

June 22, 2011

Railroad Competition Hearing

Testimony for the Hearing on Ex Parte 705 at the Surface Transportation Board

Airfreight and Surface Transportation

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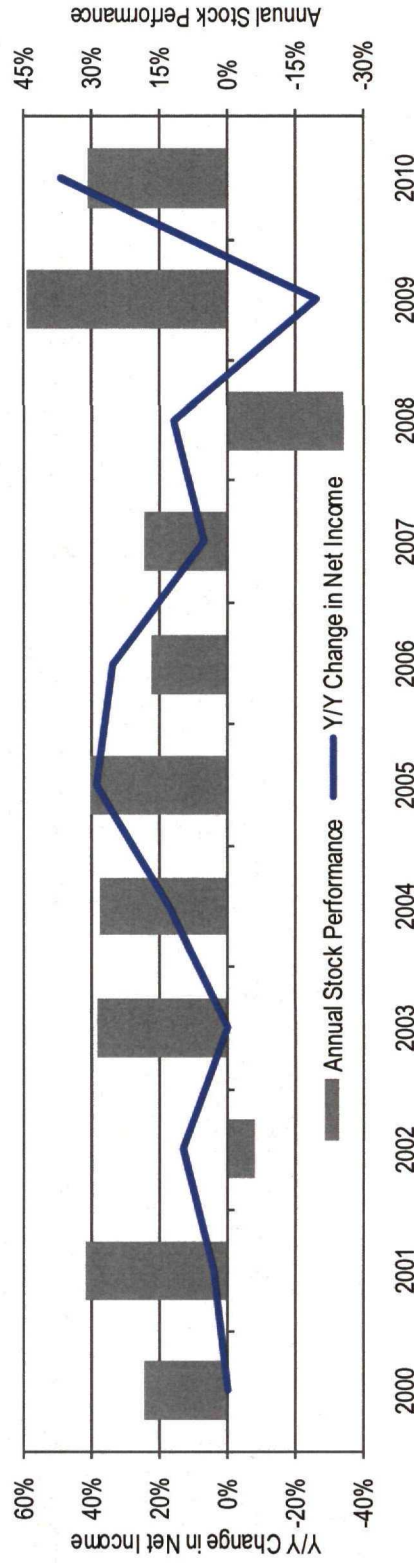
Introduction and Disclosures

- Chairman Elliott, Vice Chairman Begeman and Commissioner Mulvey, thank you for providing the opportunity to testify today. My name is Tom Wadewitz and I am an equity research analyst covering the Airfreight and Surface Transportation industry in the J.P. Morgan Research Department. I have been a senior analyst covering railroad stocks for nine-and-a-half years.
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Investor Perspective on the Railroads

- My experience as a sell side analyst in formulating recommendations on transport stocks and speaking with institutional investors over the years leads me to believe the following about what investors value in transportation stocks: (1) Investors value growth in net income and earnings per share. (2) Investors value both strong absolute financial returns, such as return on capital, and also a trend of improvement in financial returns. Favorable EPS growth performance and a broader trend of improving financial returns have been key factors that have attracted equity investors to the railroad stocks over the past seven years. The following charts show annual performance of the railroad stocks versus earnings growth and versus return on invested capital. The equity market is forward looking and so in the second chart we show performance of the rail stocks versus EPS performance pulled forward one year. As seen in the third chart, the rail stocks have generally performed well during trends of improving financial returns.

