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Transcript

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Webcast

Corporate Participants:
Keith Creel – President and Chief Executive Officer, Canadian Pacific

Other Participants:
Walter Spracklin – Analyst, RBC Capital Markets

QUESTION AND ANSWER SECTION

Walter Spracklin

Analyst, RBC

Okay. Good afternoon, everybody. Sorry for the technical difficulties there. I'll dive right into the presentation to make up time here. We do have Keith Creel, the President and CEO of Canadian Pacific with us presenting on behalf of CP. And I guess we'll start it off right away. Keith, why don't you give us a lay of the land? You've obviously given us a good update in your quarter call, but any update you can provide as to how you're managing through the current COVID-19 pandemic would be helpful. Over to you.

Keith Creel

President and CEO, Canadian Pacific

Okay. Thanks, Walter. Well, listen, I think probably the best place to start – I'd be remiss as a leader not to do this – is speak to what's enabling the success that we're creating here at CP. It's fueled the success in the past, and it's continued to do the same even in these uncertain times. Yes, the franchise but most importantly the people. I'd be remiss not to brag about what they're doing as a shareholder just as I feel honored to serve with these people; very unique set of railroaders. Call me a bit biased obviously, but I believe and know it to be true, they're the best in the business. And I'm not talking about only the leaders in this company. I'm talking about our CP family overall. During this pandemic, as this crisis has evolved, certainly no shortage of anxiety or challenges. But as I say often when I speak to our fellow railroaders, it's not the challenges that define you, it's the response. And I can tell you I'm extremely proud of the way this team of railroaders is responding. We're taking this opportunity to not only grow closer internally, to continue to evolve and mature our culture, but also to build relationships of trust with our craft employees, officers alike as we do something that in my lifetime and also in our industry and certainly in this railway's history a unique time to serve not only our customers and our shareholders in a unique way but to serve society. The trains that we're moving I can tell you there's a tremendous amount of pride within this company to be able to get the products to the shelves that we're getting to the shelves that protect the lives and the livelihoods across these both countries, Canada as well as the US. So, as we step into this and I look at the first quarter, we created a tremendous amount of momentum that's unique in this industry with our performance in the first quarter. Obviously, the last two years we've led the industry in growth. We carried that momentum with those self-help initiatives and market wins into the first quarter and exceeded even our own high expectations, which not only is a testament to the opportunity but it's also now serving as a bit of a shock absorber to weather the storm that we're enduring today. And it also, at the same time, gave us a bit of momentum and confidence and a unique way for us to do something that other roads have not been able to do and which is provide guidance. So, in line with our guidance, we said that we felt that we'd likely have and we saw line of sight to mid-single-digit reduction in business year-over-year and flattish EPS. I can tell you that so far we're halfway into the quarter, we're meeting or exceeding that expectation. The railroad is running extremely well. Quarter-to-date, our volumes are down about 10%. That's being fueled by some underlying strengths. And I spoke to this on the investor call as well. Our business mix uniquely creates an opportunity for us given that a large portion of it is bulk. That's what's driving some of this underlying strength. We're exceeding, breaking records in fact that the bulk

franchise, specifically Canadian grain volumes, all-time highs in the month of May exceeding 6,700 cars a week for the past couple of weeks. April in fact was a record volume month in CP's history. So, I'm talking about a long time to move the amount of volume that we moved that's been enabled by our investment in our hopper cars as well as enabled by our people in this unique franchise. It's something that we're all extremely proud of. And if you combine that underlying strength as well and potash, records amount of potash that we've been able to move with the operating performance. Every metric that we've got, we take a look at it. And obviously, this is not new to us. Precision scheduled railroading, it's woven into our DNA. We're eight years into this, so it's not new. We constantly tweak our assets to match our business demand. It's a process that we go through weekly. But I can tell you, if I look across the board, all of our productivity measures, I don't care if it's car miles per car day, locomotive productivity, train miles, crew starts, cost per KGTM, everything is moving in a very, very encouraging manner. And I can tell you it allowed us in April to produce for April a record operating margin in this company. So, again, there's a lot of positive things that are occurring at CP in spite of some of these challenges they give us a tremendous amount of confidence in our guidance that we provided, our ability to meet it and at the same time not sit on our laurels and just take this as a downtime. I can tell you on the marketing side, I've challenged the team and John and his team are responding to create opportunities, again, to get close to the customers. They're obviously challenged as well. Anything that we can do to create a transportation solution that allows them to weather the storm better, to save cost, to drive additional volume to the railway is something that we're pursuing. We've got a unique sales incentive commission, for the lack of a better term, program at Canadian Pacific with our sales team. And we've actually increased their ability to earn money during this downtime as they bring on new business during sort of this lull that we're experiencing. So, the sales team is extremely motivated. The operating team is extremely motivated. The metrics are moving in the right direction. The revenue we believe bottoms. It's essentially at a place now with this month, the next month, in June, where we've hit our bottom and we'll start to climb back out of this. Obviously, the continued momentum and strength with grain is there, continued momentum and strength with potash, and even in a very encouraging way, as many are aware, and if not you'll know now that the Canpotex, their negotiations with China has been resolved. So, that gives us confidence in our expectations for the balance of the year. And, in fact, this past weekend, they also settled the contract with India. So, those two areas give us a unique opportunity, and I'll point back to last year. Last year, given the uncertainty with Canpotex, actually, from a compare standpoint in the second half, there's some upside opportunity for us in that space as well. So, all that to be said, the railroad is running on all eight cylinders. Obviously, we want the demand to come back to where it was. But the same momentum that we had in the first quarter we're carrying into the second, and that recipe that's worked extremely well for us in the last two years continues to work well for us now. So, with that said, let me stop talking and I'll turn it over to you, Walter, to add any additional color and questions.

