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Transcript

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Webcast

Corporate Participants:

Nadeem Velani – Executive Vice-President & Chief Financial Officer, Canadian Pacific

Other Participants:

Kevin Chiang – Analyst, CIBC World Markets

QUESTION AND ANSWER SECTION

Kevin Chiang
Analyst, CIBC
All right. Good morning, everybody. Thank you for joining us for the third day of our 25th Annual CIBC Western Conference. It's my pleasure to kick off this morning session with CP Rail. With us from the company is Nadeem Velani, EVP and CFO.

This will be a fireside chat. For those who have any questions, as mentioned earlier, there is an app in which you can do so. Please submit them my way, I'll see them on my end and I'll go ahead and flip them over to Nadeem, as they come across my screen. But Nadeem, thank you for joining us again this year at our conference, so is great to have CP on the roster.

Maybe I'll kick off with, I guess, the headlines of the day in Omicron. Maybe give us a sense of what you're seeing on the ground in terms of what impact it's having on your operations and maybe specifically on the labor front given the headlines around labor absenteeism across a number of industries?

Nadeem Velani
Executive Vice-President and CFO, Canadian Pacific

Sure. Well, thanks. First of all, thank you, Kevin for having us. Certainly would have appreciated connecting in person. I think we're all bit fatigued with the virtual sessions, but completely understand given Omicron and the recent events why we need to do this virtually, and glad that we could support and glad that you invited us to join.

So let me just take couple moments, maybe before I answer your question, just to also thank our 12,000-strong CP family. Railroading is never easy with the challenges that this team has faced recently, and what we think is an outdoor sport is truly incredible. I mean, this team overcomes conditions day in, day out to deliver for our customers. 2021 was certainly a challenging year, particularly in BC, and in Q4 had number of times and examples when the team came together to really execute. We had that catastrophic flooding in BC in November, and the engineering team was able to get our railroad back up and running in eight days.

Earlier this year, late December and early into January, the temperatures were minus 40, and they were able to keep trains running while continuing to deal with the impacts of Omicron and COVID, which has displaced hundreds of our employees on leave. So, certainly a thank you to the team and the resiliency that they've shown.

So, to answer your question specifically on recent challenges with COVID and Omicron, we're certainly not immune to the challenges, and the current surge certainly tested our resolve. But we've been able to work diligently through the pandemic, and for the last two years in order to keep people in a safe environment; some areas that we've been short crews, not because of hiring challenges whatsoever, but rather the speed at which Omicron spread and the sheer number of employees that were taken out of service. We also had Transport Canada that mandated vaccination in our industry, which caused some labor issues.

So that being said, we have various mechanism to ensure that surge capacity, whether it's all volume-driven or due to the pandemic, that we can meet our service obligations and what we've been so proud of the service that we provide. So we've been able to support so far, and through

utilizing even managers in the field, and now we're starting to see employees steadily return to work, support our service. And so I think we're hopeful that the worst is over. We have seen some challenges as well with customer labor shortages and what that's meant in terms of loading and unloading at some of the customer facilities where they've been short-staffed.

So like I said, I'm hopeful that the worst is behind us from a COVID perspective, and we'll see steadily sequential increase in volumes that make up for the challenges that I mentioned in November and December and into the early part of this year. And I don't believe that, from a labor perspective, going forward, once we get past through some of the mandated vaccinations and some of the hiring and training that's required, that it will be a challenge for us in 2022.

<Q – Kevin Chiang>: That's a great update there, Nadeem. Maybe if I can just turn to the volume environment, you mentioned some of the challenges especially in the back half of 2021, both flooding, the wildfires, you also had a very challenging Canadian grain harvest. But if I look at volume trends, I guess ex-grain, just before the floods, you're talking about 3% – just over 3% RTM growth. And just given the setup in 2022, how should we think of underlying volume growth, I guess, over the next 12 months just as we think of all these moving parts here?