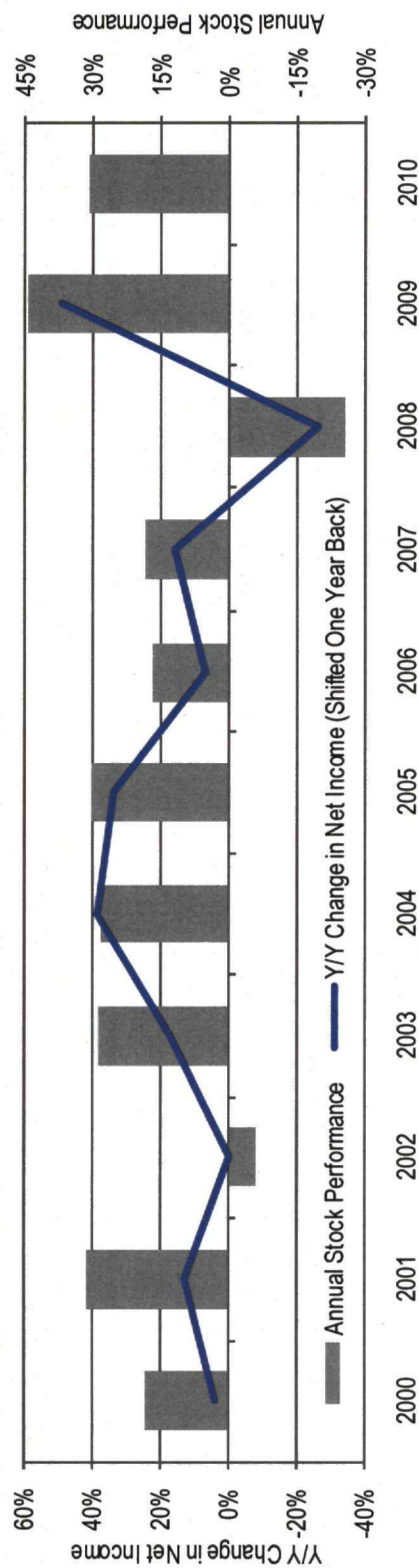
Y/Y Change in Rail Industry Earnings vs. Annual Stock Performance 2000-2010



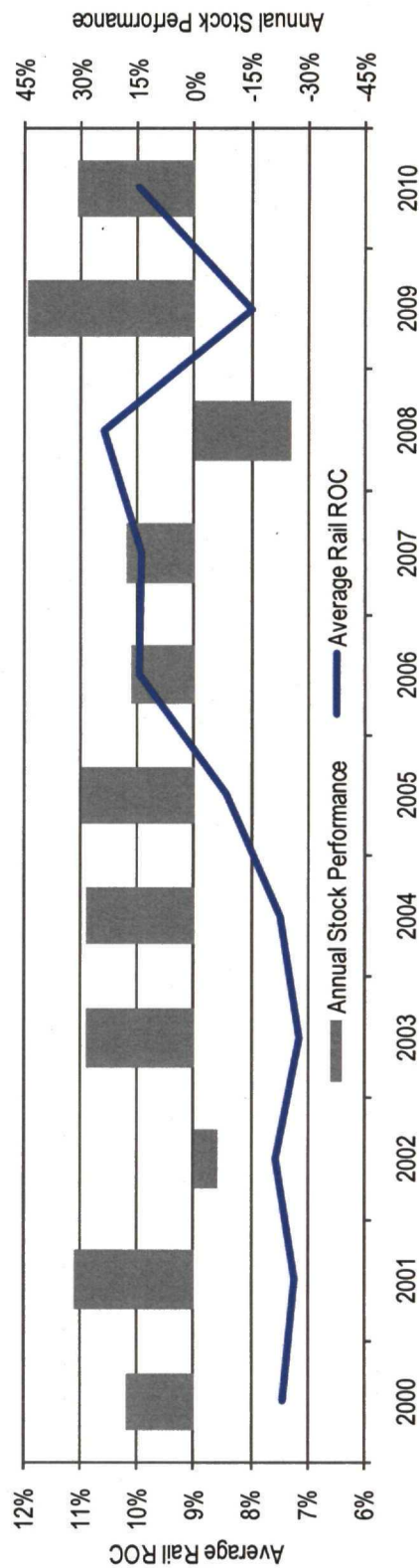
Source: Bloomberg, company reports and J.P. Morgan estimates.
Note: Past performance is not indicative of future returns.

