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Transcript

CIBC 23rd Annual Western Institutional Investor Conference

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Banff, AB

Corporate Participants:
Nadeem Velani – Executive Vice President and Chief Financial Officer, Canadian Pacific
Maeghan Albiston – Assistant Vice President Investor Relations and Pensions, Canadian Pacific

Other Participants:
Kevin Chiang – Analyst, CIBC

QUESTION AND ANSWER SECTION

Kevin Chiang

Analyst, CIBC

All right. I think we'll kick off this 11:10 session here. It's my pleasure to introduce CP Rail. With us is Nadeem Velani, Executive Vice President and CFO; and Maeghan Albiston, who heads up their Investor Relations. Thank you again for joining us here at our Banff conference just in your backyard essentially.

Nadeem Velani

EVP and CFO, Canadian Pacific

Yes. Seldom you get to actually drive to an investor conference for us Calgary-based companies.

<Q – Kevin Chiang>: That's right.

<A – Nadeem Velani>: Thank you for hosting us here**.**

<Q – Kevin Chiang>: It's a fireside chat. For those who have questions, please raise your hands and I'll get to you. But maybe I'll kick it off here. CP reported Q4 results yesterday. I thought pretty impressive in a challenging fourth quarter environment, and an outlook that we'll call conservative. But when you look out for 2020, maybe if you can walk me through some of the key headwinds, tailwinds that you're seeing that comprise the guidance of, let's call it, 10% EPS growth?

<A – Nadeem Velani>: Sure. So, maybe I'll start off with a few kind of opening comments before I get into that, Kevin. First of all, it's great to be here in Banff, which is certainly a town that Canadian Pacific has a long history with. I think also being in the Van Horne ballroom, who was our second President. He had the vision to build this hotel, which is one of my favorite ones in the world, so thank you for hosting us. We're really excited to be here, but we're very excited about 2020. So, if I take you back even a little bit in terms of maybe those that aren't as close to the story, 2018 October, we laid out a vision of what we're going to do over the multi-year plan in terms of after fixing the engine and transforming the company, getting our cost structure in place, how we're going to leverage our network strength to grow the business. And at the same time, not take our eye off who we are, which is a precision scheduled railroad that prides ourselves in having a low cost structure, and continue to drive margin improvement. We also want to be mindful of capital allocation, we generate a lot of free cash, and to look at how we reinvest not only for the short term but for the long term, and reward shareholders as well. So, if you look back at what we've been able to deliver, we're coming off, yes, very strong results. I think this was the third year in a row we've grown EPS double digits. We've been the industry leader in revenue growth. We've seen a dividend increase of leading the industry in the last five years, average about 21% a year. We've bought back a lot of stock. I think we bought back close to 30% of the stock back since 2014. So, we've certainly rewarded shareholders at the same time. So, at the same – in terms of a long-term view of how we look at the business, it's not necessarily from an operating ratio, but we use a measure of return on invested capital, which we've been able to, this past year, increase up to 16.9%, which not too long ago in 2010 was closer to 10%. So, we're extremely proud of what we've been able to deliver in our journey so far, but we're equally excited about what's in store for us going forward. And so, yesterday we reported our results. We laid out our vision of guidance for 2020. In many ways, it's

