Morgan Stanley

MORGAN STANLEY RESEARCH

May 13, 2009

Research
North America
Transportation

Railroads: A Wall Street View

Overview

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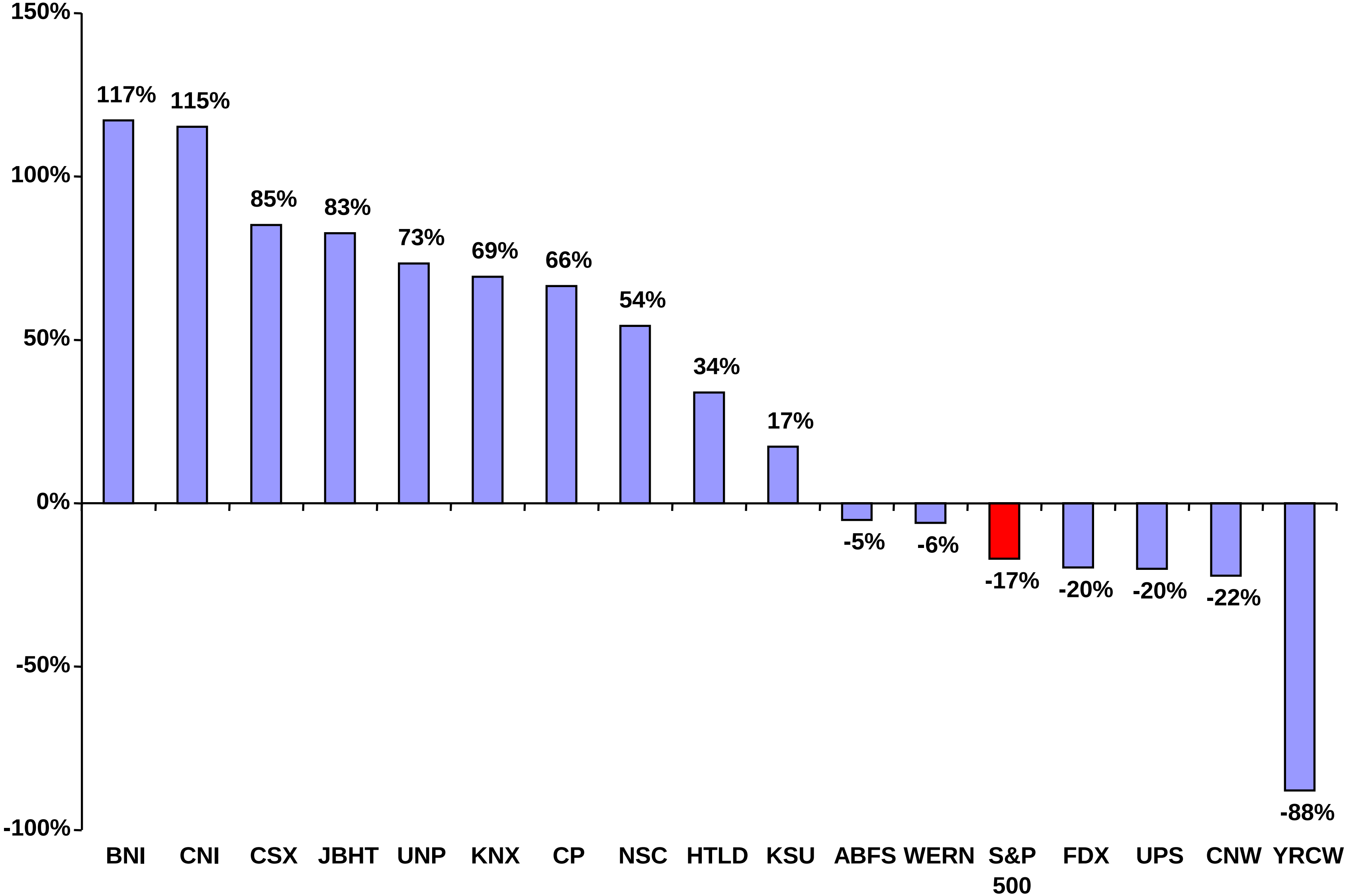
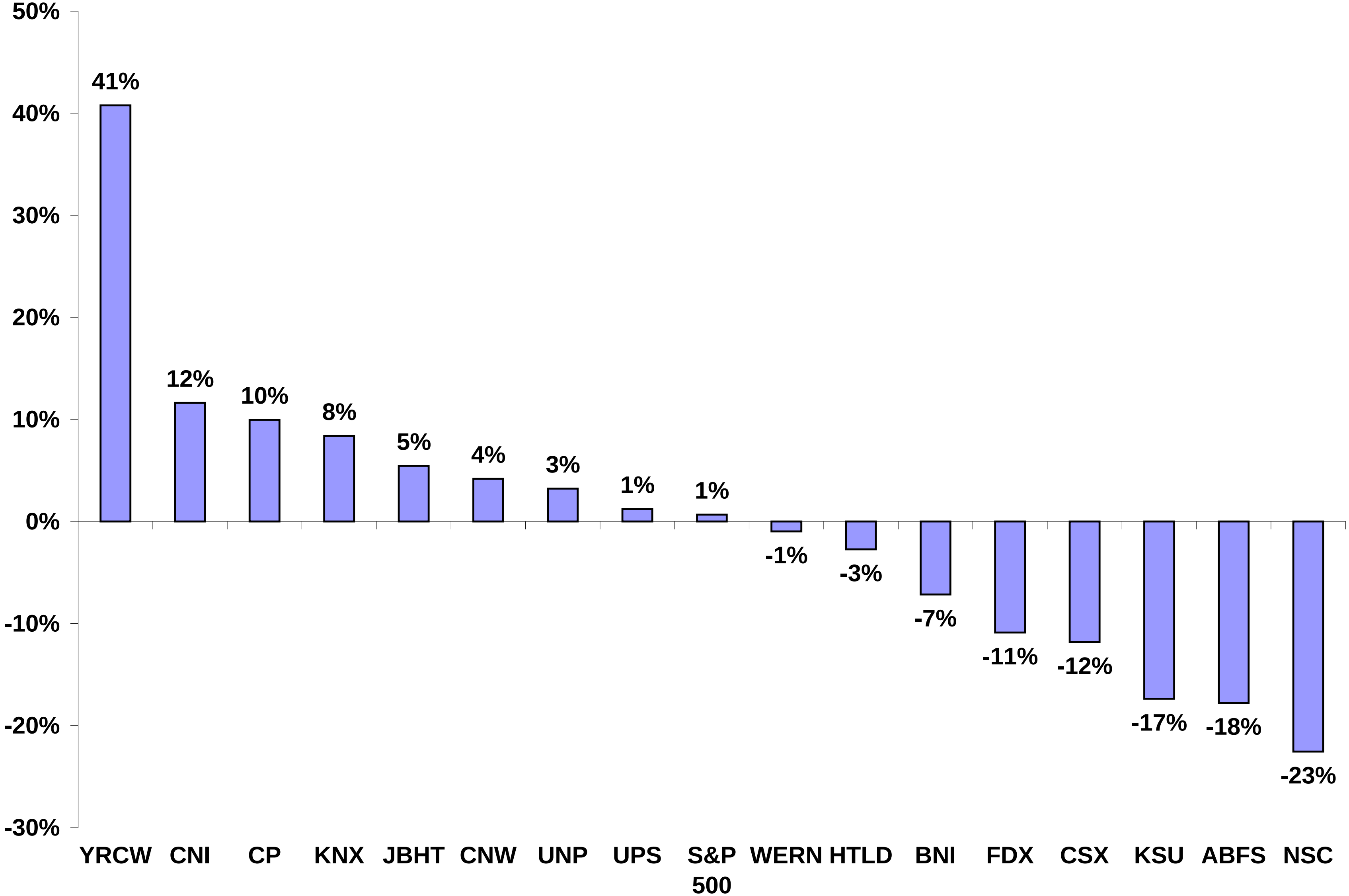
Five-Year Stock Price Performance