Investor Perspective on the Railroads

Y/Y Change in Rail Industry Earnings (Shifted One Year Back) vs. Annual Stock Performance 2000-2010



Y/Y Change in Class I Rail Stock Performance vs. Average Rail ROC 2000-2010



Source: Bloomberg, company reports and J.P. Morgan estimates.
Note: Past performance is not indicative of future returns.

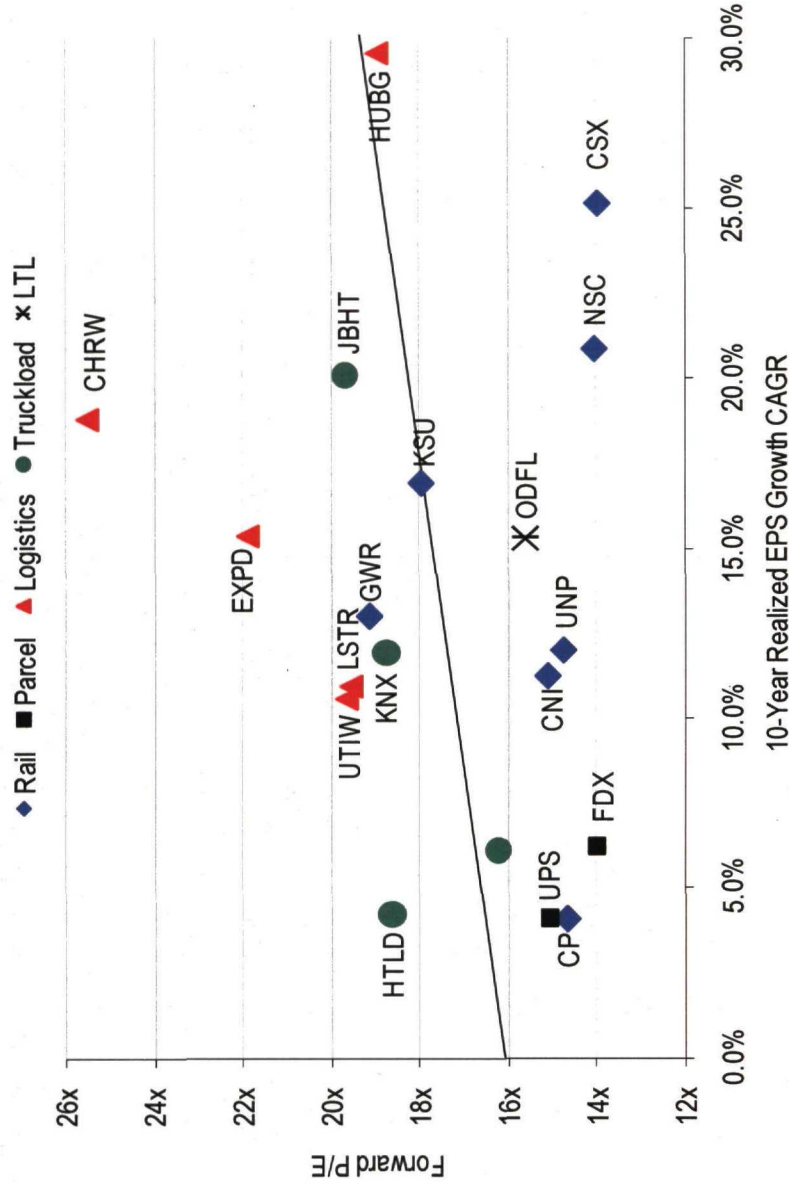
Investor Perspective on the Railroads

- Volume growth, pricing improvement, and productivity gains are underlying drivers of earnings growth and financial returns. In addition to cyclical factors such as growth in the economy, we believe that the railroads can benefit from secular growth opportunities to convert truckload freight to rail intermodal freight. In the medium term, intermodal volume growth typically requires rail capital expenditures and capacity expansion in terms of new terminals as well as sidings and double track. Even though it requires meaningful capital investment, we believe the secular volume growth potential of the intermodal segment is attractive to investors in the railroads.