<A – Nadeem Velani>: Sure. So let me – we'll get into our guidance next week and give a bit more color, but certainly, that kind of ballpark of volume growth, we do expect to grow volumes in 2022 despite the slow start and some of the challenges you mentioned. I think the grain headwind is well-documented, but we do see growth across all of our remaining lines of business. So, the volume impacted by the floods in BC certainly delayed revenues and delayed volumes, so that's not lost.

But given, as I mentioned, it was minus 40 in late December, early January, that's impacted some of our length and train speeds and some of our capacity. So, we haven't been able to claw all that volume back. But like I said, I think that we're over that hurdle and starting to see some improved operating conditions and improved labor issues given hopefully that we're starting to see employees come back.

So, I think as we kind of work through Q1 and even into early part of Q2, we'll start seeing some of those volumes that were delayed materializing. I'm really excited about 2022 with some of our initiatives that we have in place. So, we have a number of international intermodal contract wins and market share shifts that we saw in 2021 that we're going to see the benefit in 2022. We have a new plastics facility opening up just north of here, north of Edmonton for Inter Pipeline, so that will certainly generate volumes in our ECP category.

Continued strength in domestic intermodal. We got our new Maersk transload that will continue to support that volume growth in and out of Vancouver. We have our diluent recovery unit in Hardisty. The potash has been strong, particularly, given some of the challenges that market faced in Q2 and Q3 of 2021. And one area, we talked a lot about the drought in Canada, but certainly we see there are a lot of enthusiasm about US grain, which we haven't been able to talk to, for many years. But right now, we're moving record levels, and this was a market that our team, our operating team, our sales and marketing team combined with industry to fast action and they basically created a product in a matter of months to support a need for – or feed into Alberta. The facilities, the process of supply chain just didn't exist, and there's a local dependency and the team mobilized and created a supply chain to feed – of feed to support Canada.

So very enthusiastic about US grain. We've moved more than 8,100 carloads of corn into Alberta in 2021, and just put that in perspective. In 2020, we only moved 600 carloads. So it allowed us to hit

an all-time revenue record in US grain in December. And we think that that's going to be a – show a lot of support for our grain business into 2022.

DDGs that go into Alberta have seen a 300% increase. So very excited, I could talk about US grain for a while, but I'm really proud of the team. We like our Alberta beef here in Calgary and proud of our team's ability to support this in a challenging environment on the Canadian side. We're also seeing record biofuel revenues in December that we think is going to be a key enabler of growth as well in 2022 and Canadian grain, we've had a lot of precipitation or bit of snowfall.

We're hopeful that we get more of a normal crop in the back half of the year. And so if you combine everything I just mentioned, put it all together, it's why we have confidence that despite the grain drought and the tough start in January that we can grow our RTMs in 2022.

<Q – Kevin Chiang>: I feel like there's a foot of snow everywhere in Canada that's for sure. And maybe let's turn on the pricing side, can you speak to the pricing environment today and just remind us the timing of contract renewals as you could take advantage of what seems to be maybe stronger pricing than normal?

<A – Nadeem Velani>: Sure. Yeah. I mean, this is certainly a strong pricing environment, one of the strongest I've seen in my almost 25 years in the industry. It's something that we – I'll remind you that we look to work with our customers for long-term sustainable growth. So we'd rather see, kind of, consistent 3% to 4% price increases that you can compound over time, and that's driven by the value of our service instead of seeing commodity volatility in the pricing market.

We do expect this environment to remain as long as the supply chain is stretched which I think is we're going to see through the 2022 calendar year. And I'm very pleased with the discipline the team had showed. They've been selling our product and selling our quality of our product. And given how tight capacity is in the trucking space, I think it's something that we'll see the ability to drive our revenue per car, our cents per RTM up pretty significantly. And our sales team is incented to capture price. This is part of our – how they are incented and motivated. Price is a big component of their sales targets that they're measured quarterly.

In terms of renewals, I mean, we probably have about – I'm going to say about 35% to 40% coming up in the following 12 months. So, certainly, a good part of our book has the ability to capture this strong pricing environment.

<Q – Kevin Chiang>: That's a great update there. Maybe turning to your ongoing merger with KCS, you obviously hit a number of milestones exiting 2021. So, first off, congratulations in getting that into trust. If maybe you can just lay out some of the upcoming milestones we should be thinking about as you work through the approval process here with the STB.