Source. FactSet, Morgan Stanley Research

YTD Stock Price Performance



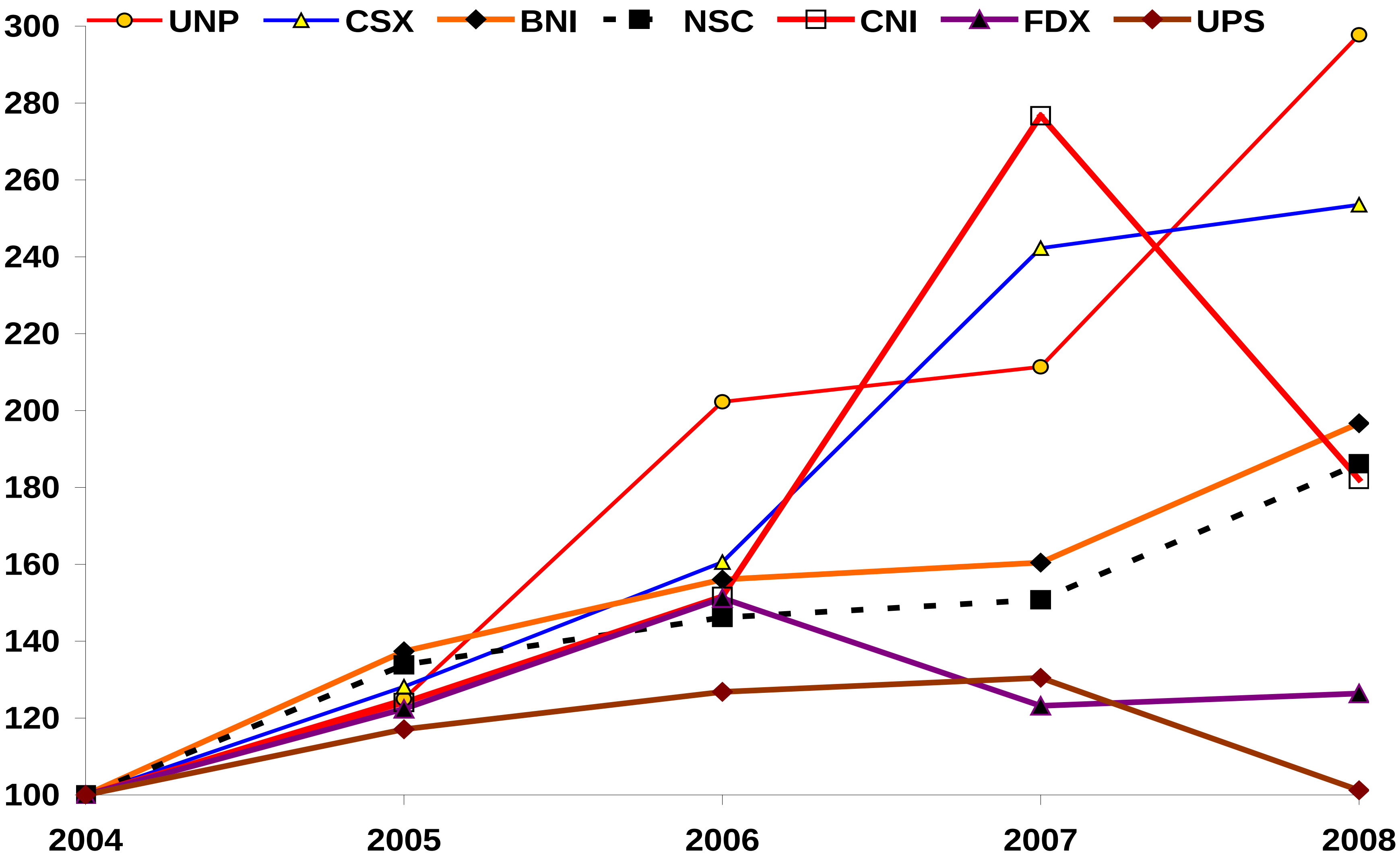
Source. FactSet, Morgan Stanley Research

Freight Transportation Outlook

What will investors pay for?

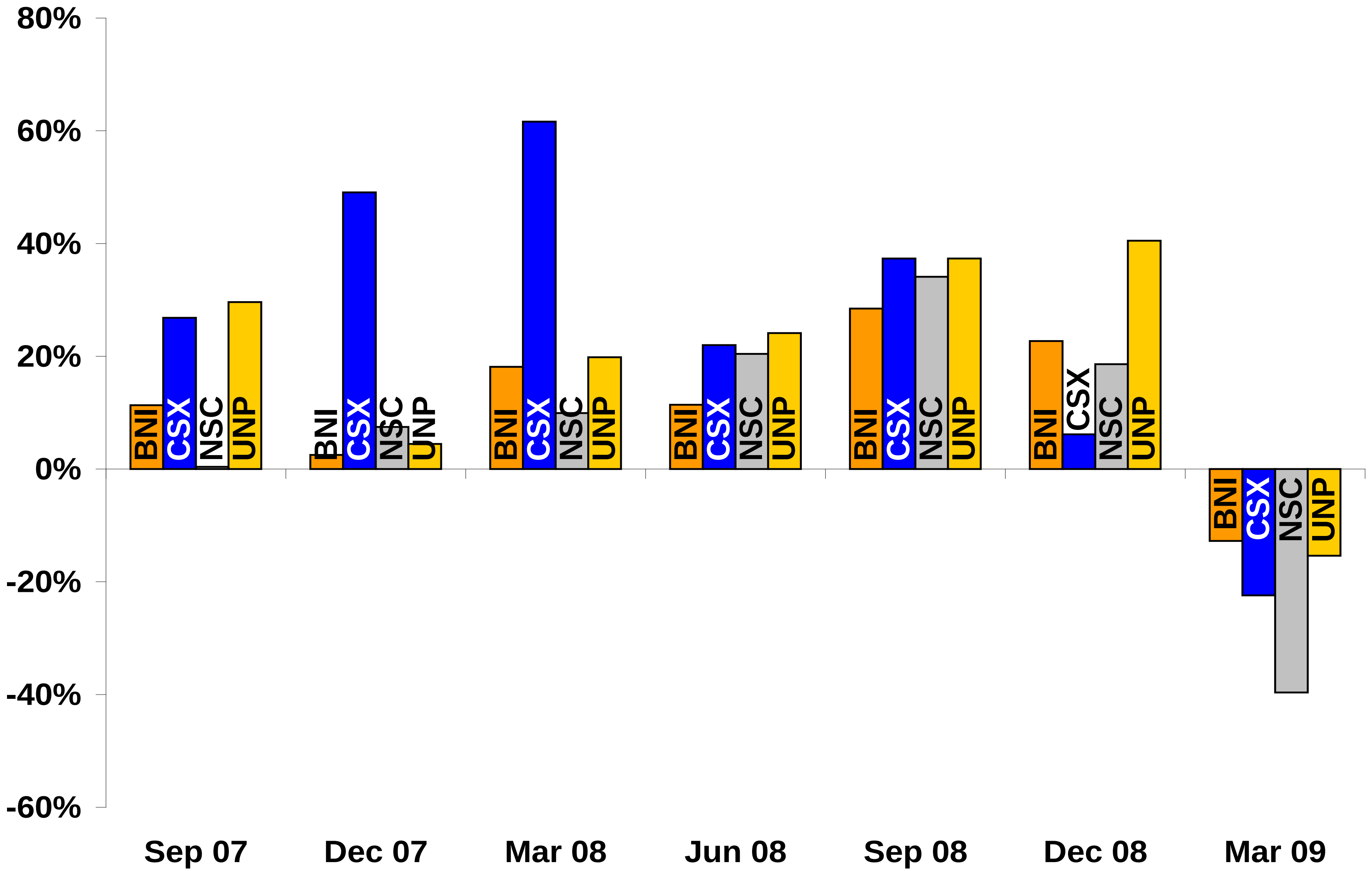
Growth and Rising Returns

Earnings Growth



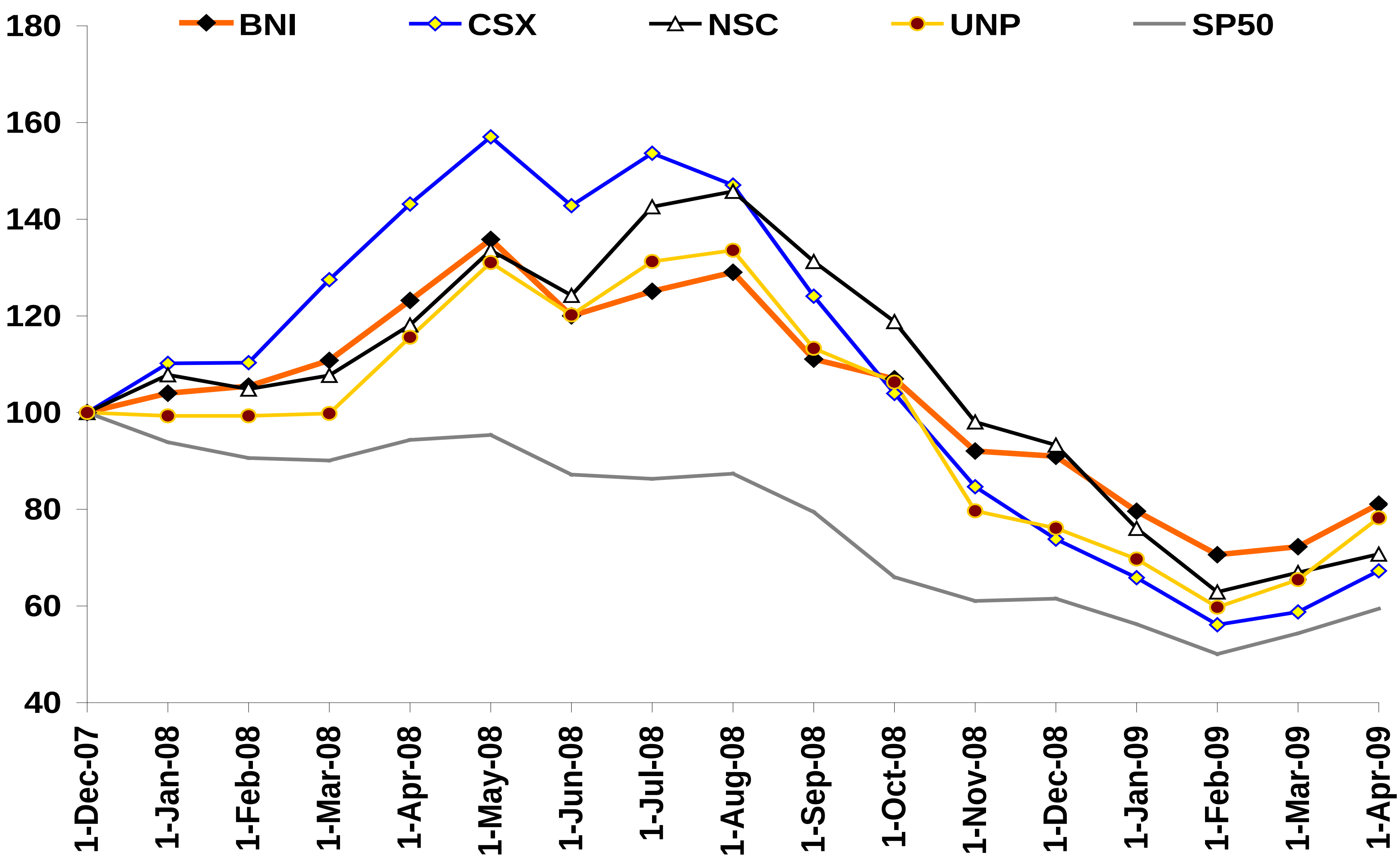
Source. Company data, Factset, Morgan Stanley Research

