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Transcript

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Corporate Participants:

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

Other Participants:

Ken Hoexter – Analyst, BofA Securities

QUESTION AND ANSWER SECTION

Ken Hoexter

Analyst, BofA Securities

Good morning. Welcome to our next session. I am Ken Hoexter, BofA's airfreight and surface transportation analyst, and marine shipping analyst. With us, next up we have Canadian Pacific. Nadeem Velani, the CFO. This is actually – Nadeem, this is your first time presenting at the conference over the years. I know you've been here many times in your prior roles, though he was named CFO at CP back in 2016. This is the 16th time Canadian Pacific has participated in the 21 years we've hosted the event, so we thank you for your continued commitment.

With us in the audience, I don't see him but Chris de Bruyn somewhere from investor relations, so Nadeem will send you to Chris with all the tough questions. So, with that, Nadeem, welcome. I think you have a few slides to get us started?

Nadeem Velani

Executive Vice-President and CFO, Canadian Pacific

No, no slides whatsoever.

<Q – Ken Hoexter>: No? Good. Okay. So, well then, let's just talk about what's going on. Maybe I'll just turn it over to you for an update, here we are midway through the second quarter, and how things are progressing.

<A – Nadeem Velani>: Good. Well, thanks, Ken. Thanks for having me and, yeah, it's our pleasure to participate. Great to be back in person. So, I'd say tough start to the year, challenging first quarter. Whatever could go wrong seemed to go wrong. We had down 14% in volumes, tough winter weather, impact of Omicron on crew shortages, etcetera; high derailment costs, high stock-based comp. Anyways, it was a challenging first quarter.

That being said, we highlighted that we expect that to be an anomaly and that we'd see sequential improvement in the OR on the order of at least 1,000 basis points and that we'd see a second half that could see double-digit RTM growth and still line of sight to positive earnings for the year. And pleased to say that since then, we've had a very strong April. May is also on track.

Arguably, volumes are a little bit better than expected. So, the headline number is down, but we're still battling through a very poor grain crop in Canada. Volumes are down about 65% on Canadian grain, our largest business unit. But if you strip that out, our volumes overall are up mid-single-digits. So, we'll see continued kind of weakness in grain and it will probably fall off a cliff here soon as we fully run out of Canadian grain and they go through the seeding process as we speak over the next week or two here. That being said, we're optimistic for a more normal crop. The moisture levels are looking favorable, so we're optimistic that we'll see a very strong rebound in Canadian grain starting with the crop in August 1st.

So, with that, I think we have a very positive outlook as far as our volumes, the operating leverage that comes with that. The network is running very well. Train speeds are up, dwell is down. We're getting some more density on the network which is key to operating leverage. And as we get the volumes of Canadian grain recovering and where we see some of our own self-help initiatives when we look at some on the intermodal side, on the ECP side, it's a pretty strong outlook for the rest of the year.

And then of course, we head into 2023 with, subject to STB approval, the opportunity to consolidate CPKC. We're optimistic in the first quarter of next year. And then, we start layering on some – the potential of what we can do with that network in terms of the revenue synergies, the USD 1 billion synergies that we've outlined. And by the day, we're getting more optimistic on the ability to the size of that pie growing, so I'm very optimistic on the next several years of what we have in front of us. It's a good time to be at CP.

<Q – Ken Hoexter>: So, if I think about your volumes, you mentioned carloads are down 4% and RTMs is down 5% somewhere, give or take, and both in line with our targets. Revenue per RTM was up nearly double digits in the first quarter. Any indication in terms of what we're seeing on maybe pressure on the spot market, in trucking? Is there any impact on pricing as you look on the rail side?

<A – Nadeem Velani>: We're not seeing that in the near-term at all. In fact, we look at our overall pricing, about 40% of our book is being repriced this year. Long-term contracts are being renewed kind of in that 6% level, so in my 25 years in this industry, it's never been as strong as I see it today.

We're seeing in some areas in the spot market on the intermodal side high single-digits. In end of April, we got the decision by CTA on Canadian grain that's regulated. The increase on the VRCPI, as they call it, is up 12.7%. Obviously, that does include a bit of fuel. That being said, when a regulated environment is increasing at that level, it sets quite the tone in terms of the pricing environment.