more of the same, so we guided to kind of mid-single-digit volume growth, continued margin improvements, and high-single-digit to low-double-digit EPS growth. Well also at the same time kind of maintaining our capital at CAD $1.6 billion, and with a path to increase our dividend over the next several years closer to 25%, 30% payout ratio. So, as far as your question in terms of what does 2020 look like in terms of the headwinds and tailwinds, I think [audio gap] of tailwinds certainly last year, we had a very difficult challenging winter. We had an outage that that impacted us pretty severely in terms of direct kind of costs as well as what it impacted our network. And it was a terrible tragedy that cost the lives of three of our CP family members. So certainly, as we look at what's in store over the next short-term from a volume point of view, we started the year off a little bit challenging in terms of volumes down a little bit, but we're seeing some real strength, and we expect those volumes to turn positive very quickly here. I think – and it's when we look at our business, it's pretty much broad-based kind of opportunity. So, the new grain crop last year in Q3, Q4 was kind of slow to move. There was some wet weather, and that crop year didn't move as fast as it could have, but Q4 we finished the year in terms of grain with our biggest quarterly movement of grain in the company's history. And so that momentum we see continuing through at least the first half of the year with a very strong carrying crop as well as about a 73 million metric ton crop. So grain, we see as a key driver of volumes. From another bulk point of view, potash is an area that we'll continue to see a ramp-up in K+S, which is the mine that we are the only sole server of. That has nameplate capacity of close to 3 million tons that we're nowhere near getting to that level of movement yet. So, that has long term kind of ability to ramp up those volumes. When we guided to kind of mid-single-digit volume growth, we factored in Canpotex cutting a deal with China kind of late Q1. So, stay tuned for that. Obviously, the impact of the coronavirus remains to be seen what that could mean in terms of a supply shock. So, that's something we're also mindful of in terms of what that could mean to the global macroeconomic environment. As far as other opportunities for us, we do have a number of tailwinds. We have a new transload that we announced will be operational in Q2 of this year in Montréal looking to increase our merchandise line business, so forest products as well as some steel, and some other kind of inputs into the merchandise supply chain overall. We have a new contract with GLOVIS that we announced several years ago. We only had a small component of that business, but this year in September that will start ramping up to the full amount. So, that'll be a tailwind to our auto business. We also have a new auto compound in Vancouver that we're going to looking to – that is sold out now. And so, we'll start seeing the benefits of that to our auto franchise. Just taking a step back, autos obviously has been in secular decline. But for CP, we've had a bit of a benefit in terms of how we've been marketing our land marketing and leveraging the strength of our franchise to connect with customers, and so we've seen a lot of build-ins into our network utilizing our land to build some of these auto compounds. So in 2018, we saw about 11% revenue growth. Last year, I think we were closer to 7%, and we see a path to double- digit revenue growth in autos this year. Intermodal has good tailwind as we speak, we signed on a new contract with Yang Ming. We're the provider of that imported traffic mainly from Vancouver, and so that's been a big contract win for the franchise. Now to be fair, we'll see a contract move to another railroad in the second half of 2020. So, we will – that will turn into a bit of a – that tailwind will be reduced, I guess, in the third quarter of this year. But overall, intermodal volumes have been very strong for us. Domestic intermodal, the last three years, we've had record volumes and record revenues each year successively. We see domestic intermodal continuing to grow. We have our new short line the CMQ that we acquired on December 30th. We've acquired the Canadian operations, and the US operations will go into – is being held in trust until STB approval. We're hopeful that in some time in Q2, we'll be able to take that on and run the

entire property. But as far as the Canadian operations go, we've already started to move some of the domestic intermodal traffic into that. We see opportunities to add to the auto franchise as well as down the road international intermodal. So, I think that'll be more of a 2021 story, but near term we're also seeing some volumes move there as well. It'll be – I guess, we'd have to talk about crude while we're here in Alberta at this conference, and so certainly crude, we exited Q4 with our highest run rate, quarterly run rate in terms of crude volumes. We're seeing strong demand in the current environment as well. So, we see that as a tailwind to 2020 volumes certainly in the first three quarters. So, crude as a whole is definitely going to be a tailwind. Energy, chemical products as a whole. We have a new refinery or new refined product transload that we've been ramping up in the Milton area to serve Greater Toronto consumers. And so, that's something that will start ramping up in the back half of this year, and again will be a bit of a tailwind. So if you sum it all up, said a lot there, we do see kind of near-term opportunities as well as – it's pretty broad-based across the book of business which is exciting. It's not just one area that we're reliant on it, it shows the diversity of our book of business, diversity of our franchise as well.

<Q – Kevin Chiang>: Maybe turning to CMQ acquisition, maybe you can speak just strategically what you think this means for the CN network. Being able to go further East and into the Port of Saint John there, potential synergies and maybe what volumes you think you can grow faster because of this extension of your network.