Recent YoY Earnings Growth for US Railroads



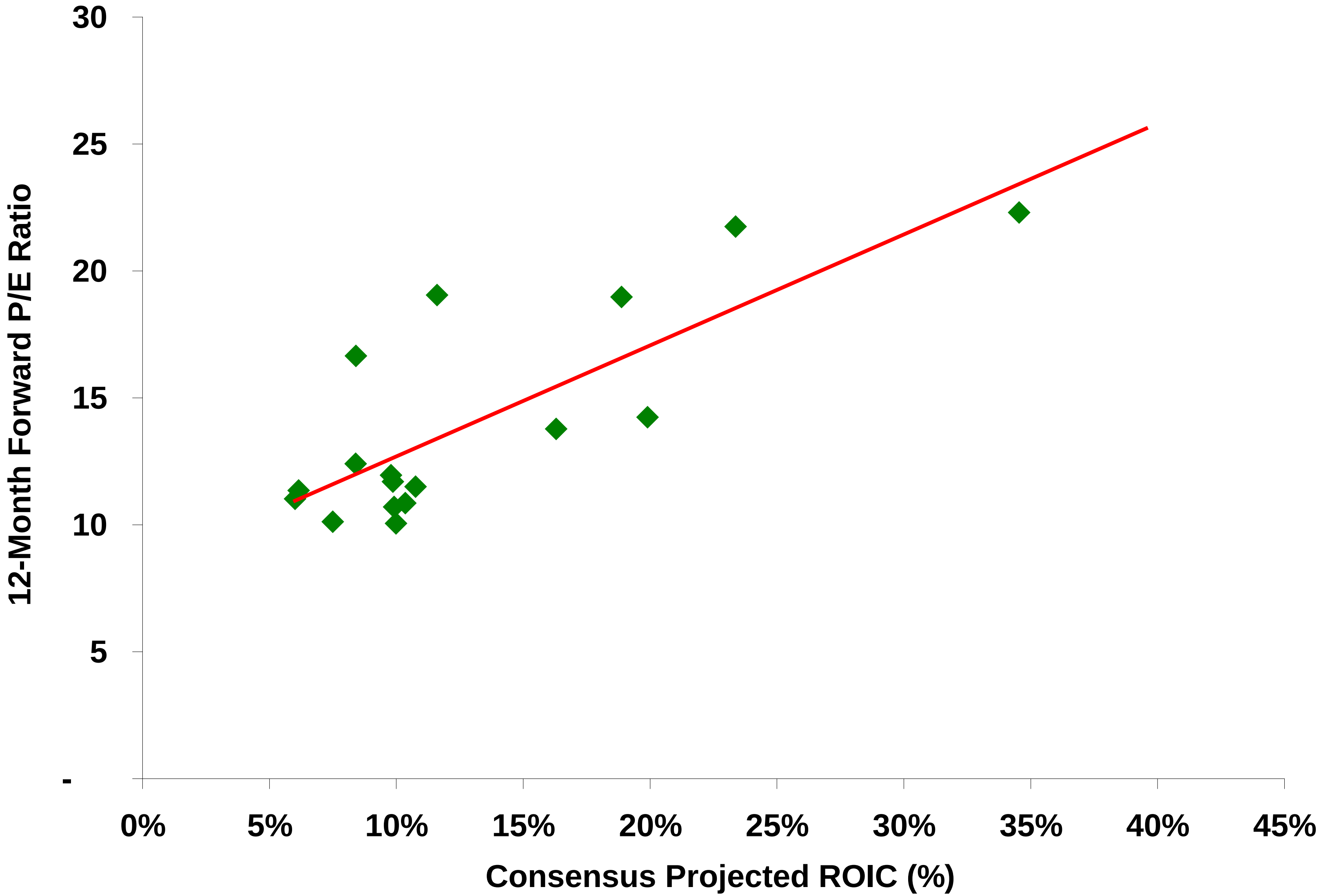
Company data, Morgan Stanley Research

Stock Price Movements



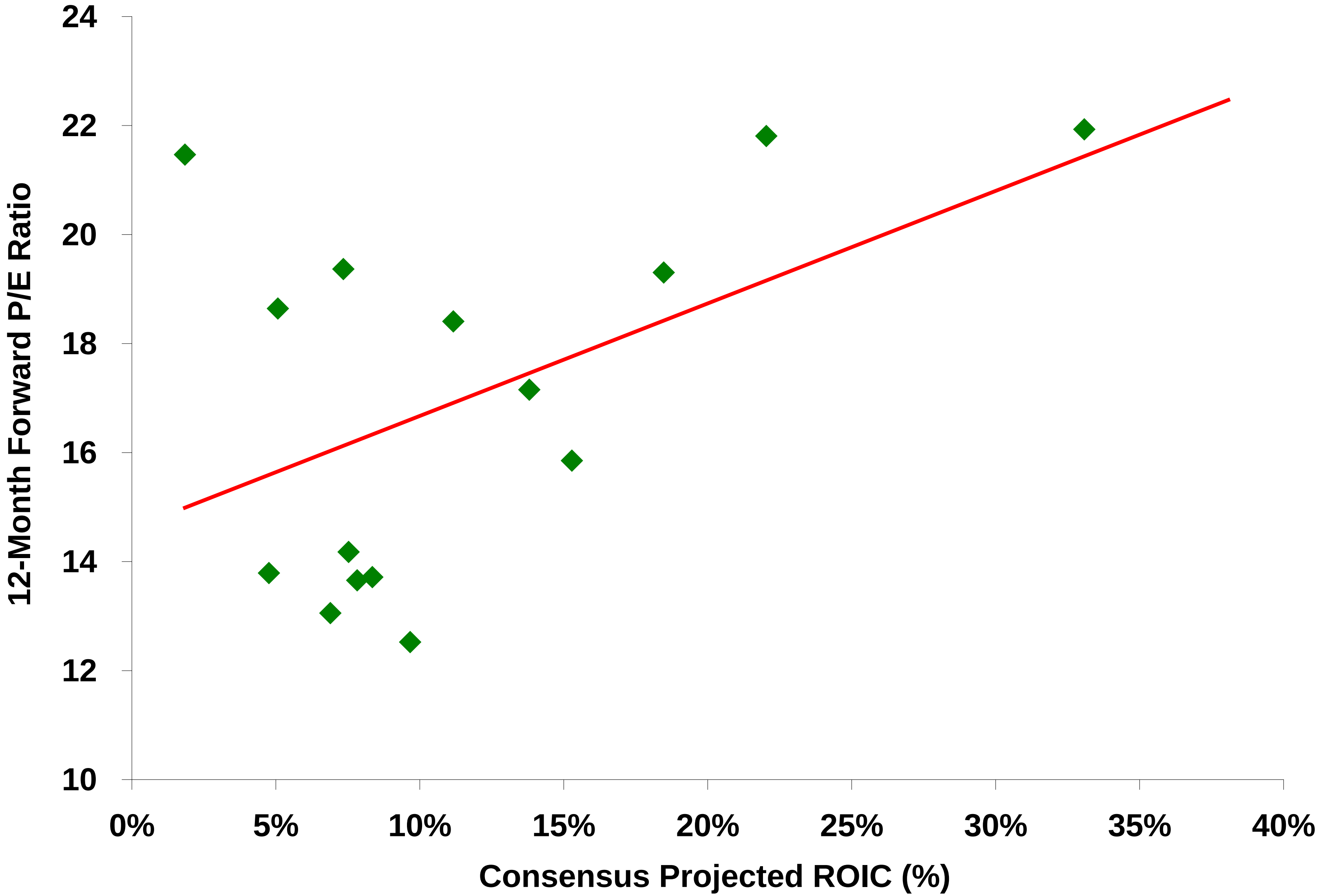
Source. Company data, Factset, Morgan Stanley Research