<Q – Walter Spracklin>: Yeah. Yeah. Thanks very much, Keith. And I think that's one of the differentiating factors that you've been highlighting is your bulk franchise and a bulk franchise that obviously does not have thermal coal and that's really holding in well. You touched on grain, which is great and the potash with Canpotex contract, and the resolution they had with India. That was certainly good news to hear. How quickly do you think will we see that volume ramp happen with potash, and was that in your – did you have in your original guidance the expectation that the Canpotex deal would be reached at around this timeframe or is this earlier or later than what you had been envisioning?

<A – Keith Creel>: You know what, it's actually a little bit later, Walter, than what we envisioned. But Canpotex did a phenomenal job of filling in with alternative markets. So, actually, you're seeing the strength now, it will continue. The place we will pick up year-over-year is in the back half. If I go back to last year, I think about some things that we were challenged with. We didn't spend a lot of time talking about it because we worked through it. But on the domestic side, with all the wet weather that we had on the US, there's a couple of seasons of lack of fertilizer application, which is fueling demand on the domestic side coupled with this export potash opportunity for us. So, if I look at that back half of the year, there's upside. There's an opportunity for us to move about a million more metric tons than we moved at the back half of last year. So, that gives us some confidence and underlying strength. And then on the grain side obviously they're going to start doing some seeding over the next couple of weeks, but we still see fundamental strength through the balance of the crop year. And assuming that we don't have obviously a drought or something that we can't predict now obviously, we're assuming normal production post the end of this crop year going into the last quarter I guess of this year that's going to continue to give us some underlying strength.

<Q – Walter Spracklin>: And your hopper cars is obviously serving you well now that you've made that investment, contributing to a record April. It sounds like that grain is coming on at a time where you're much better able to handle it. Is that right?

<A – Keith Creel>: Yeah, it absolutely is. And I'm here in Vancouver now, went and toured the South Shore and looked at the facilities we have. And the pride that stands over the new records, they continue to raise the bar working with AGT, working with Pacific, working with Cascade. There are expansions down on the South Shore with Viterra, a very large facility Cascadia. We just finished on the, I guess, I'd call it the west end, which is where we spot the train and ability to land an 8,500-foot grain train. And we're on the verge of completing the east end, which is obviously – as they go through the facility where they come out. So, within this crop year, we'll be able to land an 8,500-foot train, make one double, and then depart at originated the empty from there as well. So, we're just moving to another level that this company has never experienced, creating capacity for our customers and efficiencies for our own network. We're about 2,500 of those hopper cars. And I'll remind our investors, we signed up to buy about 5,900. By the year-end, we should be about 3,300, and that's in lockstep with expanding the terminals both on the origination end and of course coming here to Vancouver on the terminating end to be able to handle this 8,500-foot high-efficiency model that we've created. So, we got 15% of our high-throughput elevators now that are capable of launching that 8,500-foot train. And by the end of the year, it will be at 30%. So, again, it's all about incremental improvements driving our capacity, controlling costs, that's allowing us to move records amount of grain at a margin that is compelling and it's moving the needle for us. It's certainly encouraging.

<Q – Walter Spracklin>: We've had a question kind of a revenue-related question, so I'll ask that now. Your competitor had indicated that their revenue would be down more than their volume in May, down 25% revenue and 20% volume. That is implying RPU of negative 5% due to mix and associating it with the auto shutdown. The investor here is saying that you had guided to mix to be positive in the second quarter. So, why would that be different from your competitor?