So, we're – near-term, we don't see the softness. We're kind of watching for it. We don't have our head in the sand - that the economy is just going to continue to grow. And obviously, there's a lag in what the Fed does and what the Bank of Canada does on the macro side, but so far so good.

<Q – Ken Hoexter>: Wonderful. Let me just take it down to near-term before we go longer-term, right? So, your first quarter adjusted OR came in just around 70% from mid-50s last year with degradation from the strike, from fuel. You noted that CP can operate sub-60 for the rest of the year. Is there anything that you see that derails that, whether it's fuel, whether it's other costs that have crept up?

<A – Nadeem Velani>: No, not at all. I mean, I have the utmost confidence. I wouldn't have said it if we didn't feel that way. Utmost confidence will be sub-60 in Q2 and still have a view that mid-50s in the back half of the year is achievable. If you think about what I highlighted in terms of where volumes are, where the network is, sure, fuel has gone up but that also creates opportunities on the intermodal side.

And some of these things that we've seen upside on when we talk about the VRCPI, the better grain performance or better grain pricing outlook so, no, absolutely optimistic, the fact that we've had a very strong April, a very strong start to May as well or halfway through May.

<Q – Ken Hoexter>: And the regulated grain pricing kicks in.

<A – Nadeem Velani>: It kicks in August first on the new crop.

<Q – Ken Hoexter>: With the new crop? Okay. So, let me jump over to PSR for a second. You were part of the original team, deploying it with Hunter, and the recent STB debate on the impact of PSR and the reduction of industry employees and kind of almost blaming it for congestion and lack of fluidity in the rail network. What do you think the misperception is about PSR in terms of – or where is the industry missing how to use it to flip to growth?

<A – Nadeem Velani>: Okay. That's a...

<Q – Ken Hoexter>: It's a loaded question.

<A – Nadeem Velani>: ...loaded question, it is. No, so I'd say better that I don't speak for the US rails. Let me speak from our perspective which at CP and previously at the other Canadian railroad, PSR, it's not an overnight thing. You can get some quick wins overnight. But to me, it's something that has to be kind of integrated into the culture of the organization, which takes years. We've spend a lot of time – Hunter used to do Hunter camps and spend majority of his time with people; Keith has continued that.

And what we do in terms of the leadership development, the training, the education of PSR, how we structure internally within the organization, how we collaborate, a lot of that has – to me, you get the added benefits of PSR and how it gets really integrated in the culture into how we operate day-in, day-out, how we allocate resources, how we adjust when volumes are down, how we adjust when volumes are up.

It also takes a great deal of, to me, the right type of capital investment. You look back – Ken, you've been around for a long time – how we spend a lot of capital and a lot of discussion around how do you get the benefits of PSR with the longer trains, with some of the blocking, what you do in terms of terminals and investments, the extended sidings. It's years of capital investments that you can save on locomotives, you can save on railcars. If you're running PSR the right way, you're asset utilization is going to improve significantly. But I'd argue that some of that capital needs to be put into the base infrastructure to get the most out of running PSR, running these longer trains and getting the density on the network, working with customers to get the loading and unloading to get to – that supports asset utilization.

So, to me, it's not something that you can just necessarily do overnight. I think there's been a lot of success in the US network. I think there's maybe a bit of lack of experience, to be honest with you. I think some of the rails have had great experience and operators that have done PSR for a long time, but some don't and it doesn't just occur overnight.

I'd say that when you pivot to growth, leveraging that low cost and better service, it drives opportunity to grow from rails, grow from truck. We haven't seen that yet, but I'm optimistic that they'll recover well. I think they'll hire and get some of the training that's required to get capacity up to what they need to grow, and I'm optimistic about the industry.

<Q – Ken Hoexter>: Wonderful. And I think to prove this point, right? Despite the work stoppage, weather, your operating metrics improved, right? I mean, we saw train speeds up 1%, train lengths up 1%, right? So, were there specific measures you took in terms of getting there or is this just continued PSR improvement?