Valuation Versus Returns on Capital as of November, 2008



Source. Company data, Factset, Morgan Stanley Research

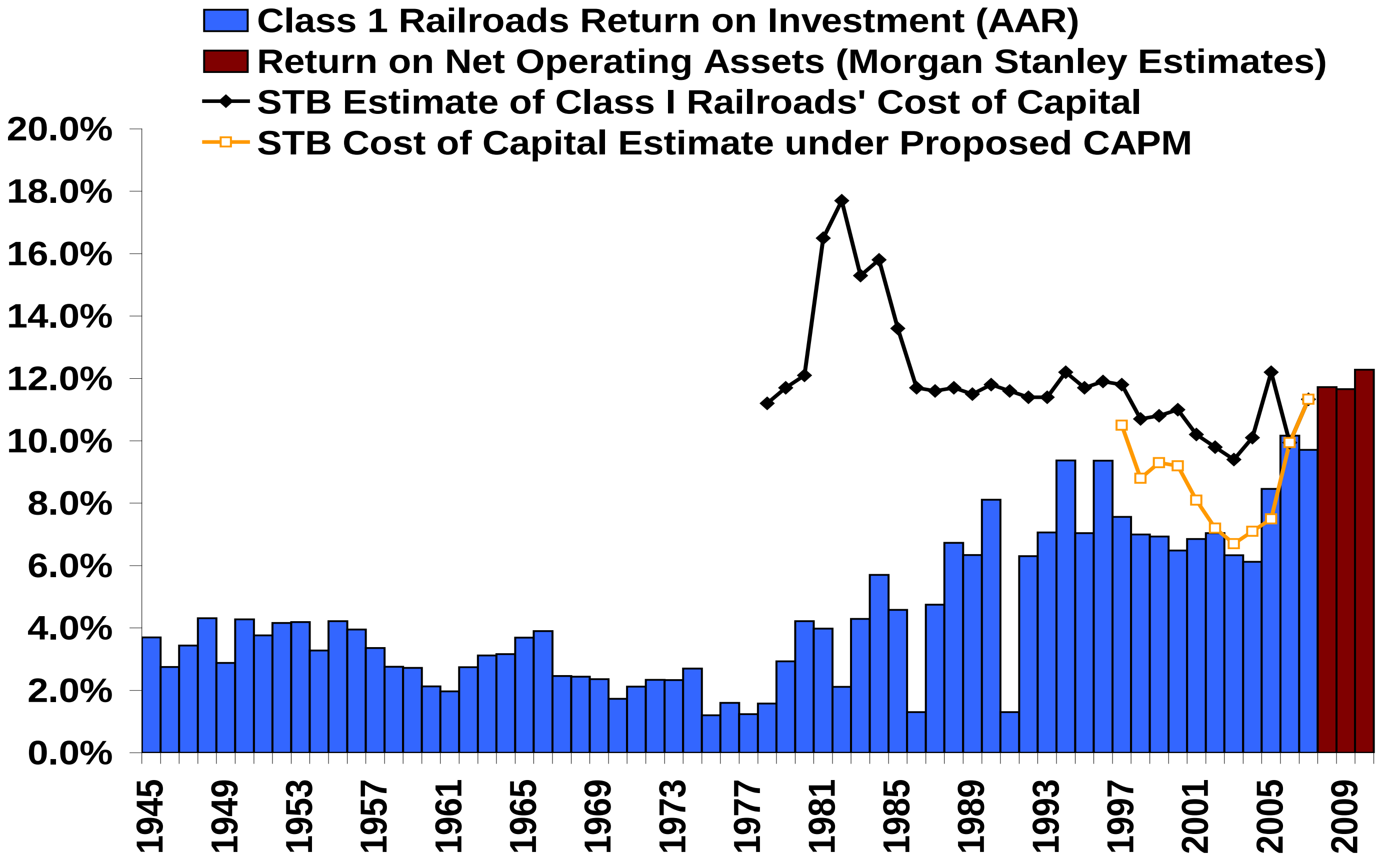
Valuation Versus Returns on Capital as of May, 2009



Source. Company data, Factset, Morgan Stanley Research

Rates of Return Should Rise Through at Least 2012

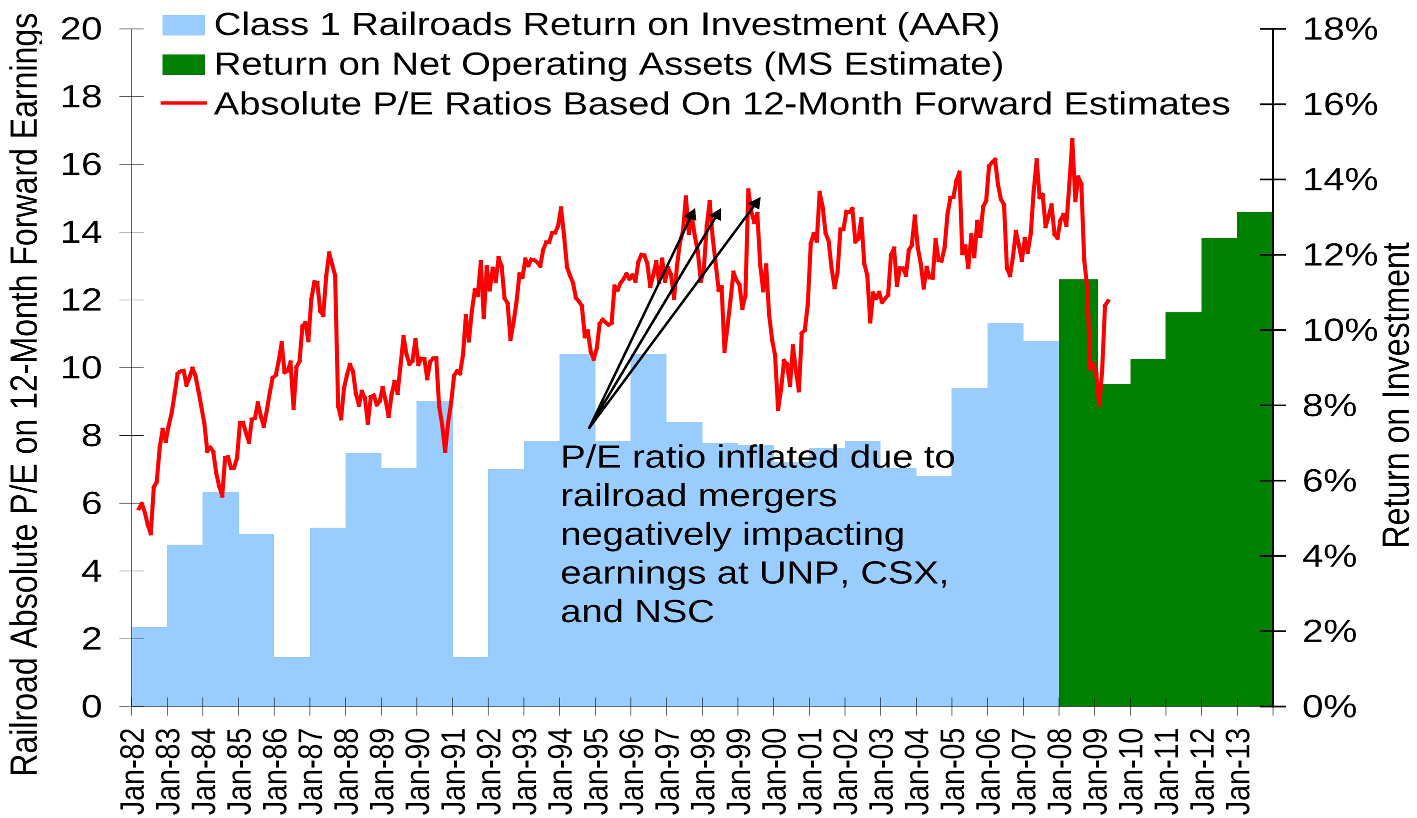
- **Railroads are on the cusp of turning the corner and generating positive net returns on capital** after decades of failing to earn an adequate return on capital and plowing billions of dollars of capital back into the business



1945-2007 AAR return on investments for Class 1 railroads. 2008-2010E Morgan Stanley estimates of Return on Net Operating Assets for Class 1 railroads.
Source: AAR, Morgan Stanley Research

Railroad P/E Multiples Have Been Rising With Returns

- **We expect returns on invested capital to rise to 11-14% in the next few years, which should support P/E multiples of 13-16x.** Railroad P/E multiples averaged 9-11x forward consensus in the 1980s and returns were 4-6%. In the 1990s, the average group multiple expanded to 10-12x, as returns rose to 6-8%



1945-2004 AAR return on investments for Class 1 railroads. 2005-2010E Morgan Stanley estimates of Return on Net Operating Assets for Class 1 railroads.
Source: AAR, Morgan Stanley Research

Railroad Industry Fundamentals and Outlook

Volume:

- We assume rail carloads will fall 15-18% in 2009, which would be unprecedented since deregulation. Note that carloads fell 2-4% in 2007 and 2% in 2008. RTMs should be down less than carloads.