- Historically, productivity improvement was a significant factor supporting rail financial performance but the pace of improvement in some productivity metrics such as RTMs / employee has been slower over the past five years relative to the significant gains realized after the Staggers Act in 1980. Since 2004 we believe that a favorable pricing trend has been an important factor that has attracted investors to the railroads. In our opinion, significant changes to the railroad's favorable pricing trend would negatively affect the attractiveness of the railroad industry to equity investors.

Drivers of Transport Stock Valuation

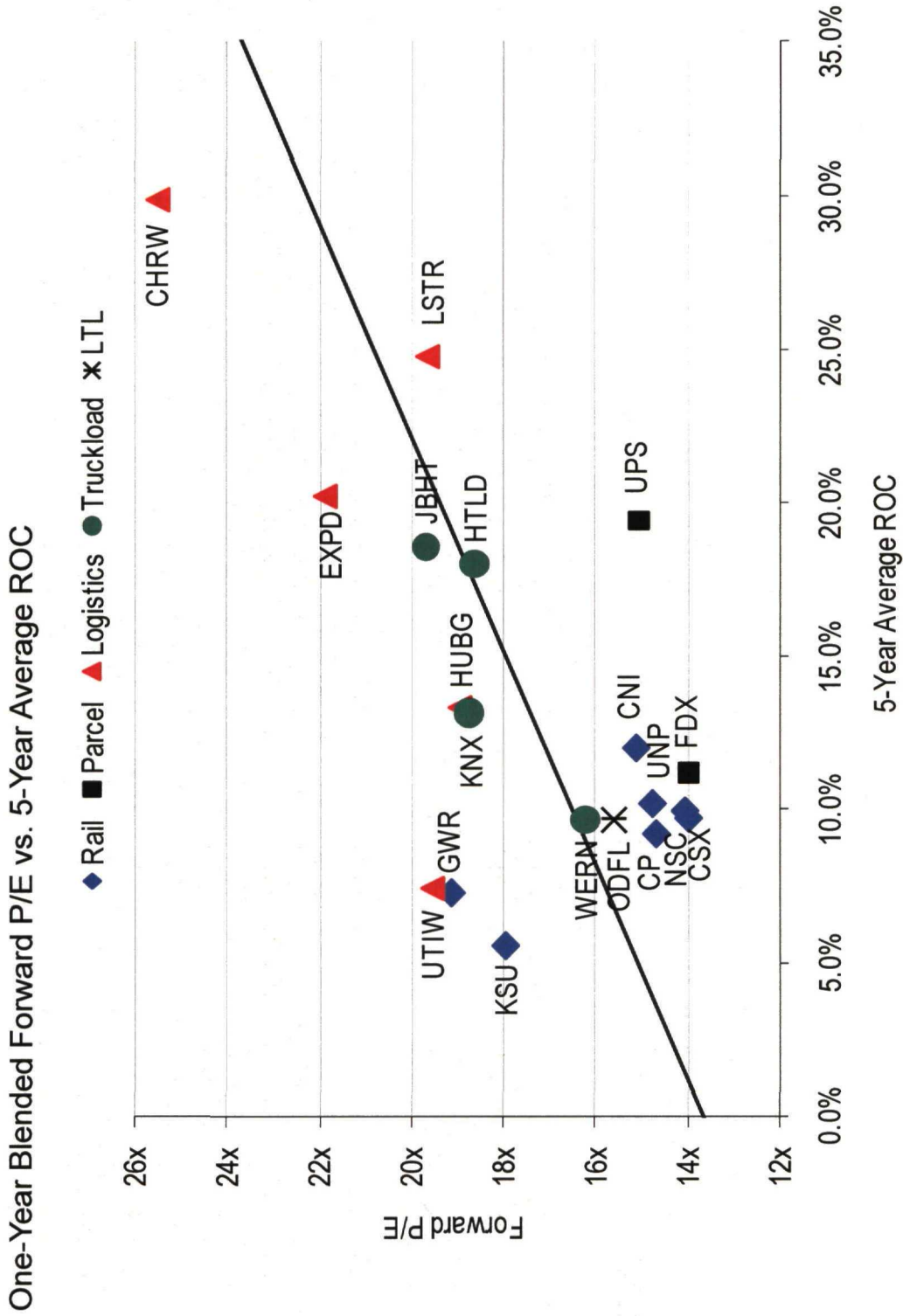
- The following two charts show scatter plots of railroad one year forward price-to-earnings ratio versus 10-year earnings CAGR and versus Return on Capital. The transports which realize the highest valuation are those with a combination of both strong earnings growth and strong financial returns such as CH Robinson, Expeditors International, and JB Hunt.