<A – Nadeem Velani>: Yeah. I mean, we had a choice, right, in January when we had to cut train lengths with the weather when we didn't have – when we were down almost 10% of crews because of Omicron and COVID and so forth. Can you look at it short-term and say okay, we're going to cut costs as much as we can to overcome that significant drop in volumes?

The short-term view would be yes. The long-term view would be continue hiring, continue to stick to the plan because as you recover and you get out of the short-term kind of headwinds, you'll be able to generate the benefits of the volume growth. So, through this, we didn't take that kind of short-term view of just slashing and burning; that's not PSR anyways. It's setting yourselves up so that when the network is in a position to recover, you've got the resources and the ability to leverage that growth, and that's what we did.

So, we've been hiring, we've been training with this view of everything I talked about in terms of some of the growth in market share that we have in front of us and this more normal grain crop. There's going to be a significant volume increase starting in August-September for us, so we need to hire, we need to train. And so, despite kind of volumes being down, we had to kind of have that longer-term view and increase our labor force to set ourselves up for kind of the longer-term success.

<Q – Ken Hoexter>: You can definitely see the companies that are moving faster; they're seeing the need for those employees. So, where do you expect to climb, right? So, is there a percentage you've given on employees in terms of where we should...?

<A – Nadeem Velani>: Yeah. We'll continue to – we're adding as we speak. So, the training process, six months or so. So, across the network, we're adding employees back because you always have attrition, right? I think that's something that maybe the naysayers are forgetting, that there's 7% to 10% attrition in our industry. And then, you take a look at what's happened with the great resignation year with COVID and so forth, that's accelerated that as well.

So, you need to hire, you need to train just to get to base level and then for growth. So, we expect to be flat, flat head count for the year. So, we'll continue to ramp-up through Q2, Q3 and get to that kind of flat level.

<Q – Ken Hoexter>: So, you mentioned the CP-KSU merger in terms of the USD 1 billion and opportunistic on even beyond that. Maybe just walk through what happened with the data submission? Did that delay anything on the back end? Is it still – January-February, is that still the timeframe? And maybe what are the opportunities on that USD 1 billion? Can you maybe revisit those and talk to us and walk us through how you get there?

<A – Nadeem Velani>: Sure, yeah. So, the STB asked us to refile some of the data. There's an adjusted procedural schedule that they gave notice on end of April. They gave us till the end of May or May 27 specifically to file that. We filed it May 13, so a couple weeks ahead of schedule. Now, any interested parties have 20 days to respond and then we would then respond to that.

So, we're looking at – similar timeline is kind of what we highlighted in January in that we do think we'll have a decision sometime first part of 2023. By statute, they do need to provide a decision on February 23, by February 23, 2023. So, I think we're on track; we're back on – the schedule is now active again, so I don't think there's a significant delay in our view.

<Q – Ken Hoexter>: So, nothing changed with that February 23 deadline? That's still...?

<A – Nadeem Velani>: That's correct.

<Q – Ken Hoexter>: Okay. And then, your thoughts on the USD 1 billion?

<A – Nadeem Velani>: Yeah. So, I mean, I think the USD 1 billion that we highlighted, originally it was closer to USD 800 million when we announced the transaction back March of 2021. Then, as we went through the year and went through the process, as we dug in - you learn more. You engage with customers, you look at the opportunities, and you engage with your employees and so forth. And, we bumped that up to USD 1 billion, the majority of that through growth.

Since then, we've continued that process. And obviously, when macro events change, that can drive other opportunities as well. You look at what's occurred; the horrific issues overseas, the geopolitical events that are occurring. I mean, that's – on the positive side, it's creating some opportunities. I mean, if you look at what – potash demand is exceptionally strong. The perfect

example when we look at our synergies and the size of the pie potentially expanding, potash export by Canpotex. We're the majority of that contract. Their biggest customer is now Brazil, outpacing China. They're looking for outlets. They're looking for other opportunities to export, diversify their transportation. K+S, we're the sole supplier of their potash transportation within Canada.

So, recently, we had part of the team – by team, I say John and Keith looking at the network and looking at opportunities. And they were down in Port Arthur, Texas where we do export or where we do – move some of the DRU crude out of Hardisty down to Kansas City, interchange with KCS and move it to Port Arthur. Well, that terminal has untapped capacity, that they used to do soda ash. Why can't a terminal such as that be an opportunity to export potash?