<A – Nadeem Velani>: Yeah. And thank you. We're very excited that we're able to close them in the trust on December 14. So the remaining hurdles really rest with the STB. So we filed our STB merger application at the end of October. The STB has seen that application complete. They set a procedural schedule which lays out the key dates for submissions and their review. As it's laid out, puts us on a path to be able to take control in late Q4 2022.

So, the next milestone is the end of February, where parties, opposed to our application, have to file their comments. They would include any request for conditions and responsive applications. The filings will likely have many comments and ask and may create some headlines, but these are only comments and requests will all have to be proven and reviewed by the STB. The STB will also decide on the requests and what specific conditions would look like.

So we have the opportunity to provide our rebuttals to those comments, request 55 days later, which puts us at April 22. So just a reminder, we've said it many times that I think the STB has supported it in terms of it being an end-to-end merger that enhances competition. So we have no shippers that are losing options as a result of the combination.

The facts do matter as we've said time and time again, and we are confident that the facts will show exactly that. So the team is excited about the opportunity, lot of work underway on the integration planning front, while we go through the regulatory review process over the next 10, 11 months.

<Q – Kevin Chiang>: Sorry, I did want to touch on some of the details in your merger application. You provided a lot of granularity on some of the revenue opportunities in that application with the combination of CP and KCS and as to why it is procompetitive. If I could just start with intermodal, you noted the opportunities at Port of Lázaro as an alternative to LA Long Beach. Just wondering in your conversations with steamship lines and your customers, what's been the feedback of creating a new corridor here, and do any investments need to be made at Lázaro to handle any kind of step-up in volumes?

<A – Nadeem Velani>: Yeah. I mean, creating opportunities, creating service is something that customers are always excited about. It creates opportunities for them to grow their business, to cut their costs out of the supply chain. And, certainly, in this environment, it becomes more and more important what we've faced the last few years and the supply chain challenges.

So, Lázaro Cárdenas, it's an uncut gem. It's running about 50% capacity. They already have state-of-the-art infrastructure. KCS today does not have cross-border and intermodal service and the opportunity for single-line service from Lázaro Cárdenas to Chicago in the US Midwest. It's really an untapped opportunity.

So our discussions with customers have been more around fact finding and education I'd say at this point. Certainly, interest about options and potential for moving away from LA Long Beach, considering the congestion that's been ongoing there.

I expect we'd see some interline movements tested in 2022 as an opportunity. It's actually 300 miles shorter to Houston than LA. So there's absolutely an opportunity to take advantage of what we call the Texas shortcut. It's not too dissimilar of how we sold the value of our shorter distances from Vancouver to Chicago, Toronto, Montreal, and gained shares through a better product in the marketplace here up north.

So, very excited about that opportunity. I know it's been talked about for many years. So, I think it's – given the nearshoring efforts and so forth as well, I think it could be a huge opportunity for us and a big part of our synergies going forward.

<Q – Kevin Chiang>: Okay. And maybe just turning to the automotive industry, the overall industry is going through arguably a major transformation here as they transition their product line from ICE vehicles to EVs. Does this change how you look at the North American supply chain or global supply chain for autos? And I appreciate it's early days for these OEMs as they embark on this journey, but any thoughts on what potential impact this could have on your own auto franchise?

<A – Nadeem Velani>: Sure. And let me just speak from a CPKC lines for a moment, but we looked at the opportunity to integrate the supply chain further by being able to provide service both from the origin and the destination, it can be pretty exciting and create a lot of value for the OEMs. So, we'd be able to service the OEMs from our perspective, whether that's auto parts needs or plastics, steel,

some of the inputs and – and as you know, just near your back yard, there's a major auto parts supplier that certainly could benefit from our service and reach.

So, it's certainly a complex dynamic environment and we shift to a greener future. Fundamentally, rail is going to be the most efficient way to move finished vehicles, and demand for finished vehicles is not expected to change meaningfully with the shift to EV. So, watching closely. As you said, it's early. There's a lot of trade noise in a lot of markets.