Pricing:

- We expect rail pricing to be up in the 4-5% range in 2009, a more modest rate of growth than in 2006-08, but still healthy, as it includes some repricing of legacy contracts. Declines in fuel surcharges means total rates will be down Y/Y in '09.

Cost Inflation:

- Rail cost inflation appears to be running at ~15-17% in 2009 (ex. fuel) on a carload basis and ~13-15% on a GTM basis. Lower incentive comp, lower headcount, fewer locomotives/cars on line are all helping drive productivity in unit costs.

Competitive Pressures:

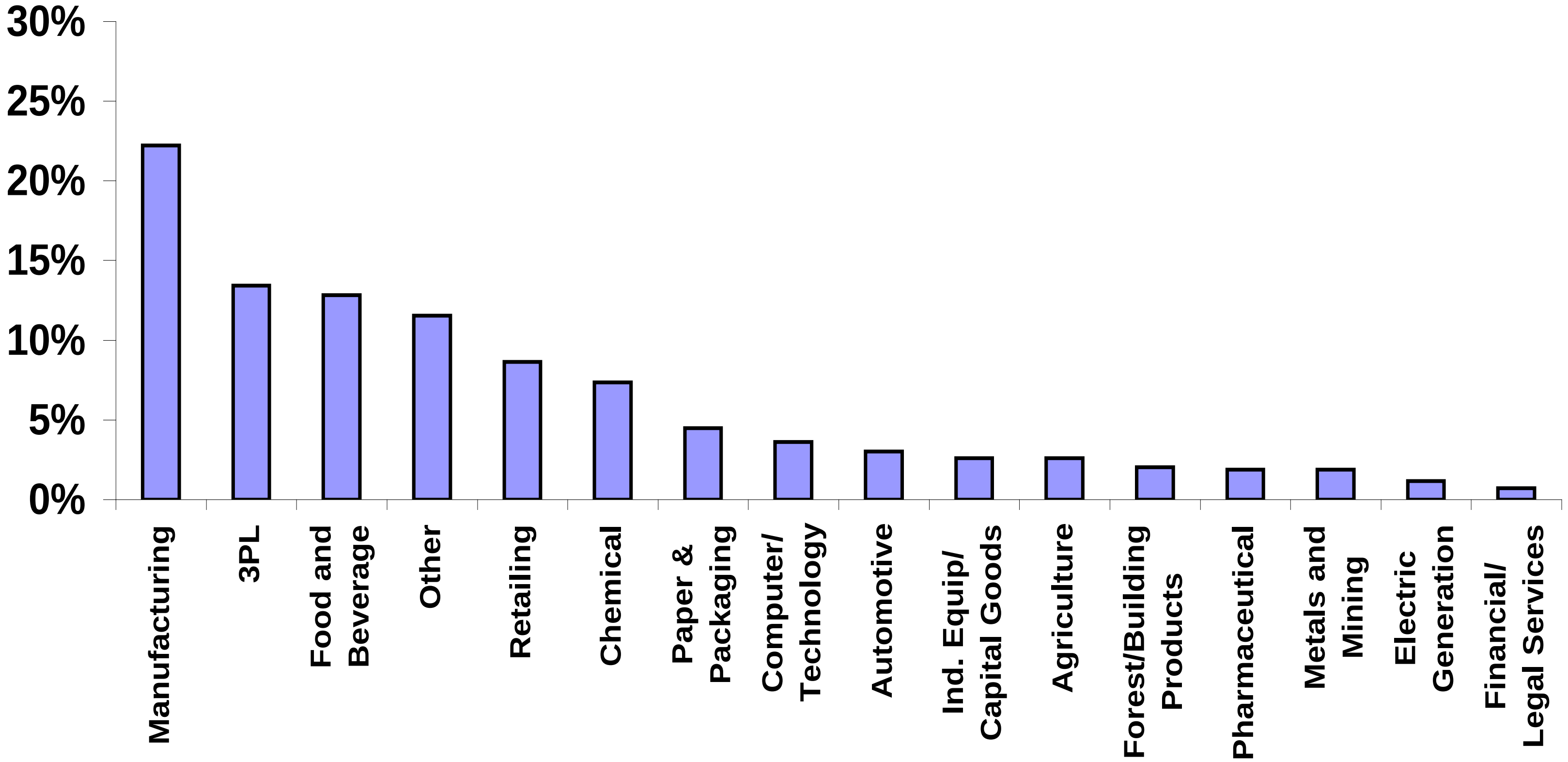
- The collapse of the US industrial economy has hurt rail volumes. With coal and grain also weak, rail earnings will fall sharply in 2009. Trucks are trying to steal share in shorter-haul markets. Though rail is still the cheapest modal choice in most situations, the rails' desire to drive earnings and returns higher through price may limit volume opportunities in a rebound.

About the Freight Pulse Survey

Insights from Nearly 400 US and Canadian Freight Shippers

- Results from our 16th *Freight Pulse, a* semi-annual survey of nearly 400 railroad, trucking, and intermodal shippers conducted with *Outsourced Logistics* magazine.

Freight Pulse 16 Industry Profile
(just those shippers providing an industry classification)



Source: MS Freight Pulse 16

Railroads: Key Survey Findings

- **Shippers expect higher rail rates, even with the steep volume declines**
  - Respondents expect rates to be up ~5% for full-year 2009, which suggests the pricing story still has legs
  - Fewer legacy contracts are renewing, but organic pricing appears solid .
- **Shippers suggest Intermodal will continue to take share**
  - Fuel efficiency, improving service and shipper efforts to cut costs are driving share gains
  - Lower fuel prices and truck competition should pressure intermodal rates
- **Shippers expect more of the same in terms of weak volumes –** Unlike truck shippers, rail shippers show less conviction that volumes have bottomed
- **Rail service and value rankings continue to improve, which is supportive of long-term pricing**
  - BNI leads in service and value while UNP was the most improved
  - Lower traffic helps fluidity, but improving service also suggests rails are having success removing costs

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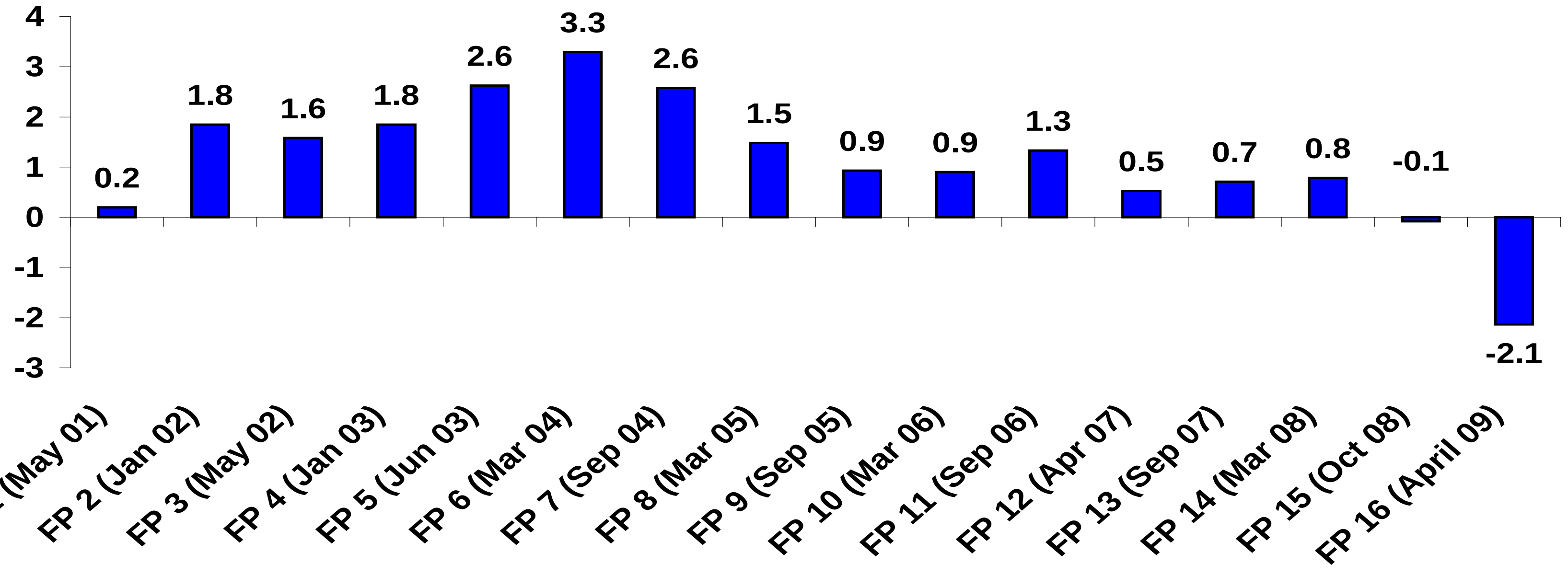
Rail Volumes: Not Surprisingly Shippers Forecast Worst Volumes in Survey History

- **Historically, our surveys have been accurate forecasting the *direction* of volume trends, but not the *magnitude***
- **Recent volume declines are almost unprecedented and recent earnings results suggest that 2Q09 volumes are still likely to be down double digits**

