal is still up. It's up about 4%. But offsetting some of that are grain and grain products, that's off [ph] 1% (00:04:25). Our fertilizer is down about 10%. And then I look at food and beverage and that's off about 8%. So offsetting some of the coal – growth in the coal is impacting the Bulk.

Then you look at Industrial, our Industrial products is still up 3%, which is good. So you've got metals and minerals up 13%. Some of that is rock, which is less economically sensitive. Some of that also is attributable to some of our business development efforts where we've had some good wins. I look at energy and specialized, that's up 5%. Industrial chemicals and plastics are off 2% and then the probably the most linked economically sensitive one that we've seen, the biggest drop off so far is lumber and forest products, and that's actually off 17%. So think about housing, think about paper when you tie that into the e-commerce segment.

And then our Premium business, our premium right now is up 5%. So think about that in two different segments. Autos, our autos are actually up about 10%, primarily finished vehicles. Finished vehicles are actually up 23%. As you're seeing more restocking happening in terms of dealer inventories, parts are pretty flat on a year-over-year basis. And then intermodal volumes are up 3%. And again, it's a little bit of a tale of two stories there, you've got our international volumes that are up 25%. That's off of a very soft comp from last year. And then on the domestic side, that's actually down 9% with parcel kind of unfortunately leading the way there, down 20%, and so that's where you certainly see some of that economic softness play through.

So we're sitting here today, we've got basically one month left in 2022. It's a pretty big stretch for us to think that we're going to be able to get to 3% volume growth overall. It's just a very challenging environment for that. Encouraging though, we are still very confident that we're going to be able to reach our operating ratio goal that we set out in October, an updated goal of around 60% reported OR. So we're still very confident on that, even though we are seeing a bit of weakness on that volume side.

So then, last thing I want to talk about just real quickly is 2023. And still a lot of uncertainty there and I'm not going to give any guidance for the year, but we do see several things that we're very optimistic about next year, and some things that I think are unique to Union Pacific that should help us outperform our peers in 2023. Fundamentally though, is our franchise. We've got a great rail franchise. We think it's the premier franchise in the industry. It gives us broad reach, diverse markets, and it helps us when you have things like potentially a little bit of an economic slowdown or you've got exposure to coal, you've got exposure to rock, both areas that we expect to see some good growth in next year.

The other thing that is something that we obviously have been working on the last several years, we need to reinforce and kind of double down on that a bit as our overall efficiency. As we embarked on the PSR journey, you saw us drive great efficiency and improved the service product, taking a bit of a step back, but we certainly have the opportunity to get back to those efficiency levels, get back to those higher service levels and are committed to doing that and taking steps towards that obviously today, but we're working forward into that in 2023. And that lowers our overall cost structure and opens up the book of business for us and sets up Kenny and his team to be able to go out and compete for new business. And that's another point to raise is that business development piece. You've seen us be very successful with that in 2022, and moving to 2023, we absolutely have some great opportunities and kind of the marquee win there is the Schneider business that will be onboarding.

And then the last thing which some impact in 2023, but I think really is a longer bigger term picture for us that we want to make sure people keep in mind, is the ESG part of the story, in terms of the footprint for rail is so much more ESG friendly than trucks. And as we improve our service product, continue to lower our cost structure, we see that opening more and more doors for us. And I like to refer to it as the easy button. So if you're a shipper and you're moving goods by truck, if you convert that truckload onto a rail carload, you've immediately saved 75% in terms of your emissions profile. And so that's a great new story. Not converted a lot of business to us at this point, but we do see that as a great long-term fundamental for us.

So excited about 2023, excited about the long-term prospects for our franchise, for our industry, and look forward to taking your questions.

QUESTION AND ANSWER SECTION

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Excellent. So that's a great rundown and definitely I want to dig into a bunch of different points that you raised there. But let me start on two areas that are kind of topical because they've been in the news. So last week, the SMART Union voted down the proposed labor contract. Obviously, we've had even yesterday, President Biden weighing in and Nancy Pelosi and Congress weighing in on this matter. What do you see as kind of the eventual outcome of this? Do you think there's a real risk of a strike happening? Have you guys been in touch with Congress? Where do things stand with your labor unions?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. So we're obviously in very active dialogue right now with our unions, with the White House, with members of the House and Senate, because we absolutely believe it's critical that we avoid any kind of a work slowdown, a work stoppage or a rail strike. And we very much want that to happen. It does seem at this point that it is going to come down to congressional action. We're pleased by the White House's statement coming out and urging the passage of what has been before our unions, which is the PEB plus a little bit of unpaid sick time that was agreed to back in September.