So, we had part of the Canpotex team, part of the K+S team, our team looking at that facility and saying could this be a 2 million, 3 million ton kind of export facility? So, there's opportunities like that that come along that you can't model back in March when we announced the deal or you couldn't model it back in September when we re-announced the deal. So, as you kind of mine the opportunities, other things come up. As the macro environment changes, other things come up.

So to me, that's one example. I've got a half dozen of those that we probably don't have too much time to go through them. But to me, the size of the pie is growing. Our confidence in the ability to deliver the synergies is growing, so we're excited. We just – we got to be patient. We're in trust right now; we'll honor that. But I can assure you that as soon as, STB-willing, we get the approval, we'll be hitting the ground running and deliver that USD 1 billion.

<Q – Ken Hoexter>: Wonderful, huge opportunity there. So, when you think about intermodal, right? So, we're coming up on the July 1 negotiation deadline for West Coast ports. They seem confident that they're going to keep operating and not an issue.

Are you seeing some share shift already ahead of that to Vancouver? Are you seeing increased congestion? I know you like to talk about the East Coast opportunity, and we're certainly seeing that, but let's stick on the West. How is that trending so far?

<A – Nadeem Velani>: Yeah. I mean, you got to remember, Vancouver relative to LA-Long Beach, Prince Rupert relative to LA, it's such a small piece. But small moves are meaningful to us in Canada, so we continue to see strength. I wouldn't say – I can't point to something right now, Ken, to say that because of this strike we're seeing a shift. That'll be a bit bold for me to say; I can't give credence to that. But I think if you look over the last decade of what's the share shift in Canadian ports, as Canadian – the reliance and the reliability of Canadian rail, the labor stability, the cost advantage, currency certainly helps, I think it's a great opportunity and I think we'll continue to see some share shift. And, yeah, we are excited to talk about the East, and so happy to speak there as well if you'd like.

<Q – Ken Hoexter>: Yeah. I mean, feel free. I mean, talk about your – I mean, it's something Keith loves to talk about, about the development of East Coast untapped capacity within the network.

<A – Nadeem Velani>: Yeah. So, we acquired the CMQ two years ago. It was a USD 40 million railroad which we were hoping to grow to a USD 100 million railroad. We're on pace now for over USD 200 million of revenues through that network. Big focus was on Saint John, the Port of Saint John, an untapped port that had huge potential but just wasn't realized.

And this week, or next week actually, we're going to start moving a second call for Hapag-Lloyd. They've got ships in the water as we speak. That's 1% of total revenue type of opportunity, just this

additional call. And you can argue that you're utilizing capacity that is very underutilized, right? It's an opportunity to grow margins.

When you look at why Hapag-Lloyd in this environment chooses its rail partners, I mean, service matters. Their ability to turn their assets, get them back on the water for them to get another revenue move is so critical. And so, it's a classic example of utilizing untapped capacity, working with partners at the Port of Saint John with the NBSR, the short line that we work with, and then our chief or main customer being Hapag-Lloyd selling service and driving opportunities on untapped rail. So, it's very exciting. That move in and of itself is growth from Northern Europe. It's an opportunity to not necessarily take market share but just to benefit from unprecedented growth, so it's exciting.

<Q – Ken Hoexter>: So within – I'm going to go to some of the commodities real quick. So, within EC&P, what's the status of crude contracts, liquidated damages? Are we cycled through that or is there still some to fall away?

<A – Nadeem Velani>: It's slowing down. So, that was the – you'll see kind of the year-over-year kind of headwind is – was at its peak in Q1. So, overall, as we go through the year, you're going to see kind of a cents for RTM in crude of about CAD 5.25, CAD 5.50. Crude overall is relatively slow.

There's still pipeline capacity. We'll see what occurs with production at \$115 crude. The Canadian producers are doing well. They've been able to reduce their costs significantly over the last six years, seven years. But I'm not sure whether they're going to just start ramping-up production. They've got a lot of dividends to pay back and buybacks to do, so we'll see.

<Q – Ken Hoexter>: Grain? Are you still seeing incremental benefits from the new cars and the train capacity or is that now grandfathered-in?