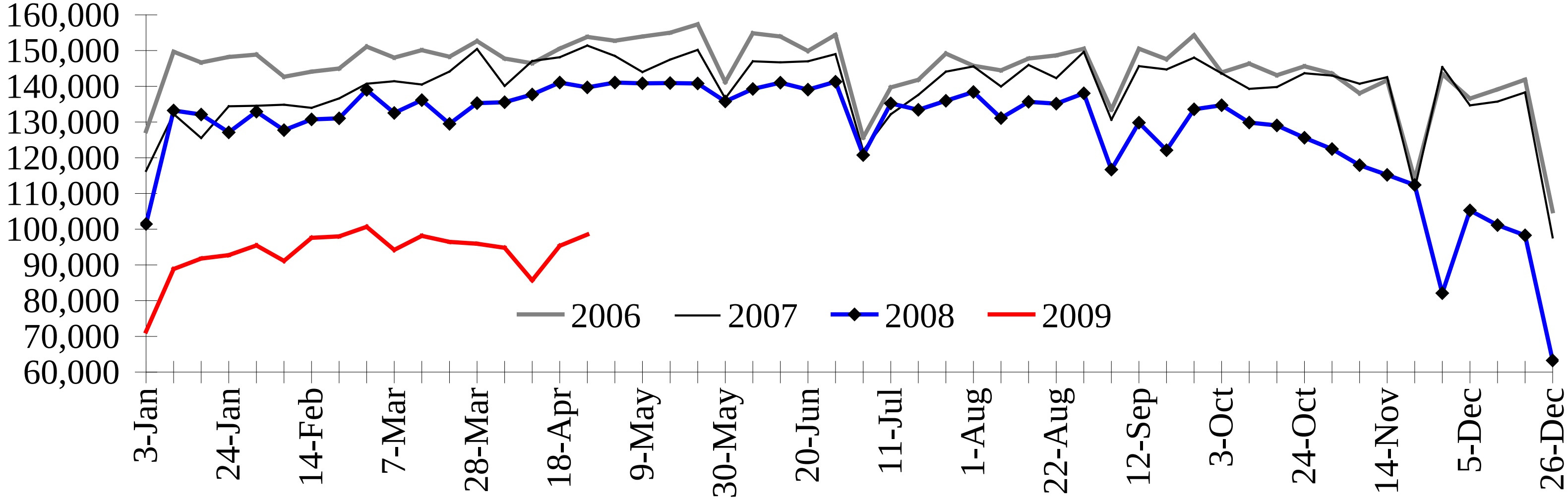
Shippers' Volume Expectations Index for "Changes in Railroad Volumes Over the Next 6 Months vs. the Same Period in the Prior Year"



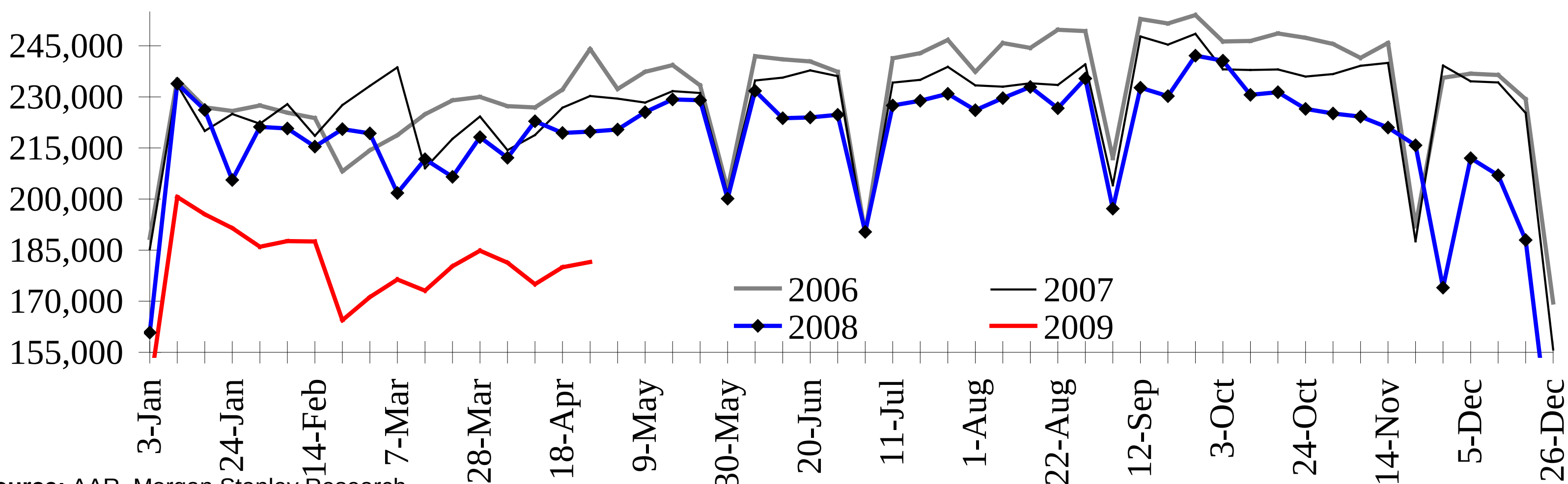
Source: Morgan Stanley Freight Pulse Surveys

Volumes Slowing, but Easy Comparisons Should Provide Some Relief by 4Q09

Class 1 Originated Economically Sensitive Commodity Carloads (excluding coal and agriculture)



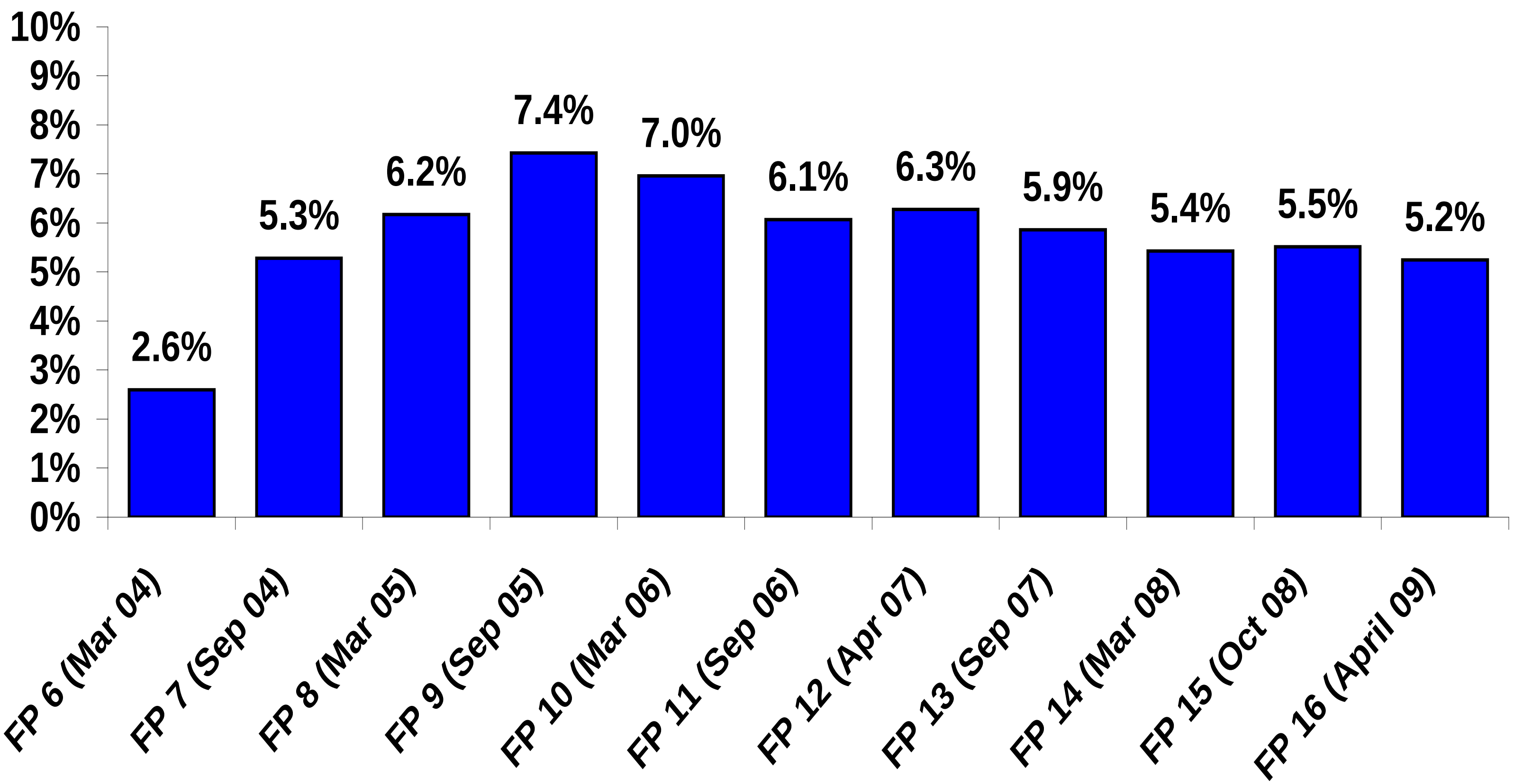
Class 1 Originated Intermodal Loads



Source: AAR, Morgan Stanley Research

Rail Rates: Secular Rail Pricing Story Continues, Though Momentum Slowing

Survey Results for Shippers' Expectations for Average Railroad Base Rate *Increase (Excl. Fuel Surcharge) Over the Next Six Months**