<A – Nadeem Velani>: Sure. So, we went through that transformation, and part of that was shedding assets and shedding unprofitable lines. We came out in a very good position to now extend our reach and look for opportunities to grow where it makes sense. And where it makes sense, by that I also mean where it makes kind of strategic sense in terms of who we are, which is a railroad. So, we're not necessarily looking to go deeper in the supply chain. We don't know how to run ports. But we know how to railroad. And so from our perspective, when this line came up, we were going to do it only if it made sense from a return point of view. But it was also a very strategic asset in terms of getting connectivity to East Coast ports. So, we have access to two deep-water ports, both in Searsport and also in Saint John. And so as we look at our ability and our network strengths again, we have the ability to move traffic from the Maritimes into the Montréal, Toronto, Chicago region faster than our competitor. Once – it's going to take some investment. I'm not saying this is overnight. But when we look at that network, it was underinvested in from our perspective in terms of our standards. So, we've allocated capital towards getting that line up to our standards. So, the basic ties, ballast, and so forth. So that'll be a two-year project for us, and we'll continue to kind of invest in those opportunities to kind of get that network up to our level of – from a safety point of view, capacity point of view and from a speed point of view. So as far as the – sorry, the second part of your question on that?

<Q – Kevin Chiang>: Oh, in terms of your potential synergies, so...

<A – Nadeem Velani>: Yeah.

<Q – Kevin Chiang>: ...maybe you'll be run trains faster on the network post these capital investments, things like that?

<A – Nadeem Velani>: Yeah. I think, if you look at some of the customers, the customers we've talked to, they were kind of beholden to one opportunity or one supplier in the East. And so, we've been – as we lay out our vision of what we can do in terms of service, and what we can do in terms of providing

outlets for those key producers and customers in that region, they've been very receptive and kind of very supportive. And so again, it's going to take some time to grow. I think you're looking at some of the forest products, some of the autos. Even there is some opportunities to do short sailing South up into the Eastern port and getting on rail. I think there's opportunities within the intermodal space. Again deep-water ports that needed another opportunity beyond what Halifax provides. So DP World is running the port there. They've committed a pretty significant [indiscernible]. There's also existing capacity there that's been heavily underutilized. So, yeah, we didn't necessarily buy it as a huge revenue opportunity. We saw an opportunity to run it efficiently and have a better product for the existing customers. But more and more the deeper we look at this opportunity, it's creating more of a top line potential over the next several years.

<Q – Kevin Chiang>: And you spoke of giving some of your customers an option. Does this also help drive truck-to-rail conversion, which I think has been kind of the ultimate growth opportunity for a lot of railroads to take more volume off the road there? Does this help with an acceleration of that strategy out East?

<A – Nadeem Velani>: Absolutely. The more options that customers have, and rail is certainly a more efficient option. It's a cheaper option. The problem is sometimes it's not as reliable as a truck. So, as we continue to improve that service and invest in the network, invest in the infrastructure and so forth, you can increase the speeds, you can increase the reliability of the service offer in that area. It creates this opportunity to take trucks off the road. Obviously, rail is much more efficient in terms of fuel efficiency, and in terms of the ability to reduce overall emissions. And so, in this environment of ESG focus, certainly it's an area that we see we can play a role as well.

<Q – Kevin Chiang>: Any questions in the audience? Maybe turning to your relationship with Teck, or your Teck contract, your competitor there will start moving some of that volume in 2021. You have highlighted it's about 1% EPS hit in next year. But there are opportunities to backfill that capacity. So, maybe if you can walk me through that pipeline of opportunities that you see? And then, maybe when you look at your network, do you see logistical risks given that more complexity is being added to the Teck supply chain to move this coal from their mines out to Neptune, Ridley or Westshore?

<A – Nadeem Velani>: Absolutely. I mean, I see complexity being added for our customer, I don't see as much complexity for us. So, we'll originate this traffic. It'll still move from the existing mines we serve today, except in this case we'll hand that traffic off to Canadian National in Kamloops at that interchange, where they and Teck will deal with it from that point on. We've had some recent discussions and meetings to work through what that transition looks like. So from our perspective, we'll still move two-thirds of the miles, and won't be responsible for the ultimate destination beyond Kamloops. I think there's still a lot of work that needs to take place. There's a lot of investment that needs to take place in both the North Shore, and as well our rail competitor will be doing a similar amount of investment, I think they've already been doing some. But working through responsibly the best way to continue to kind of move that traffic to its ultimate destination is what we're discussing, and we're focused on ensuring that that interchange works to the best of its ability. I think we are adding a significant amount of complexity unnecessarily, and I think we are adding or Teck is adding multiple handoffs, which is never a good thing. I think they're also adding route miles if they ultimately choose to take it to Prince Rupert for export. That's a lot of extra miles being added into the supply chain, which

has a cost, it also has an environmental cost. So, I don't fully understand it, but we respect it and appreciate it, and we'll work through that.