<A – Nadeem Velani>: We're still adding to the fleet, so we're not done; we'll be done early part of next year. But you're going to see the benefits of the new hopper cars kind of this year with this new crop so obviously, we've been ramping-up. Unfortunately, we ramped up at the peak when we got the drought, so we haven't seen the benefits yet. But at the same time, we've been investing.

Our customers have been investing on the 8,500-foot model that allows us to both originate and land our longer trains, so they're going to benefit from these hopper cars. So, part of the reason why I'm so optimistic about the operating leverage we'll get on the upside is all of that. We haven't seen that at all.

<Q – Ken Hoexter>: Okay. Perfect. Auto timing? Is there a SAAR target you kind of have built-in? Your thoughts on the rebound here?

<A – Nadeem Velani>: Yeah. We don't. I don't have a SAAR target, and the reason being is our auto branch is a bit unique. It's not as, call it, economically sensitive. We have a lot of our own self-help initiatives. Right now, autos is up double digits for us. Part of that are market share shifts we've seen at the end of 2021. We've seen some of our customers, the Toyotas of the world that have strong sales that are allocating some of the chips that they have to the production of their vehicles.

So, we have some additional kind of upside on autos when we look at other potential contracts. And then of course, when we get into the synergy potential, I think that can be a big area of growth for us. So, yeah, not a base economic kind of SAAR number that I'll point to.

<Q – Ken Hoexter>: And then coal? Have you grandfathered the loss of the Teck business? I don't know if that was in April last year.

<A – Nadeem Velani>: I think we have. Yeah, I think we have one more month. You'll see the end of it this quarter. And then it was April of last year, so you'll see it through this quarter and then we'll lap it.

<Q – Ken Hoexter>: And then sustainability of demand? Just consistent met coal exports?

<A – Nadeem Velani>: Yeah. I mean, Teck is an industry leader in terms of their cost structure, their ability to get it to market. So, I think that it's – I think the demand for steel and met coal is going to continue over the foreseeable future. I don't think that there's a viable replacement for it in the near-term. I think there's a – global demand is still exceptionally strong and we're aligned with Teck being a key producer.

<Q – Ken Hoexter>: So, let me get your thoughts on rails in an inflationary environment. Historically, I mean, obviously, you talked about pricing which looking at this, the regulated grain pricing, what's going on on the rest of your bases is just really robust, and that's kind of a follow-on effect of when truck pricing also skyrocketed. Now, we're starting to see that loosen and we've got some rails in the US having some service issues, but the rails have been protected on pricing for a while. So, what's your thoughts on in an inflationary environment, how do the rails perform and their ability to continue to get those pricing gains?

<A – Nadeem Velani>: Well, I think we're in also a bit of a new environment. If you think about the benefits of rail from a sustainability point of view, the environmental benefit, so I think that it's unique kind of going forward. We haven't really seen the benefit of that historically. I think generally, when you think about how rails can do, obviously our margins are very strong, the ability to price above inflation. You've still got the alternative being truck still having challenges from hiring, from hours of service. I don't think we've seen the ability to really drive market share gains in any sort of meaningful way the last decade.

To me, in an inflationary environment, you're going to see opportunities for customers to choose lower and cheaper transportation solutions. You look at some of the major retailers that have released results the last few days. Part of their challenges with their earnings has been transportation costs. Well, I can assure you that they're moving a majority of their freight by truck. And for them to find opportunities within rail, within intermodal that can be much cheaper than the truck alternative to me is the solution. So, in this inflationary environment, I think that there's a big opportunity for the rails.

<Q – Ken Hoexter>: I'm going to – I want to switch it to CapEx, but let me just see if there's any question in the audience. Nope? All right. So, CapEx, you talked about CAD 1.5 billion which is about 18% of revenues would be high. I guess, what we're seeing in the – PSR railroads have moved it down to kind of 14%. When you want a position of growth, it kind of starts creeping up again.

What are your thoughts in terms of – your thoughts on as you prepare for growth? Obviously, we saw your peer in Canada kind of get hit by growth multiple years and then kind of behind the curve on CapEx. Is it the recognition of that to stay ahead of kind of where you see the pinch points and keep investing? Is that a right level or is there some catch-up that you're looking at? What's your thoughts on it?