And I think it's important to note that 8 of the 12 unions have ratified the agreement and roughly half of the workforce has ratified the agreement. And when you look at the part of the workforce that didn't ratify the agreement, those were very close votes, kind of a 50/50 kind of split. So I think there's a strong desire by the workforce to get this behind us and move forward. We want to be able to pay the wages that our workforce deserves. And certainly as part of the package, 24% wage increases over five years. We think it's a very strong deal for our employees and look forward to moving that behind us. You never say never in this business. So I'm not going to say there's no possibility of a strike. But it does seem like with the actions and the statements that are being made by the White House and in Congress, that they are prepared and are moving forward on taking actions that should alleviate that.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

So just to be clear, in the case of congressional action, no major changes to the updates that you guys put forward at the end of third quarter in terms of adjustments to the labor accruals that you had recognized?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Well, it does depend on what congress does. So what President Biden, urged and what Speaker Pelosi, urged in her first communication was to pass the agreements as is. It's my understanding that there's potentially an amendment being proposed that would add some paid sick leave. If that's actually amended to the bill that's being proposed, obviously, that could potentially slow things down. If it's passed separately, that could add potential costs. So I think that's still a little bit of a TBD. We're hopeful that they stick with what the White House and Speaker Pelosi originally came out with, which was passing the PEB plus the tentative agreements.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Understood. And then so the other item that's kind of been in the news, the STB obviously is asking Union Pacific to come down to Washington and discuss the use of embargoes. And specifically the STB cited that UP has been using embargoes at a much higher rate than some of your peers. Maybe you could talk about obviously it's still early stages, but what's kind of the expectation there in terms of what's the outcome from those hearings. And then specifically, maybe you could also discuss why has UP used embargoes more frequently than peers...

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

...and kind of how do you guys strategically think about using that to control the flow of freight on the network?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. So let me start maybe with what an embargo is and what an embargo isn't. So it really is a tool of last resort for us. As a common carrier, we don't have other mechanisms to fully suppress volumes coming on to our network. And so you'll see in the case of a derailment or maybe a weather outage or different, maybe if a facility for one of our customers is closed or even for safety concerns, you'll see embargoes be put in place to help control that flow. What you have seen us do here more recently are something what we would call congestion embargoes. And it's what I refer to in my opening remarks where we are very much working with our customers. And many of our customers have employed what I'll call self-help, where they have taken deliberate measures to help, pull back on some of the volumes that are on our network, help ease some of the offering inventory. But in cases where that hasn't been able to fully happen, we have put in place embargoes. I think it's important to note though, that an embargo can be done with 100% permits.

So you allow permits for the customer to continue to ship against that embargo. So when I look at these congestion embargoes that we have put up here recently, there are – I don't believe any where we have fully stopped service to that customer or prevented them from shipping any quantities from a certain location. So you are able to permit against that. And so, I think it's important to understand some of those distinctions. And again, it's a tool of last resort. It's not what we want to do. But in terms of trying to regain fluidity on the network and to be able to provide service to all of our customers in some select locations and areas, we have done that.

In terms of outcomes relative to these hearings, I think it'll be an educational process for the Surface Transportation Board, our opportunity to educate them more or certainly in constant contact with them and have been talking to them about the different steps that we have been taken. They asked in May for all of the railroads to be providing them with biweekly updates. We've been doing that as part of that. We've been talking about some of the operating inventory actions that we've been taking, but I see it as an opportunity to educate. Certainly the customers will come and I know some of the customers are upset with us because of some of the embargoes. And so I'm sure there will be some venting that occurs. But net-net, we want to serve our customers, we want to grow with our customers. To do that, we have to have a fluid network. And this is just one of the tools that we've been using.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