<A – Keith Creel>: Well, on our automotive side, we got some of the same challenges because that's some of the highest revenue per RTM in the book of business. So, that is a mix issue that's been a challenge for us. Canadian grain, the crude piece as well, crude is completely out obviously. So, I don't

see a whole lot of difference, Walter. I mean, we're down – right now, I'm looking at our numbers, we're about 10% on the RTM basis and on the revenue side, and again the Canadian dollar being weaker. It's helped offset a little bit of this. But there's not a big gap. There's about a 4% or 5% percent difference on the revenue versus the RTMs.

<Q – Walter Spracklin>: Finishing up here on the revenue opportunity if you look longer term. You've obviously made some investments in the East Coast expansion via Saint John, Vaughan terminal expansion. You mentioned your hopper cars. If we've got COVID-19 in the rear-view mirror as we hope we will soon, what's the biggest area of long-term volume opportunity as you see on your franchise?

<A – Keith Creel>: Well, I think you're going to see some additional strength in the automotive side obviously. We've got this – we can talk about it now. We've sold out in Vancouver this facility that we built in partnership with FCA. So, FCA is coming on July 1. We'll pick that lane up, we'll pick Calgary up. And we haven't really talked about this a lot, but I'll point out that we're doing the same thing in Chicago there by our terminal in Bensenville, Schiller Park. We're in the process of building an auto compound. So, FCA will be shipping there and we're in discussions with other OEMs. Very strategic location. Again, speaking to the strengths of the franchise converting land assets. It's right by O'Hare Airport, which is a large destination and obviously a big consumer of those vehicles for the OEMs. So, strategically it's in a great place for us. And then the other big piece that I'm super excited about is the CMQ. The more we learn about opportunities, the more we see to grow in that space. I can tell you now that we're already winning additional business on the LPG side, originating and terminating, where in the past we weren't in that lane. That's the big opportunity for us. We're in discussions obviously looking at automotive opportunities, the pulp side, refined products, as well as intermodal. So, that piece of railroad for us strategically allowed us to answer the challenge that our customers have given us. They wanted additional service opportunities. It's a best-in-class route. You can go from tidewater to the key markets in Montréal 200 miles shorter than our competitor, which, on our best day, you can't overcome that from a time reliability service advantage and its truck-like competitive and truck-like reliable. We're in the process now of spending money investing in the capital to get the infrastructure up to a CP standard. By the end of the year, we'll be able to get from Saint John into Montréal within 24 hours. So, it's a very compelling opportunity, service opportunity, that's going to fuel growth. I see line of sight – that's a USD $40 million revenue railroad that we purchased. The STB obviously just approved that we take over complete control of the railway on the US side October 4. I'm sorry, not October 4, June 4. So, I see within the next 24 to 36 months that piece of railroad is going to enable an additional CAD $100 million worth of revenue. So, that USD $40 million has an opportunity to go somewhere between CAD $100 million and CAD $150 million within 24 to 36 months. So, strategically and from a value proposition, if you think about that CP margins, it's compelling. It's a needle move for us.

<Q – Walter Spracklin>: Absolutely. One question on Teck. Have they signaled into you – certainly, they've noted that they will be looking to shift volume. Have they signaled into you whether this will be all at once come the end of the contract they're going to move X million tons away, or has there been any indication from Teck as to how much volume and when and what cadence they intend on moving over to your competitor?

<A – Keith Creel>: Yeah. Well, essentially, I'll just remind the way it works. We'll originate all the tonnage. So, we're going to get two-thirds of the miles to Kamloops. The last third or the last mile be it going to Vancouver to their facility on the North Shore, which is where we believe to be, although they

haven't advised just yet the final desired tonnage once they get their expansion. They'll get as much of it there as possible. Obviously, it's the closest route to tidewater because if you go to Ridley, which obviously is an alternative going over the Kamloops gateway with our competitor, it's twice the distance. You're talking of rough numbers a 700-mile total trip versus a 1,300-mile trip. That's a lot of time and distance to overcome from a cost standpoint. So, once the contract flips in 2021 to Kamloops, I'm sure that Teck intends to take all of it that they can obviously. But right now there's still a tremendous amount of work to be done at Kamloops for that interchange to be able to handle that tonnage to-date. That interchange is a 60-car interchange. So, you can imagine if you want to try to take 20-plus-million metric tons over a three-mile connecting track, it's going to take a lot of infrastructure. CN and Teck obviously are responsible to do that, and I'm responsible to make sure that we protect our main line and that they get that capacity in place to handle that tonnage otherwise we can't move it over that gateway. So, we'll see. I think they're obviously – their intention is to get it done and they're hard at it, and we're going to work collaboratively with them to make sure that our interests are protected. And once it's time to flip the switch, we'll be able to flip the switch and shift it over in a productive manner and not have an adverse impact on our network.