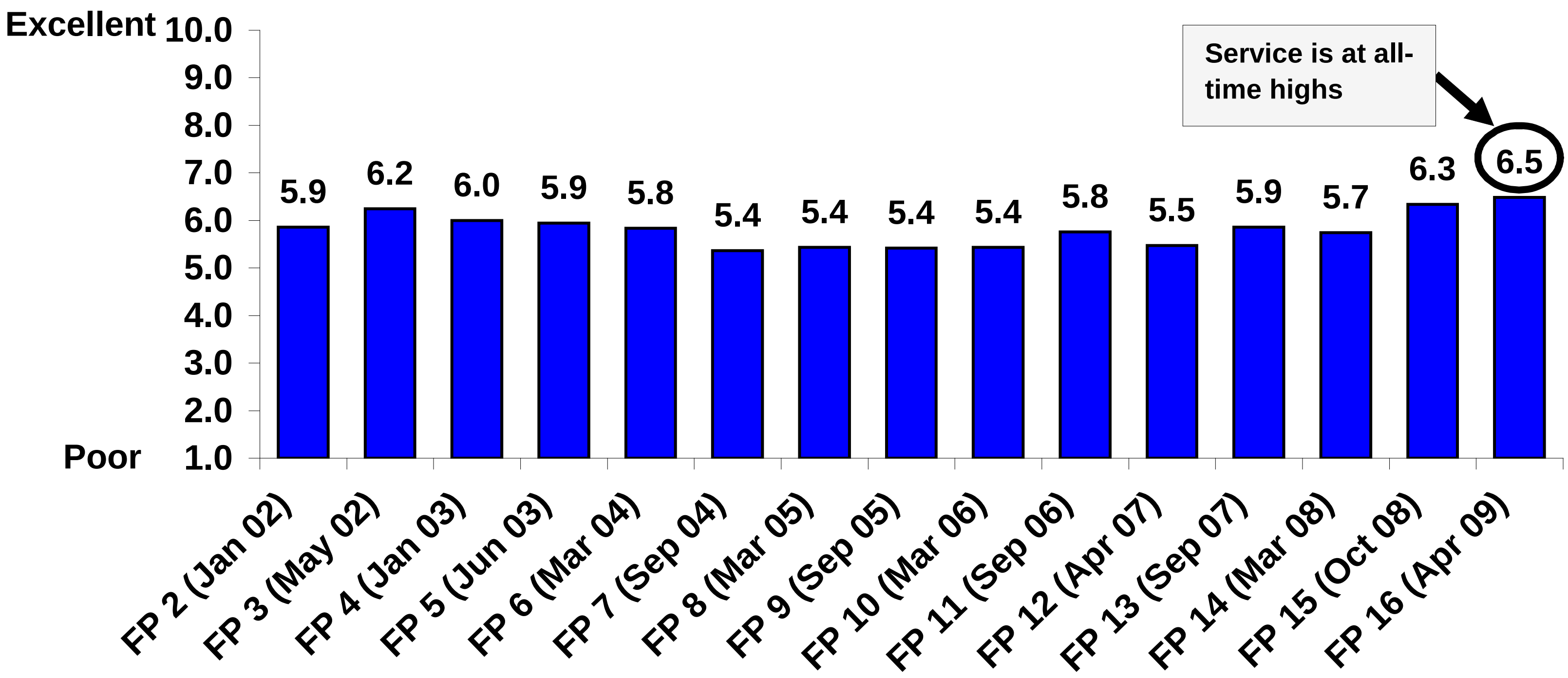


***Just those shippers reporting an increase**
Source: Morgan Stanley Freight Pulse Surveys

Rail Service Trends: Rail Service at All-Time Highs but Still Lags Other Modes

- **Rail service rankings are at historical highs, though still well short of truck-like ratings**
- **Though recent declines in volume may have helped service as well, railroads continue to focus on improving asset utilization and raising on-time performance to drive core service improvements**
- **Recent service improvements will be tested when volume growth eventually returns**

Avg. Railroad Shippers' Ratings of Industry-wide "Delivery When Expected" and "Value for Dollar"



Source: Morgan Stanley Freight Pulse Surveys

Rail Service Trends: UNP Is Most Improved in "Delivery When Expected"

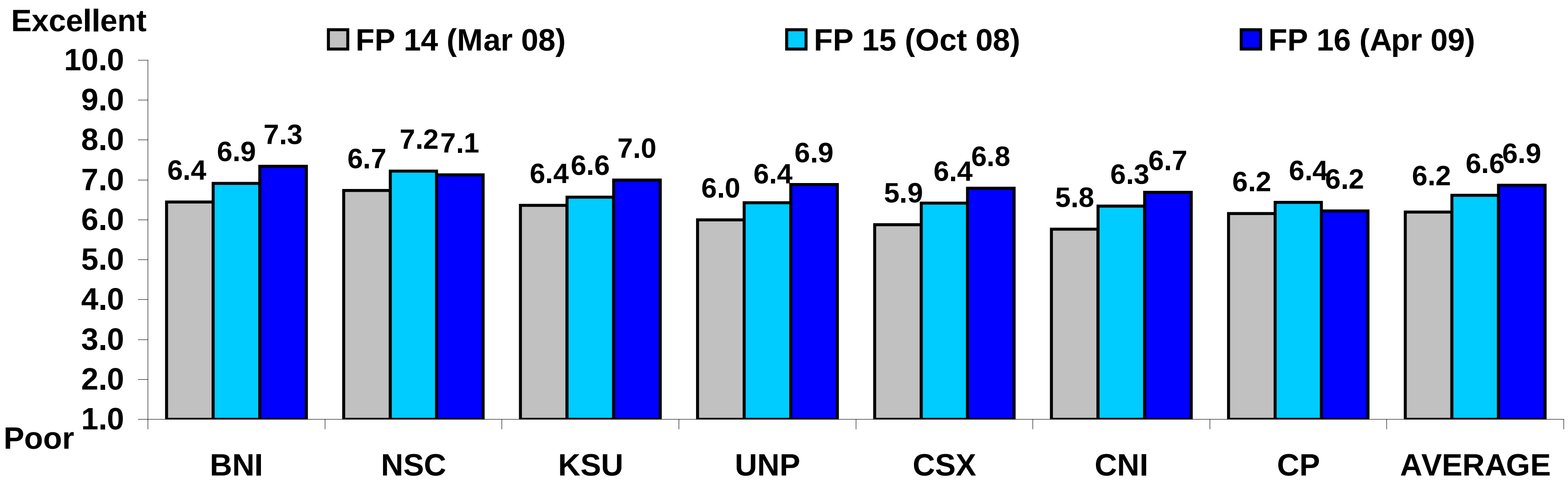
BNI and NSC rank highest on service

- NSC was one of 2 (the other was CP) to register declines in Delivery When Expected which caused the company to lose its long-standing top-ranking on this metric to BNI

Most Rails show improvement vs. our Oct. survey

- Weak volumes are likely contributing to rail service gains
- We believe that service improvements will be required in the long-run for the rails to continue to capture rate increases in excess of inflation