One-Year Blended Forward P/E vs. 10-Year Realized EPS Growth CAGR



Source: Company reports and J.P. Morgan estimates. Note: Forward P/E as of June 21, 2011.
 Note: Past performance is not indicative of future returns.

Drivers of Transport Stock Valuation



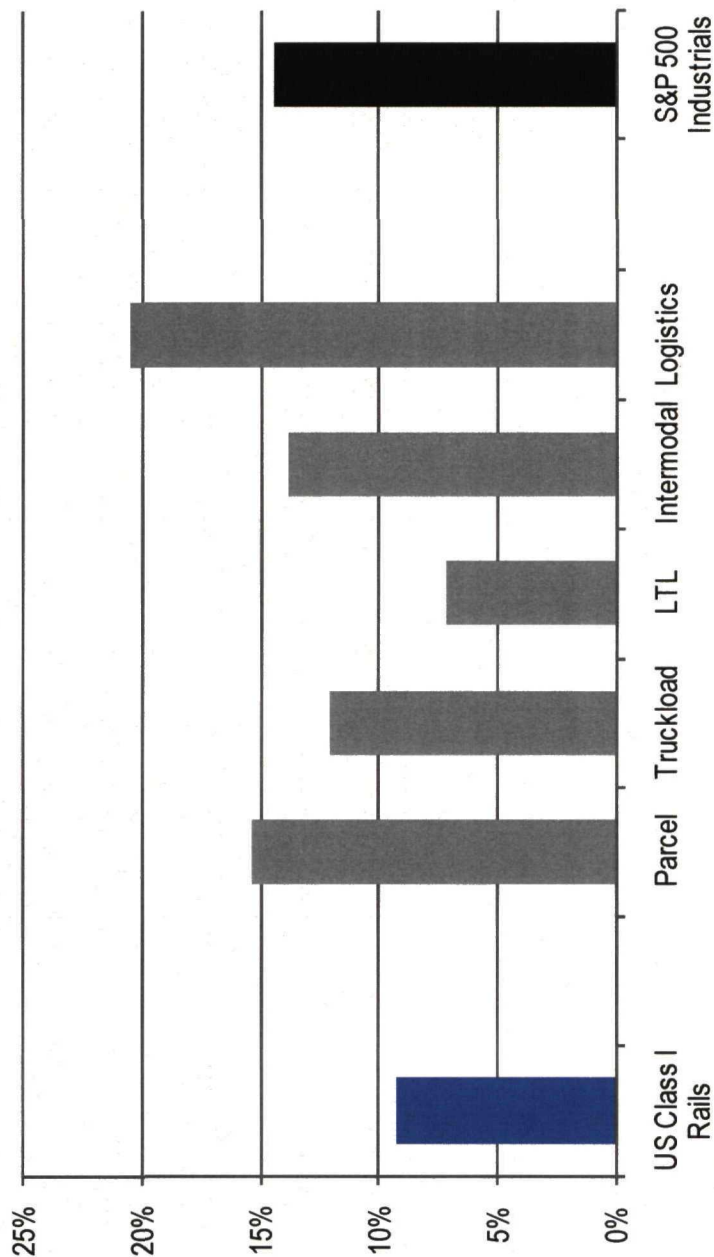
Source: Company reports and J.P. Morgan estimates. Note: Forward P/E as of June 21, 2011.
 Note: Past performance is not indicative of future returns.