<Q – Walter Spracklin>: Makes sense. Moving over to the pricing environment, Keith, obviously a lot of disruption, a lot of pain out there, can you talk a bit about, particularly around intermodal where there tends to be a lot more irrational pricing playing out, whether you're seeing that in your own pricing on intermodal? And then in general, are you seeing pressure on pricing from rail or otherwise due to what's going on in the current environment?

<A – Keith Creel>: Well, honestly, customers are going to ask, Walter. I'm not going to say they're not, but I can tell you this. We've – this has been our playbook from the very beginning and it will remain. We're not going to allow ourselves to be commoditized. So, we're very disciplined when it comes to price. We're very reasonable when it comes to price. The two to four model has been the Canadian way. Two to three in a down markets, three to four in the up markets. 2019, we obviously saw some of those pressures, but we stuck to our guns and we sold the value of the service. And we came in a little north of three, and we're seeing the same continued strength overall on our book of business around that same space. Now, obviously, specific to intermodal, there's some softening in the domestic side because there's some excess capacity that's out there. But, again, we're maintaining our discipline in renewing our book, and we're not going to allow ourselves to be commoditized. And it's workforce. I mean, the value of our product, the retail customer that we partner with, the products have to get to the shelves, and those are the products – the Loblaws of the world, the Home Depots of the world, that are critical to what's going on in today's world even more so. So, we're sticking to that. We'll be able to maintain even in that space inflation plus pricing. And that's the other thing, we got to be cognizant obviously with this challenge that we're going through. Inflation is going to be we believe it's going to be low as well, which allows us to continue to stick to that inflation plus and around that 3% number. So, we're not going to change.

<Q – Walter Spracklin>: And that's certainly, like you said, is service-driven. I mean, pricing is easier to get through when the service increase or improves. And I know we hear – surveyed your customers over a long period of time, and we've never noted you being as high as you are today, in fact, the highest among all your competitors in Canada and US. So, service wins are important. Do you see opportunity for share gains through your service to continue? Can you talk a bit about it versus your rail competitors but also versus the truck competitors if that opportunity emerges in a post-COVID-19 environment?

<A – Keith Creel>: Yeah. Our product – and that's the fuel of it. It's all about the asset turns. If you really get into PSR, it's about assets and it's – if you've got the shortest route and you've got reliable service, truck-like reliable service, you can, with the advantage we have on the cost standpoint versus the competitive alternative truck, you can win market share to the railway. And if you've got the shortest route from a rail-competitive standpoint in the key markets that we serve and we do, our franchise does, and we also couple that with capacity and with land, we can create and continue to create unique transportation solutions that are allowing us to win share, and that's going to continue. If I look at 2021 and 2022, I just took back a note, back-of-envelope numbers this morning looking at our merchandise mix over 2021 to 2022 with specific initiatives, I've got it written down in front of myself on this envelope, there's CAD $100 million of opportunity that's in the pipeline that's coming online. That represents some things that we've talked about, some things that I'm not yet in a position to be able to talk about. But it's merchandise business. We're not above and beyond being a bulk railroad, and that was part of the strategy as well when we came. We wanted to diversify the mix. We wanted to get closer to the customers based on an ability to provide reliable service that they would trust us in their supply chain running their assembly lines. Because, effectively, if you think about it, the margins on the 10 and 15 to 20 car shipments are more compelling and more exciting in most spaces than some of the bulk train movements are. So, it's a place where we've continued to grow, it's been the strength for the last two years, and I don't see that changing in 2021 and 2022. I believe firmly, based on what we're seeing and what we're experiencing, and what you can see in the numbers, there's no one else in the industry. Yes, it's contracting, but we're not contracting like everyone else. And when we were growing, we were growing beyond everyone else. So, that same momentum, which is fueled by this strategy, it's doing well in this downturn and it's going to be even stronger as we come out of this, Walter. There's no doubt in my mind. I'm very convicted about that, not based on hope, but based on fact and the opportunities that we've negotiated and were in the process of bringing to the railway.

<Q – Walter Spracklin>: Well, I'll be certainly looking forward to seeing what you've jotted down on the back of that envelope in the investor sessions to come for sure. We can go over a little bit here on time given we were late to the start. I want to focus a bit on your margin and how do you manage margins in this environment. And I always get the question, so I'll ask it to you. How much more room is there in CP's operating ratio? Is 55% an absolute floor without sacrificing business? I know you want to grow. So, given the intention to grow, what kind of efficiency level can you bring CP to?