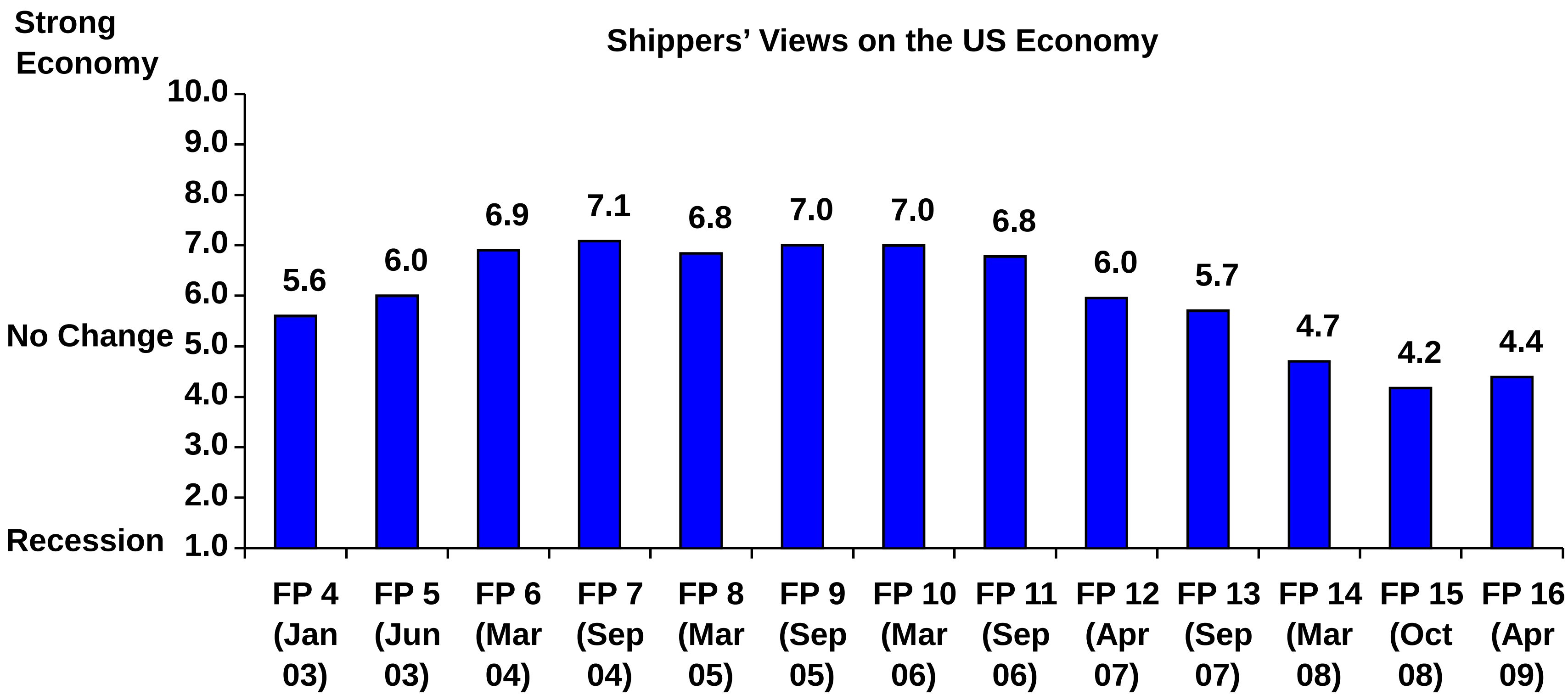
Railroad Shippers' Rankings of "Delivery When Expected"
(ranked from left to right based on most recent results)



Source: Morgan Stanley Freight Pulse Surveys

Shippers concerned about the economy, but not looking for a deep recession

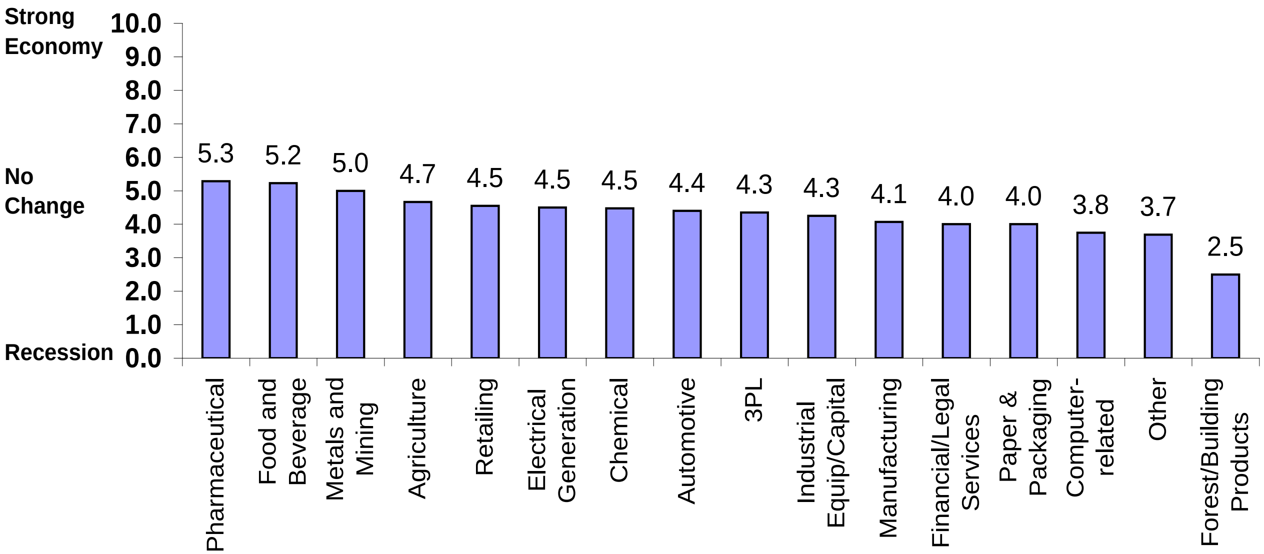
- As expected, shippers rated the state of the economy at one of the lowest levels in the history of our surveys
- However, shippers reported a small improvement from our October survey
- Improved outlook is consistent with end to volume declines in 6 months, but isn't indicative of a V-shaped recovery



Source: Morgan Stanley Freight Pulse Surveys

Manufacturing, Autos, Electric Generation Report Largest Revision to Economic Outlook

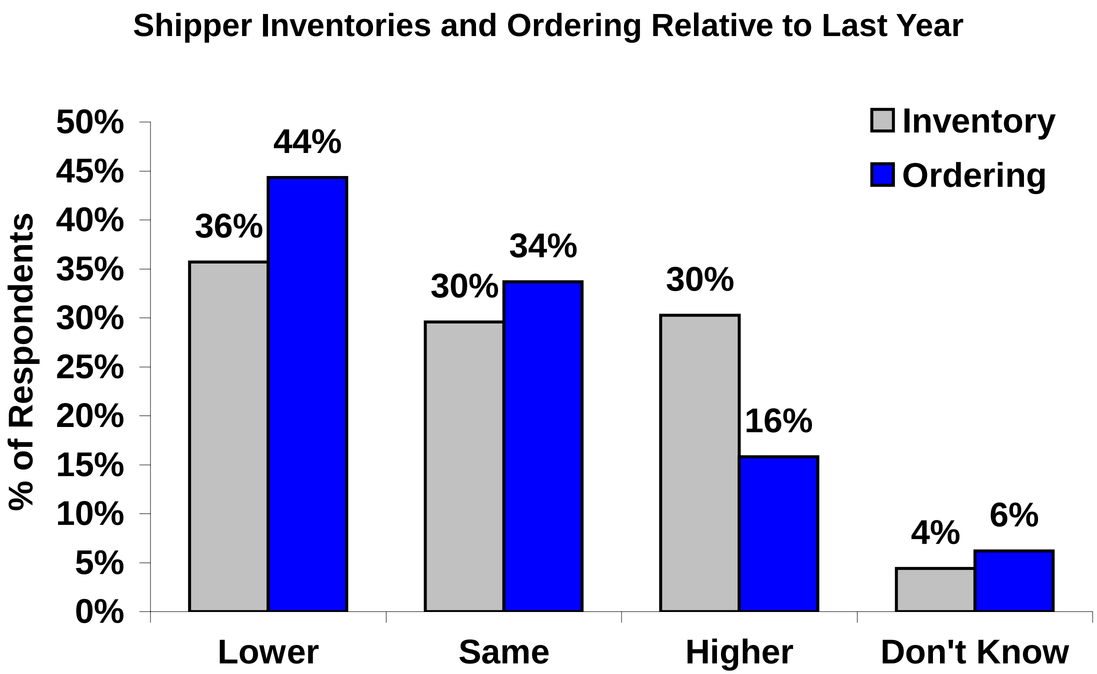
Shippers' Current View of the Economy by Industry Segment



- Pharma, Food/Beverage, and Metals/Mining are the most optimistic about the economy
- Manufacturing, Autos, and Electrical Generation shippers noted the most improvement from our Oct survey
- Forest/Building products and Metals/Mining shippers reported the largest decline in their economic outlook relative to our Oct survey
- Retail shippers were marginally more upbeat as hopes for less destocking and a possible rebound take hold

Source: Morgan Stanley Freight Pulse Surveys

Ordering Slowing Faster Than Inventory Destocking



Source: Morgan Stanley Freight Pulse Surveys

- ~80% of shippers noted ordering is below or inline with prior year levels
- But only 65% said inventories are lower than last year, suggesting there is more destocking to come
- Shippers noted inventories are farther above plan than during our Oct survey, which may temper hope for greater restocking near-term

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**668**	**30%**	**205**	**35%**	**31%**
Equal-weight/Hold	**1005**	**45%**	**272**	**46%**	**27%**
Not-Rated/Hold	**33**	**1%**	**8**	**1%**	**24%**
Underweight/Sell	**517**	**23%**	**108**	**18%**	**21%**
Total	**2,223**		**593**		

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Industry Coverage:Freight Transportation

Company (Ticker)	Rating (as of)	Price (05/11/2009)
William J. Greene, CFA		
Burlington Northern Santa Fe Corp. (BNI.N)	U (01/12/2009)	$70.29
CSX Corporation (CSX.N)	E (03/18/2008)	$28.63
Canadian National Railway Co. (CNI.N)	E (10/31/2008)	$41.03
FedEx Corporation (FDX.N)	E (07/30/2008)	$57.17
Norfolk Southern Corp. (NSC.N)	E (01/15/2008)	$36.44
Union Pacific Corp. (UNP.N)	O (05/07/2007)	$49.34
United Parcel Service (UPS.N)	U (01/28/2009)	$55.83

Stock Ratings are subject to change. Please see latest research for each company.