We've seen – so this year, we've seen the STB be a little more aggressive in terms of their stance towards the railroads. What do you think their objectives are here? Is it just to raise attention to the issue or do you think there's some actions that eventually come out of this? From an investor standpoint, do you think there's anything that people should be worried about in terms of the STB, maybe changing the operating environment or the kind of dynamics between railroads and their customers in the coming years as a result of any kind of STB actions.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. I mean, in terms of their motivations, that's certainly a question probably that's better for the STB, but they are our primary regulator from an economic standpoint. And we as a quasi-regulated industry, when you think not all of the commodities that we move are regulated, but certainly a subset of those are, is ensuring an equal access and an open playing field for customers. And we very much support that. When we look at some of the things that the STB wants to do in terms of making it easier to bring rate cases, doing things that would help it be easier for a customer to potentially bring a complaint or protest a rate. We're supportive of those things. We want to be able to compete and we're open to that. In terms of any long-term impacts that it could have, it's probably early days to comment on that. But I think first and foremost, we need to fix our service product, and that's always been our best defense from a regulation standpoint. And for our customers is to serve them and serve them well. We recognize that. And that's where our full attention is on.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

So let's turn maybe to kind of the macro, the revenue side of things. In terms of – speaking of the service product, you said that the volumes maybe kind of taking a little bit of a step back in fourth quarter and maybe seeing that kind of volume target is a little bit less achievable. How much of that do you think is attributable to kind of the macro environment? What are you guys seeing in the macro environment versus how much of that is kind of issues related to service and maybe customers looking for other solutions because of the service, that they're getting at UP?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. I mean, it's hard to parse that out, Ari. But certainly when I look at some of the commodities that I named off for you, think about the forest products, think about parcel, industrial chemicals and plastics, those certainly are economically sensitive parts of our business. And we are seeing a bit of a pullback there. You think about finished vehicles. So you would typically put that in the category of an economically sensitive part of the business yet, finished vehicles up 23% because of the lower dealer inventories. When I look at our Bulk network, that's probably an area where you could probably most clearly point to and say those volumes could be stronger if we were operating more fluidly.

So again, coal up 4% or 5% here in the quarter. We know we're not meeting all of the coal demand that is there. We know that there's still further opportunities there. You could probably say the same thing in rock where although the rock volumes are up strongly, there's still more demand there for us to be meeting. So I think it's in segments of our business. It's certainly not across the board, but that's probably how I think about it.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

Fair enough. Fair enough. And then one of the things I thought was interesting, you mentioned it today, and I've also heard Lance Fritz, your CEO, talk about this. But that expectation that UP can outgrow the industry over – just to be clear, is that 2023 or is that over the longer term? And then what are the real drivers of that growth? What are the categories within that that you think really can be powerful kind of growth drivers?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. Well, certainly it's 2023 in particular, and it's in large part because of the new Schneider business that we're bringing on. But as well, it's also because of some of the pent up demand that we know is there and again, areas like coal, rock, some of the other business development wins that we have had in steel, autos and really across the board. I can point to different segments of our business, biofuels, where we've got business wins.

And so that's really while it's a 2023 comment, our longer term expectation of ourselves is to be able to have our volumes outpace industrial production, and we think that's a really strong set up for us. It's something we've not done historically as a company and for us to be able to do that kind of year-on-year, we think would be a very strong statement. And what enables that is our franchise, we'll further enable that as our service product and our cost structure, and then also just the appeal to the trucks and being able to take their business off the highway.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

So let's talk about pricing then. One of the things you were pretty adamant about on the third quarter earnings call, which was great to hear, was this idea that the rails can continue to price above inflation. And obviously, we've seen the rails have a great track record of pricing above inflation. Maybe you could dig into that a little bit more in terms of your conversations with customers, both to what extent services have been an impediment to getting pricing and then kind of what drives that optimism for being able to continue to price above inflation?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. Well, I'll first channel my inner Kenny Rocker, who's our Chief Marketing Officer. And he would tell you price is never easy to get, regardless of what the service product is like. But we recognize we do provide a value to our customers. We know that relative to other modes of transportation, truck in particular, there's still a cost advantage to rail beyond the ESG benefits. And so that's our imperative. And we look at each of our pieces of business individually, and each piece of business needs to stand on its own and earn its own return. And pricing above inflation is kind of a key metric for us in terms of ensuring that we're getting that. But that's not what's driving us going out into the marketplace. We're going out, and we're competing, and we see a marketplace that has inflation in it, too. And so that's where we need to continue to provide that value to our customers and demonstrate to them that we can help partner with them and help them grow in an economic way.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