<A – Nadeem Velani>: Sure, yeah. So, I mean, we plan our capital kind of multi-year. Percent of revenue, we haven't been a big fan of that as a metric. But that being said, when we look at what opportunities we have in front of us, of course, the base investment back into basic capital which is about CAD 800 million a year. Above and beyond that, we look at where the growth opportunities are. We look at what we need to do from a systems point of view, etcetera.

I mean, so CAD 1.5 billion is a fair number for us. We've had accelerated investment into the hopper car program that I mentioned of about CAD 150 million a year, so that's going to roll off early part of next year. But then, we've got some other opportunities to grow when we think about what we're going to be spending on capital for the CPKC network. I think when all told, when we look at our capital investment, CAD 1.5 billion, CAD 1.6 billion is a fair number.

<Q – Ken Hoexter>: Okay. As CFO, thoughts on timing of debt pay down? You've now got, what, about CAD 20 billion in debt, 5 times leverage post the acquisition. What's your thoughts on timing to get back to your target?

<A – Nadeem Velani>: Yeah. So, we're sub-4 as we speak. I think we'll be – end this year around 3.5 times. I think we'll – end of 2023 is our target to get back to that 2.5, 2.6 times. I think outside of a massive change in the currency, if the Canadian dollar depreciates significantly, could that move a little bit? Perhaps, but I think we're on pace for that 2.5, 2.6 times in the next 18 months.

<Q – Ken Hoexter>: Okay. And 2.5, 2.6 times, that's where you – your target or that's just...?

<A – Nadeem Velani>: Yeah. That's what we've always targeted as our – that's kind of our sweet spot...

<Q – Ken Hoexter>: Okay.

<A – Nadeem Velani>: ...and that's what we've committed to when we did the financing for the acquisition. We've been very clear with the rating agencies that we want to get back to that level. We won't look at any sort of buybacks. We won't look at any sort of dividend increase until we get to at least to that level.

And we have a lot of pretty exciting investment opportunities in front of us on the CapEx side. So, we've historically had a 16%, 16.5% return on invested capital. We've had a lot of meaningful opportunities to get returns through our capital process and generate value for our shareholders. As we reduce our debt and we get that draw down to that 2.5 times level, we'll re-assess our capital allocation at that time.

<Q – Ken Hoexter>: In the past, is there – as you mentioned fuel getting up to \$115, is there a point where you start to see degradation in economic activity based on fuel?

<A – Nadeem Velani>: It's a great question. I mean, being a Calgarian living in Alberta, we're a bit maybe biased that there's huge benefits obviously locally. But no, you do question and you do look at it from a macro point of view. Like I mentioned, Target announcing today and Walmart, you can see the impact on the consumer. At some point, it is going to – our fuel surcharges, the truck fuel surcharges, etcetera, it's going to impact the consumer and it will slow down the economy, whether that's \$115, \$100, \$90.

To me, I've always felt like a sweet spot is in and around that \$80 to \$90. It's kind of balanced in terms of the benefits to the economy and what we move as a company versus the impact on inflation and the consumer. So, \$115 is getting a bit high.

<Q – Ken Hoexter>: Yeah. We just heard from J.B. Hunt, too. They said on the lower end, they're also seeing it on their furniture kind of moving business. All right. So, I guess just to – we've got just a couple seconds here, so if I try and sum up, right? So, pricing very robust, regulated, even better, a boost in August. Mid-50s OR certainly in the second half, hitting sub-60 in the second quarter despite the impact of fuel. Operations continue to perform very well. Excited about the acquisition and the USD 1 billion opportunity, and I presume you even see some upside to that as you move

forward and look at some of the opportunities. Is there anything you'd kind of want to wrap-up with or anything I'm missing here?

<A – **Nadeem Velani**>: No. I think you summed it up well, Ken. We're excited for finishing this year strong and more excited about what's in front of us starting 2023.

<Q – **Ken Hoexter**>: Wonderful. Sounds great. Thank you.

<A – **Nadeem Velani**>: Thanks, Ken.

<Q – **Ken Hoexter**>: Thanks, Nadeem. Appreciate it.