Railroad ROC Relative to Other Transports and Industrials

- The railroad industry has realized improvement in its financial performance over the past seven years but its financial returns are still lower than four of five other groups of transport stocks that we cover including small package, truckload, logistics, and intermodal names. Average ROC for the US Class I railroads in 2010 was about 9%, which was only higher than financial returns for the depressed LTL group. On the following bar chart we also show ROC for the industrial companies in the S&P 500. Average ROC for this group of large cap industrials was slightly below 15% which was well above the 9% average ROC for the Class I US railroads. Based on our comparison of financial return performance, railroad returns do not appear to be particularly strong relative to other large industrial companies or relative to other transport groups. We also note that these returns are calculated on current book value, which is significantly lower than replacement cost of the rail systems. In our view, a trend of improving financial return performance provides a key consideration for many investors in the railroad stocks.

Railroad ROC Relative to Other Transports and Industrials

5-Year Average ROC of the US Class I Rails Compared to Other Industrials



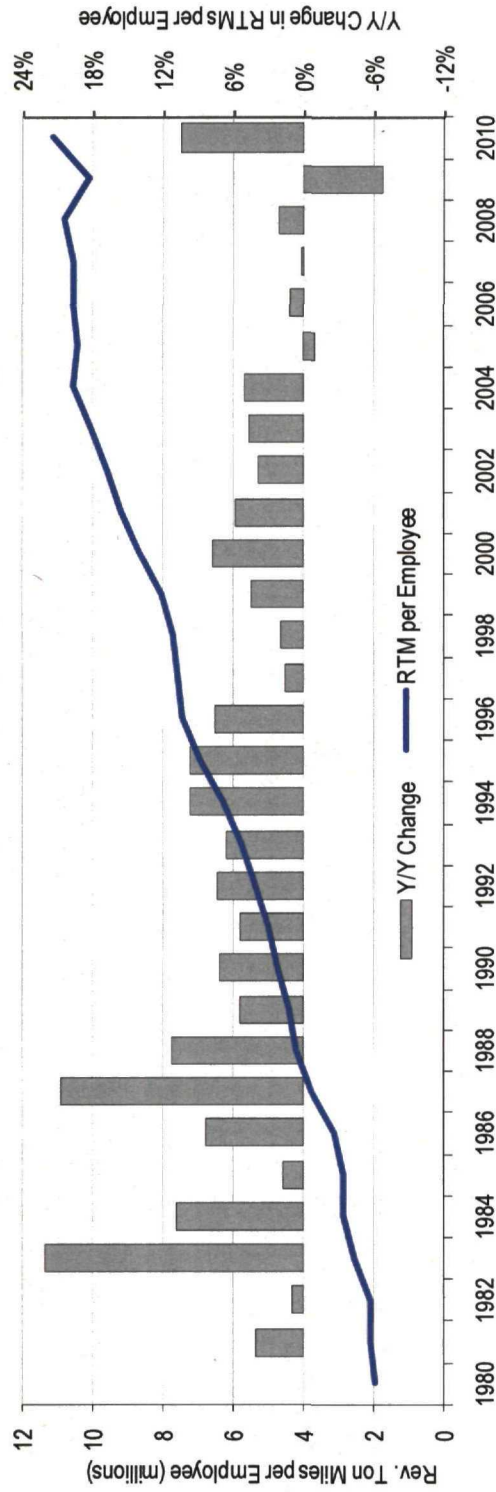
Source: Bloomberg, company reports and J.P. Morgan estimates.
Note: Past performance is not indicative of future returns.