Do you feel like customers have been pretty receptive to notion of price increases that might in the kind of, I don't know, mid- to upper-single digits and are they pushing back because of the service issue I guess [indiscernible] (00:21:52)

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Customers are never going to welcome a price increase. That's – no one should do that. None of us welcome, though, when price increases are presented to us in our daily lives. But when you see things I mean, inflation is not anything that any of us are immune to. It's in the headlines daily. When you think about the labor inflation that we're facing here, in particular with the PEB, those are well known factors. And so when you look at the inflation in our costs versus perhaps others, while it's high, it may still be less than what their competitive alternatives are.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

So [indiscernible] (00:22:27) I don't want this to sound like criticism because I think the numbers were quite strong. But if I look at where revenue per carload was up, for UP, it was up about 15% year-over-year in the most recent quarter. If I look at some of the peers, it was up kind of closer to 20%. Do you think there's an opportunity that maybe UP has been underpricing relative to some of its peers or less aggressive on pricing than some of its peers? Is there anything to that or do you think it's more mix related? And then as we think about 2023, also onboarding Schneider, which is obviously a lot of intermodal business, do you think that that maybe weighs on that yield kind of the overall yield picture a little bit?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Okay. We've got a couple of different questions in there.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

Yeah.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

So I'll maybe start with the current comparison. So mix is an impact. We talked about mix in the quarter that we had a little bit of negative mix in the third quarter. I would also say within that though, you have the ability to move the volumes. And so the way that we count price, I think we do it in a very what I'll call purist fashion. If I give somebody 5% price increase but I don't move their freight, I'm not realizing that 5%. And that's not how we count it within our yield calculation. So when you think about some of our service challenges, if we're not moving the freight where we've put good, strong prices into the marketplace, that has an impact on us. And so, as you see us improve our network fluidity and move some of that carload volume, I do think we're putting as strong or stronger prices into the marketplace. We're winning business with that. But we then also have to move it. So set that aside.

Now, moving on to 2023 and your Schneider commentary, if intermodal is going to be a growth engine for us next year, and it certainly feels like it will be with Schneider coming on, that will have a negative mix impact for us when you think about that just in terms of the average revenue per car. Also looking into 2023, it's hard to think when you think about just kind of overall total yields that fuel is going to increase at the same level that it did in 2023 versus 2022. In fact, if you see an economic slowdown, my expectation that you'd actually be see fuel take a step back and so that's going to be a factor when you're just looking at those high level yields in 2023.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. Got it. So fuel taking a step back obviously would have an OR benefit there. And so maybe it's a good opportunity to kind of transition and talk about margins. We've seen UP have to walk back kind of its OR target this year. You guys started the year talking about a 55% OR, now we're talking about kind of closer to 60% granted, sounds like that's on a GAAP basis. So maybe a little bit better than that on an adjusted basis. But maybe you could talk about that progression of – what were the reasons we had to walk that back?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Was that mostly fuel? How much of that was attributable to service and kind of as we think about what that could look like for 2023, where – how should we be thinking about what that number looks like?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah. Yeah. So, I'm not going to give any guidance for 2023. I'll just set that aside. With each of our quarterly earnings releases, I think we do a pretty good job of laying out the components of our operating ratio. Fuel certainly has had a negative impact from an OR perspective, it's been accretive in terms of EPS and operating income, but it has had a negative impact to the operating ratio. You also have the inflation coming in higher than what we originally thought. We came into the year. We thought it was going to be a higher than normal inflation year for us at around 3%. It's actually closer to 5%. And so that certainly is having an impact as well. And then you do have some of our service challenges and we know that that has brought additional costs into the network as well. So I would say, it's all three of those factors that have come into play different than our expectations coming in to 2022 that have led us to walk back to operating ratio.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

And you also mentioned that you guys still feel pretty confident in getting to a 55% OR.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

What is the timeline look like for that? And kind of what are the steps to getting there? Is it mostly pricing or are there still cost cuts that you can realize across the network?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah. So we are still very confident that we can get back to that 55% target. We've not set a date on that, but we would look to make progress obviously starting next year. In terms of the levers that help us achieve that, it's the same levers that have gotten us to this point. It's volume, it's price, and it's productivity. We've taken a step back, obviously, this year in terms of our efficiency and productivity. So next year it's going to be a great opportunity for

us to make up that lost ground and then start to move forward on that. We've already talked about price and price above inflation. And then the volume piece of it, and being able to efficiently leverage the volume across our network. There's no special sauce, so to speak, in terms of getting to that 55%. But it's absolute execution on those three fronts.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