So, when we look at it today, maybe the locations that are manufactured could change, and that could change some of the shipping patterns that we have in our customers' supply chains. But we are very excited about the fundamental demand and the opportunity that auto could mean for our franchise. We haven't seen auto volumes, and it's been impacted for the last several years. And certainly, it's still going to be impacted into 2022.

So, I think that's near term the biggest issue once we get this chip shortage behind us. I think we'll see some real strength in autos. And then like I said, the CPKC franchise and some of the opportunities that we see part of the business rationale of the CPKC opportunity was centered around automotive. So, we still see this being as a great driver of value for CP.

<Q – Kevin Chiang>: It sounds like even though there could be a little bit of a shifting of the supply chain between the three countries that it – just this combined network creates a little bit of flexibility from CP's perspective.

<A – Nadeem Velani>: Yeah, that's a good summary.

<Q – Kevin Chiang>: Okay. I do have a question coming my way, just back to the Lázaro Port opportunity. The question is, when you laid out your synergy estimates at the onset of the merger; did it include business opportunities at the port? Or, I guess, that's the question. Did it include synergies from the Lázaro Port here?

<A – Nadeem Velani>: Yeah, there's certainly synergies as we look at what we can do to create a product that are national products coming out of Mexico, up north into Chicago, and into Canada as well. So, yes, there's a component that factors in the ability to grow volumes on the international front. If you think about some of the customers we serve today, coming into Vancouver or Montreal, the ports that we serve directly, even Saint John, the opportunity to grow business with our existing customers as they look to take advantage of greater reach and better served ports, we factor that into our synergies absolutely.

<Q – Kevin Chiang>: If I could turn to your potash franchise, you recently renewed your contract and extended your contract with Canpotex. I believe CP, I guess I'll call it legacy CP, has more exposure to the export potash market versus the North American domestic market. Do you see opportunity to grow that domestic potash market share post-merger and basically having this tri-coastal, three-country network?

<A – Nadeem Velani>: Yeah. So, we are very excited about that contract to Canpotex. They've been a long-term partner to CP, and I think our service provides them compelling value, the ability to turn assets. It's their fleet of assets and our ability to move in and out of ports and get access through UP into Portland. We're very excited about the growth opportunity with Canpotex.

2021 was an all-time best year for fertilizer for CP and excited about that growth detection, or that growth potential, given the focus on protecting the food supply chain that countries have focused on pandemic environment. So, from a CPKC perspective, when we think about the domestic side, I'd

say that the story is more focused on grain. We haven't identified a lot of domestic potash opportunities through CPKC. We continue to mine them, doesn't mean that it's a – no pun intended – it doesn't mean that we haven't just ignored that area. Continue to work with our customers and see what opportunities there are.

And Mosaic's been a key domestic potash customer for us, and we've had a long and successful relationship with them. So, haven't identified significant volumes on the domestic potash side there. But we'll continue to focus on it.

<Q – Kevin Chiang>: Actually, it does segue into my second question around, I guess, grains and fertilizers. On the grain front, I think back to your last Investor Day, you discussed CP's HEP train model. But if I look at some of the recent statistics, at the end of 2021, you serviced 41 highly efficient facilities in the US and Canada. First, do you know the split, or can you tell us the split of the 41 between the two countries? And then second, do you have a sense of how many additional facilities could leverage the HEP train model post-merger?

<A – Nadeem Velani>: Yeah. So it's been a tremendous success. 85% of the 8,500-foot high efficiency facilities we serve are in Canada. So, we are seeing a growing interest on the US side and actually have a new greenfield elevator that began shipping just this week in the US. And when you look at CPKC and the opportunities on that front, certainly the excitement US grain shippers have and the confidence that they have, and why we updated our synergy target, was engaging with customers after we first announced the deal. And their excitement about the opportunity and the high efficiency product is certainly part of that. So, we think that that's going to be an area that we can grow, continue to add the 8,500-foot model to.

When they look at our combined network and the locations that it serves, it really creates them opportunity for and an incentive for them to invest in new infrastructure given the new markets. So, I do expect multiple 8,500-foot facilities will ultimately be added in the US on the new network.