<Q – Kevin Chiang>: Maybe turning to ag portfolio, Phase 1 of the US-Chinese trade deal was signed. So, if I look at this as a two-part question. I mean, US grain has been pretty challenging for all the rails, so how do you see US grain post this deal. And then maybe longer term, if it's a zero-sum game in that China buys more from Canada – China buys more from the US, and so presumably less from Canada, does that structurally change how you look at your grain franchise longer term up here?

<A – Nadeem Velani>: Sure. So, just to level set, about 25% of what we move is grain, 15% originated in Canada and about 10% from the US. But they're very different markets in terms of what we move. So, our US franchise is corn and beans. Obviously, the Canadian franchise is more the six major grains and very much – an insignificant amount of corn and beans at a high level. What does this do? I think it benefits us in the near term in some of our areas within our US grain market. It's something that we're seeing the potential for more exports. But even some of our growing regions that we serve aren't necessarily going to see a huge benefit from that Phase 1 deal. What it does do is takes away some of the uncertainty in the marketplace. I don't see it affecting our Canadian franchise in a meaningful way. Number one based on what we move. Number two based on the fact that Canadian grain has markets all over the world, and has demand for a high product across the marketplace in the world. So, we don't see a huge negative overall from this. But certainly, the overall kind of headline risk you see around uncertainty with trade between the US and Canada or US and China and also Canada with China is the biggest kind of issue that has an impact in terms of reducing potential investments, and that's the bigger issue, I would say.

<Q – Kevin Chiang>: And then, you've made some investments in your grain franchise here in Canada, high-capacity cars and hoppers. You have the high efficiency product train model. And I think if you add that all together, it's like 44% increased efficiency. Where are we along this investment cycle, and maybe getting elevators to adopt this model so that you can move more grain eventually?

<A – Nadeem Velani>: Right. So, two years ago now, we announced that we were going to invest CAD $600 million to improve our – the fleet of hopper cars that we move grain in predominantly in Canada. We got some visibility from the government in terms of what we could generate as a return in terms of pricing grain, and how our investment wouldn't necessarily be – we would be able to reap the benefits of the investment solely. We wouldn't have to share that with our other rail competitor. So, it gave us visibility to our return and visibility to drive investment in this area that was much needed. And so, in terms of where we are in that journey, I think by this year, out of the 5,900 cars that we want to bring online, we'll have about half of those done, and we should have the rest in place by the end of 2022. And to your point, it's one thing to increase the capacity and improve the railcar product, but we have a two-step process in place as well, which is to ensure that the originating loading facilities as well as the loading – the unloading facilities in Vancouver can accommodate this new model of an 8,500-foot model grain product. So, we call it the high efficiency product. We're about – I think we have about 15% of our current customers that have these origin loading sites that can accommodate the 8,500-foot model. We have line of sight to about 30%...

<A – Maeghan Albiston>: 30%

<A – Nadeem Velani>: ...ramping up by the end of the year. And that's when we start getting the full benefits not only of having a meaningful amount of cars that you can build a unit train, but also that at origin and at destination they can handle it. So, the 44% increase in train load that you referenced is fully utilizing it at the origin, fully utilizing a unit train with the hopper cars, and then the loading – unloading side in Vancouver. So, we're about 20% there, getting closer to about 30% by the end of the year. And we're excited about it. It has a better product for the customer. It creates opportunities in terms of reducing our carbon footprint from a fuel efficiency point of view. It allows a better faster supply chain as a whole. So, it's a better product for customers, for farmers, for Canada as a whole. So, we're excited.

<Q – Kevin Chiang>: You've mentioned this is in a number of your comments just – and maybe a greater focus around the environment, reducing your carbon intensity through some of these productivity initiatives, rail being more fuel efficient than truck. Maybe walk us through some of your ESG initiatives, and some of the stuff that you'd like to highlight maybe some of the things you're working on to continue to drive towards a lower carbon intensity?

<A – Nadeem Velani>: Sure, I'm going to let Maeghan, who leads a lot of our ESG initiatives speak to...