<A – Keith Creel>: Let me say this, I get more enamored with operational excellence in the way we run the business, because, ultimately, if you run a reliable network, you've managed and sweat those assets, you control your costs, the outcome is the operating ratio. So, how you protect, I think about it now. I look at the first quarter, we had record volumes in this railway and our head count was down 5%, and all of our productivity metrics then were hitting new record levels. Well, in this downturn, you think that, well, you see some of that slip. Well, motherhood is the driver of innovation. Necessity is the driver of innovation. So, this team is we've adjusted, and Mark and the operating team, phenomenal job. I can look at month-to-date numbers, and, again, I've got my pencil out and I looked at it this morning. I'll give you a couple of highlight numbers. Quarter-to-date with RTMs down 9.9%. That's the precise number. As I look at it this morning, train length up 6%, train weight's up 6%. GTMs per operating horsepower productivity up 6%. Cost per KGTM down 11%. I mean, those are compelling numbers. Total crew starts – RTMs is down just under 10%, total crew starts down 16.5%. And month-to-date, it gets even better. So, with demand obviously this month has not been quite as strong as April as this thing started to go to

our trough, if I look at our month-to-date number, we're down, rough numbers, RTM around 12.7%. If I go to that total crew starts, we're down 22%. So, again, it's not slash and burn. It's continually use the metrics, you use the numbers that we use. We've got our key productivity metrics. We look at them on a daily basis, a seven-day basis, a monthly basis, and there's always compared to last year. And you get a feel for this business and you know where to push – you know where the problems are, and you know where to go problem solving. And I can tell you this team they're doing a phenomenal job managing those levers, which ultimately protects those margins. So, in spite of this downturn in business, we're still going to see margin improvement year-over-year in 2020. I don't know how many other railroads can tell you that. It's a very unique value proposition story. And if I look forward to your question, how low can it go? I'm not enamored with that but certainly mid-50's is definitely within the realm of possibility looking at a point next to your point the following year. It's a natural outcome with the way we're running the business. Beyond that though, Walter, I get to a point where I do get a bit gun shy about potential heavy-handed regulation especially in Canada where the regulatory environment we have. You get to a point there where I'm going into my customer, I'm maintaining discipline on price. We're doing extremely well for our customers and service, which is key, so they're getting value out of that obviously. But you get to a point where you might be begging for people to go to the regulator and try to get into final-offer arbitration, which is a very robust and risky way to manage your business. So, unless from a competitive response standpoint, we have to go lower. I'd rather take that leverage and grow the top line and drive earnings because that's ultimately what we're enamored with at this company, is driving record earnings, to continue year-over-year earnings growth. Even in spite of the challenges that we deal with, we still want to produce positive earnings growth.

<Q – Walter Spracklin>: And I think that dovetails into a question I've had coming from an investor here who's asking about the mix and then that is the view that if coal has an operating ratio of 40% and intermodal has an operating ratio of 82%, where do valuations go when PSR expense reductions bottom out.

<A – Keith Creel>: Well, fortunately, none of those numbers are correct. Our intermodal business is actually profitable because of the value of the service. So, when we're bottomed out, I think we're going to be at the bottom, and again we're still producing improvements. So, I just don't see the number changing a whole lot with our business mix. I think that mid-50s is the right place to sort of aspire to and that we'll naturally get to. But beyond that I'm just – again, unless it's a competitive response, I just don't see a need to go there and I don't think it's going to change a whole lot. I think that the normal cadence to run the business right, you should be in that mid-50s number.

<Q – Walter Spracklin>: Okay. Well, that takes up the time. I know we went a little bit over and apologize for the early technical difficulties to the investors on the line and to you as well, Keith. But I guess one of the items of a virtual conference for sure. But I do want to take the opportunity here to thank you and the team for your candor and your time. It's certainly a busy time for you and taking the time to talk to us a bit about the opportunity and strategy and everything that's going on at CP. It's much appreciated, Keith.

<A – Keith Creel>: Well, I appreciate it, Walter. And again, I want to thank our shareholders for spending time with us this morning allowing us to talk about our story, thank them for their trust. Certainly, I know they have a choice especially in these challenging times, but we certainly intend to reward them

for the trust and exceed expectations. Regardless of the storm, we're going to come out stronger at this company. No excuses. It's the challenge we're going to create opportunity.

<Q – Walter Spracklin>: Fantastic. Okay. Operator, we can end the call there. Thanks very much.

<Operator>: Thanks, Walter.