<Q – Kevin Chiang>: I do have a couple of questions here coming across. I'll put them together, because there's a similarity or at least a common theme. So, just regarding, I guess, post-merger – post-approval of the merger with KCS, any update on the deleveraging plan? Does your balance sheet or leverage targets stay longer term? So kind of in that 2.5 to 3 times range. And I guess what would trigger the share buyback? And maybe lastly, in your CapEx plans, does that include anything from Port of Saint John? I know it's a long question there, but if you can address some of those items.

<A – Nadeem Velani>: Yeah. Absolutely. So, yeah, we finished 2021 at 3.9 times debt to EBITDA. We have a very successful offering in December at record low interest rates and certainly pleased on the timing, and actually pleased with the support that CIBC have also provided. I will say that we are absolutely committed to getting back to the 2-point times – 2.5 times level.

It could be in that range of – end of 2023, we could start seeing getting to that level, assuming we deliver on our plan this year and into 2023. We're – when you look at what we are committed to do, it's, number one, getting our balance sheet back. That's a commitment that we – I made, and our team made to our debt holders. So when you look at when a potential buyback could take place, it will be after achieving that level. So once we get past that point, so whether that's in the 2024 timeframe, certainly, I would expect some level of buyback and dividend increase at that point. But again, not until we get back to our target leverage of 2.5 times or lower.

<Q – Kevin Chiang>: And then just in your overall CapEx plans, just I guess is there anything being allocated to Port of Saint John?

<A – Nadeem Velani>: No. I mean, I think there's – I think we see it as an opportunity for federal investment – federal government to be investing into that port. And I think that's moving ahead here very well. So I think that there's going to be an investment announced. That would be my expectation.

We're – we will spend money and our CapEx on our network. We committed when we bought the CMQ, that we'd get that track back up to our level of expectation at CP. We've been investing CAD 25 million to CAD 30 million a year into that network to get it up to the proper class that we expect. And so that's where our investment is coming through. We're also investing in equipment to support the service, so very excited about the opportunity there; but no, no specific CapEx in the port.

<Q – Kevin Chiang>: Great. We have a couple of minutes here. I did want to talk about, there's a recent press release this week just on some of the initiatives you have on utilizing hydrogen technology. So you are evaluating. You are investing in new propulsion technologies. You have a partnership with Ballard. How far are we from moving from diesel to alternative propulsion system, a greener propulsion system and maybe as an interim, just thoughts on fuel blending as a transitionary solution until we get to that technology?

<A – Nadeem Velani>: Sure. Yeah, great question. So, we are very excited about our hydrogen locomotive pilot. First units are expected to be in revenue service this year, actually. And we're excited about the leadership role that we're taking. The ability to retrofit diesel locomotives with a zero emission technology does provide a very practical pathway to decarbonizing the freight rail industry. We also like the ability to control our own destiny and ensure the path forward considers our high operational standards.

So, we recently got awarded a CAD 15 million grant from Emissions Reduction Alberta, and they see the potential as well and that's enabled us to increase the scope of the project pretty dramatically. So we are also looking at considering fuel blending as an interim step, and looking at our options within our existing fleet while also protecting our warranties on the locomotive.

So with the amount of capital required to retrofit 1,000 plus CP units, we wouldn't be good stewards of capital if we didn't look at least that opportunity as well. So, it's a number of initiatives in place, and I would just say that our locomotive GHG reduction target doesn't include the hydrogen locomotive. So any sort of success on that front will be additive to sort of the ability to reduce GHG emissions from over and above what we had already committed to.

<Q – Kevin Chiang>: Excellent. And obviously, you're taking a leadership role from that perspective. Unfortunately, Nadeem, we've run out of time here. It's always good chatting with you. There's a number of questions I wanted to get to and then unfortunately, we've hit the end of this session here. So, look forward to chatting with you again soon. And everybody, thank you for joining us today for the CP presentation. Thank you again, Nadeem.

<A – Nadeem Velani>: Thanks, Kevin. Appreciate it.

<Q – Kevin Chiang>: Have a good one, everybody.