<A – Maeghan Albiston>: Yeah. I'd be happy to. So, I think to your point, ESG has certainly been growing in the investment community. And likewise from a rail point of view, it's equally important to us I think as as an industry, but more importantly for CP specifically, components of ESG have always been an important part of our story. If you think about our safety track record having been the most – the safest railroad in North America for the last 14 years, and having part of our compensation program tied to safety performance. That's certainly a best practice. Likewise, our continued investment in hopper cars, locomotive modernization, those are all things that are in addition to being designed to make us more efficient, they also help us improve our fuel efficiency. And as a railroad since 2012, we've been able to improve our emissions by about 20%. So, these are things that – they're good for our business, but they're also good from an ESG perspective. Where we've acknowledged that we could do a better job is probably on the reporting side and bringing more attention to it. So in December of last year, we issued a new sustainability report. We launched a new sustainability website really with the aim of, one, making sure that we get that story out there, but we also did it using the new GRI and SASB standards. So, as it currently stands, CP is the first and only railroad to report using the new SASB standards. And likewise at the board level, it's also getting increased attention and focus. We created a new Risk and Sustainability Committee last year. And this week, we were in Toronto, and ESG was certainly topical in terms of board education and discussion. So, lots of work underway, and certainly something that is of growing importance to CP, our customers, our employees, et cetera.

<Q – Kevin Chiang>: Excellent. A couple of minutes here if there's any questions in the audience. Maybe turning to another...

<A – Nadeem Velani>: I think there's...

<Q – Kevin Chiang>: There, yeah.

[Inaudible]

<A – Nadeem Velani>: Sure. So, the question around – just want to make sure I'm clear and the audience on webcast can hear it. So, just a little bit more details around the Kamloops interchange with

Teck, and what that could mean in terms of network impact or operational impact. Is that fair? Okay. No, it's something that's big on our radar, and so last week we had two of our senior operating leaders meet with the senior operating leaders at CN and with Teck, and for that specific reason of just how important this interchange can be to the supply chain and how impactful it could be. So it's early discussions. We've raised some of our concerns in terms of what that could mean for other customers, and what our expectations are. And I think both parties, so our competitor and our key customer, Teck, are both open to that dialogue. They understand our concerns. And we'll build a game plan towards making sure that that doesn't disrupt the supply chain or other customers. I just say it's early in that process. We're not going to see this traffic move to that interchange for another 16 months or so. And I don't think that it's all fully understood what is going to just move to that interchange versus what will – could potentially continue to move on as it does today, what could potentially go to Prince Rupert. So, early days, we have a lot to do still. And I think the parties discussing it the sooner the better is I'm hopeful that will come up to the best potential resolution.

<Q – Kevin Chiang>: Maybe with a last minute here if you can speak to your recent announcement with Gibson around the DRU unit. How does that change your long-term outlook for crude as a commodity that might be less cyclical in your portfolio?

<A – Nadeem Velani>: Sure. So, a couple of things. We're the only rail that has access to the new DRU facility that was announced. It's going to be – we're hopeful it'll be up and running kind of Q1, Q2 of 2021. And I think it adds just in terms of the viability of crude long term. It's a small amount of what we move today probably around the relative amount about potentially of about 50,000 carloads. We moved around a little over 100,000 last year. But what it does is it takes away that potential volatility around crude volumes. It gives some certainty to those volumes longer term. It's a 10-year deal with ConocoPhillips. It's also a safer product to move. So, it's – the DRUbit is something that if you have an incident with it, you pick it up with a shovel. It's a non-hazardous product. It's something that is not as susceptible to spreads. As currently spreads need to be in that $15 to $20 kind of level WCS to WTI. The fact that the DRUbit, you can move 30% more of it, certainly improves the economics overall. So, we're excited about what that means to the long-term crude franchise and the viability. It's not a spot move that is just going to disappear. Now, let's be fair. Some of what we're moving today, we probably won't be moving two years from now if they can get these pipelines built which we're hopeful of and we're supportive of. As a Calgary- and Alberta-based company and as Canadians, we're very supportive of the pipelines, and what it means to the greater economy, and we see upside in other areas of our business if pipelines are put in place. So, we see upside both long term in crude, and we see hopefully some upside in other parts of our business if these pipelines get built.

<Q – Kevin Chiang>: And unfortunately, Nadeem, Maeghan, we've run out of time. Thank you very...