So one of the things I want to switch and kind of talk a little about our cash flow, obviously, being in the CFO seat, I think you've got a great perspective to offer on this. So, one of the things that's impressed us certainly over the years has been UP's ability to just generate cash flow pretty consistently and in good environments, bad environments. How should we think about kind of level of confidence going forward that UP can continue to demonstrate really strong levels of cash flow. And in terms of the things you worry about that could maybe alter that course or negatively impact that cash flow generation. What are the kind of things that you look for kind of key risks to that free cash flow?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

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Well, I mean, you've seen it a little bit here this year in terms of as our operating ratio deteriorated, that certainly has an impact on our operating income growth and our cash flow. And so, [audio gap] (00:28:23-00:28:35) those are certainly things that we will be working on next year to bring back in line and just start to make progress on. But again, the business fundamentals, I think, continue to be very strong in terms of being able to generate strong cash from the business. There's nothing if you think about it in terms of that long-term dynamic of being able to grow the business, of being able to bring more profitable business on to our railroad, and then move it efficiently, that's going to translate into higher operating income and obviously strong cash generation.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

So, again, in terms of risks, it's primarily what execution, I guess, and service, is that the biggest thing we should be watching for that...

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Well, I mean, execution and services is certainly the thing that we are absolutely focused on and is critical to our performance right now. Beyond that though, it is continued to be very disciplined on that pricing standpoint and making sure every piece of business is profitable. And then it's growing the volumes that can move across that very efficient franchise. It is those three levers.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. Got it. Okay. And so, UP has a great track record also of buying back shares, using that free cash flow to buy back shares. I think you guys have repurchased about 4% to 6% of your outstanding shares each year for the last couple of years. How do you think about your ability to kind of continue to do that? And I know you have a target out there for \$18 billion and \$19 billion of buybacks through 2024, which I think would represent kind of close to 15% of your float. Do you still feel comfortable about that target, that \$18 billion to \$19 billion target? And how do you think about the ability to kind of continue to buy back shares at that kind of 4% to 6% rate...

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah.

A

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

...for the year?

Q

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

So I think it's important to level set in terms of how we prioritize the use of our cash. So first of all, it goes back into the business in terms of our capital investment. The railroad is our lifeblood. It's our engine, and so, that's where we put our first dollar of cash.

A

Next priority is our dividend. And so we have a dividend target of 45% that we think is appropriate for our business. We want to be able to give our shareholders that more certain return on cash. And then the excess cash is where we use it for share repurchases. And what that has historically meant is not only use of excess cash from operations, but also using our balance sheet. And so we have since 2018, we put forth a new target that we were going to increase the leverage on our balance sheet and that has been a big sustainer of some of those share repurchases.

So we're at a point today where, I would say, the balance sheet is largely optimized. So as we generate EBITDA, that generates additional capacity on the balance sheet and obviously generating EBITDA, generating more operating income and cash. So those are the levers that we look to and the priorities that we've put to it. In terms of how we think about that 2023, 2024, it's really going to come down to what's the economic outlook and how are we performing in terms of being able to translate that into cash.

Certainly, a difference that we have right now is with our operating ratio, with it being closer to a 60% versus a 55%, that has an impact on that cash generation. The economy, inflation looks a little bit different than when we laid out those targets back in, at the May Investor Day in 2021. So I'm not going to confirm that guidance right now, but we're going to be looking in 2023, when we sit down in January and talk about how we see the year playing out, and we'll have that discussion. But those are the three priorities for our cash, and I think it's important to think about it in that context.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Should we expect an update to that buyback target in January? Is that reasonable to expect?

Q

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

When we sit down with you in January, we'll be talking to you about our expectations for the year. And historically, we've talked to it, not only in terms of how we think the company is going to perform, but then how we're going to use the cash in terms of our capital dividends and share repurchases.