Conclusions

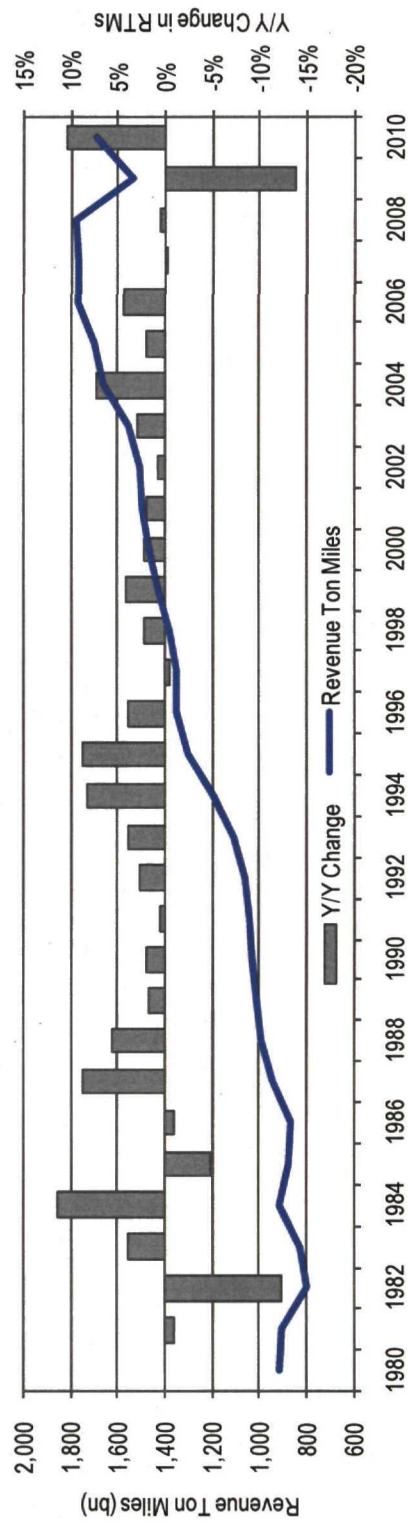
- In conclusion, following are some of the key considerations I would like to mention with respect to the analyst and investor perspective on potential changes to the STB's approach to regulation and rail access.
- 1. **Regulatory Stability Provides Support for Rail Investor Interest and Investment in the Rail network.** In our view, regulatory stability provides greater visibility to expected growth in railroad financial performance, which in turn encourages investors to own railroad stocks. This stability also provides an environment where investors tend to support management decisions to invest in capacity in order to grow volume.
- 2. **Uncertainty is a Source of Risk to Rail Investment.** While the outcome could be favorable, an extended process of considering significant change in regulation could also act as a headwind to railroad equity investors and to railroad management investment decisions.
- 3. **Railroad Financial Returns are Not Particularly Strong vs Other Transport Segments and the S&P 500 Industrial companies.** Railroad financial performance has improved significantly over the past seven years, which has been driven in part by favorable pricing trends. However, railroad return on invested capital performance lags most of the other transport groups and rail returns are also significantly below the average returns of large cap industrial companies.
- 4. **Investors Value EPS Growth but Also Financial Return Performance.** Transport stock valuations show that investors value both EPS growth and financial returns. Long -term incentive plans for the major railroads either include or are primarily based on improving financial returns. A stable regulatory environment that enables improving financial performance will also be one that facilitates strong railroad investment in infrastructure and capacity expansion.

Appendix

Railroad Productivity (Revenue Ton Miles per Employee) and Y/Y Change



Railroad Annual Revenue Ton Miles and Y/Y Change



Source: Association of American Railroads. Note: 2010 data is preliminary.
Note: Past performance is not indicative of future returns.

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