A

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Q

Got it. Okay. So I want to open it up the floor to any questions from the audience? I still have a couple, if no one has any. But I want to make sure we give folks an opportunity, if they have anything. So I tell you what, in the meantime, let me ask, we still have a couple of minutes. But so there's been a lot of speculation about the impact of the CP-KCS merger, and that's kind of expected to go through in January, February, perhaps, I mean, obviously, kind of STB will have the final word.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

But maybe you could talk about one of the things that's been notable about UP is you've often highlighted you're the only railroad in North America that has connections to all six major gateways between the US and Mexico. Obviously, CP kind of having control of KCS, altered it's landscape a little bit in terms of having that kind of single line network between the three major economies of North America. How do you think about the risks to UP from that merger? And how do you think about kind of defending your position as kind of, being a kind of premier carrier out west?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah. So to your point, we still feel very good about our franchise position relative to Mexico. And even with the CP-KCS merger, we'll still have the better route structure north and south of the border and the more diverse destination points as well. When you think about where that freight ultimately wants to origin or destined north of the border with our franchise. But the things that we have talked to the STB about and have been very public about in terms of our concerns relative to the merger is, we want fair and equal treatment. And so with that really boils down to is rates south of the border that they be proportionate, so that our customers aren't the factor being forced to ship on CP-KCS by the way, that they're pricing their business south of the border for a joint CP-KCS move versus a UP-KCS move.

The other thing we want to do is ensure that there's equal access to the new bridge that they're building in Laredo. And then the third item is that because this company will be using our trackage rights. They have trackage rights on us, particularly in Houston, which is a very busy part of our rail network. We want to make sure that any growth that they're going to be moving across that network, that there's capital investment made first. So we're happy to compete. We just want to make sure that it's a level playing field.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Got it. Understood. And we have a question from – yeah.

Just a quick one, is it [indiscernible] (00:35:15) but if volumes are slightly weaker, how do you try to get to the OR target? What's helping you with the mix or cost?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

Yeah. So the question for those of you who maybe didn't hear it is, if volumes are weaker, how are we confident that we can still hit our OR target for 2022. It is the things that you mentioned, primarily mix. So we're seeing the mix be a little bit better in terms of the business profile that we're moving. And I would say fuel, while still a headwind for us in the fourth quarter, it's probably a little bit less so than we originally thought.

Q

I'm curious, how do you push pricing when service metrics are behind target, especially [indiscernible] (00:36:00)

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

So, the question about price and service is one, and we were actually talking about that a little bit earlier in terms of how are you able to do that. It really is about the long-term value proposition that we can offer to our customers. And setting aside some of the current issues and talking with our customers long-term about what they need from us and what we can provide to them and helping them understand that long-term benefit of rail capacity. We are an integral part of many of our customers business and they know that we are still, even if we're raising our prices pricing above inflation and making sure that we're earning a solid return. It's still a very economically efficient option for them and they are set up to benefit from that.

As we improve our car cycle times, that's fewer cars, if it's a customer who owns their cars, that's fewer cars that that customer has to own and put into their fleet. So it's not only an OE aspect for them, but it also can be a capital investment aspect for them as well. So it's difficult in the environment where you're not providing good service having those conversations and trying to put that aside. But most of our customers we've worked with them for decades. And so they understand that, and they know the long-term benefits that we can provide.

Q

[indiscernible] (00:37:13)

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

No.

Q

...some of the diesel costs and pricing, how is it priced, what kind of a lag and then do you give back some of that pricing when diesel retreats?

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

A

So I think you're referring to our fuel surcharges. So we do separate from the pricing discussion that we've been having, we do on our business have fuel surcharges that by and large are pegged to on-highway diesel fuel prices. And if you look on our website, you can see the table or the scales that are there. And those are just on a

monthly basis, for the most part, we do have some particularly in the intermodal sector that actually update weekly, but most of our mechanisms update monthly. And there is basically a two-month lag there between what the on-highway diesel fuel prices and what our surcharge looks like. But those move up and down. And so as prices come down, you see the surcharges come down and that's all done separately.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Okay. Great. So I think we're a little bit over time. Jennifer, thank you so much for joining us. This is certainly an interesting discussion.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

Yeah.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

And we look forward to hearing from you on fourth quarter earnings.

Jennifer L. Hamann

Executive Vice President & Chief Financial Officer, Union Pacific Corp.

All right. Thanks, Ari, very much.

Ariel Rosa

Analyst, Credit Suisse Securities (USA) LLC

Thank you. All right.

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