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Transcript

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Corporate Participants:
John Brooks – Executive Vice-President & Chief Marketing Officer, Canadian Pacific

Other Participants:
Ari Rosa – Analyst, Credit Suisse

QUESTION AND ANSWER SECTION

Ari Rosa
Analyst, Credit Suisse Securities (USA) LLC
All right. Good morning, everyone. Thrilled to kick off day two here of the Credit Suisse Industrials Conference with Canadian Pacific. Extremely topical railroad as you all know I'm sure, and we have the CMO John Brooks. John is going to open with a couple of introductory comments and then we'll kick into Q&A.

John Brooks
Executive Vice-President and CMO, Canadian Pacific Railway
Great. Thanks, Ari. Appreciate you guys having us here today. Yeah. Exciting times at CP, no doubt. If I think about 2022 and the journey we went through, not only obviously with the big news of the day and the KCS acquisition, and that trials and tribulations to say the least. But also 2022 was quite a year. It was really, as we said, it would be kind of a tale of two halves. The first part of the year if you recall started off, our volumes and revenues were off pretty significantly, a lot of headwinds in the first half of the year. Of course, we had a Canadian grain crop that was significantly down. But as we move through and into Q3 and now Q4, our volumes have really inflected. We saw a positive growth in Q3 and we're often running here with a pretty strong quarter that we've put in so far in Q4 and expect to finish the year quite strong.

All that to say though, this is really about looking forward to 2023 and I know we'll talk about it Ari. But we are setup I think truly unique as you think about in terms of our peers and investment opportunity to turn in something quite special in 2023 and beyond. As you think about our business being I think resilient in terms of our Bulk business being a big part of our portfolio. If you think about some of the initiatives that we have brought on in 2022 and we'll enjoy in 2023, and then, also the big price that pending STB approval, which we expect, a whole lot of synergy and opportunities that we'll be able to bring on in the back half of 2023. Maybe I'll stop there.

<Q – Ari Rosa>: Got it. Wonderful. Yeah. So let's kind of continue on that trajectory. So, it looks like quarter-to-date carloads are up about 12%. I think RTMs are up 10%. Got some strength in grain, intermodal, autos, and then, a little bit of weakness on the coal front. Maybe you could kind of talk about where you are seeing areas of strength, where you are seeing areas of weakness, and kind of your take on the economy and where CP fits within that or how CP is being impacted by those kinds of economic forces?

<A – John Brooks>: Sure. So let me unpack a little bit of that. Maybe I'll first say on the economic front, obviously we are watching the headlines daily like everyone. You know what, we're certainly starting to see some pressures in some areas, our intermodal, import-export business. Now, that being said, I think we're up 60-plus percent quarter-to-date in international intermodal as a result of a number of initiatives and wins that we have brought on. But relative to six months ago, we're certainly seeing some pressures in that area. But on the flip side, our grain business is, as you said Ari, is very strong both from US and Canada. We've got the – I think, roughly the fifth largest crop in Canadian history, 75 million metric tons. I met with a CEO of a grain company the other day, he thinks it's closer to 80 million metric tons. We're going to be strong in Canadian grain, and in US grain to finish out the year, and then well into to 2023.

You brought up our coal business, there's an area where particularly the last two or three months, it's been quite a headwind. We're up, as you said, close to 12% quarter-to-date on an RTM basis, which I'm very pleased about. But the potential in – above that I thought was even going to be bigger in Q4. And a big part of that is our partner Teck has struggled with a mine outage at their Elkview mine. I think last I saw; we've missed out on about 100 trains of coal quarter-to-date. So, there's puts and takes that are out there. I would say that this market is interesting. As much as I have concerns and we're watching closely recessionary issues in the business, the supply chain is still pretty choppy in some areas, too. A lot of those things that we faced during COVID have somewhat subsided, but they haven't subsided across all the business.

So, headwinds there, tailwinds in other areas. But I think, generally speaking, our story is unique as you look to 2023, and I will talk about that more here in a bit.

<Q – Ari Rosa>: Got it. And in terms of the coal franchises, we're talking mostly export met coal here, right?

<A – John Brooks>: We are. And look, the market is strong. I know if Teck was up here, they'd be saying they're frustrated as we are in terms of some of that lost opportunity. And I think, again, as you think about 2023, our Bulk – 40% of our business is Bulk and that's our grain business, that's our potash business, and that's our coal business. And if you think about those three business units in recessionary periods, they're pretty resilient. They hold up. And I think, it's part of the story. As you think about next year, what makes CP unique that so much of our business does sit in this area. And we expect very strong Canadian grain in 2023.

We expect, frankly, our potash business – we're looking at, I'm going to say, volumes 10% to 15% opportunity to be up year-over-year as you look to 2023. And we're confident that this Elkview mine will come back at some point in December, and we'll have a strong 2023 in the met coal area.

<Q – Ari Rosa>: Got it. So, in terms of that kind of 2023 outlook, and I don't want to preempt anything that you guys might put out in January. But one of the things I think has been remarkable is on your earnings calls, you've talked about how resilient the business can be and how maybe this cycle doesn't have the kind of same level of exposure to the kind of economic headwinds that might have existed in past cycles. Maybe you could dig into that a little bit. And certainly, I know on the grain front...but maybe also what we're seeing in terms of shortages of commodities kind of across the globe?

<A – John Brooks>: Yeah. So, I do believe and you're going to hear me say the word unique 20 times this morning. I do believe our story for next year does fit that bill. We keep it pretty simple. I think about it next year to your question in terms of three legs of the stool.

One, we already talked about the Bulk franchise. We've got a significant opportunity there in all those three business units, the grain, the potash, and the coal. But the second leg of that is what we simply call our self-help initiatives. So, that's business that we've been able to create unique markets with our customers. We've been able to onboard in 2022 or we'll get the benefits of that onboarding here early in 2023. That again will help create some cushion, if in fact, we do see a significant pullback.

So, I think about opportunities like our growth within the international franchise. We're up 68% right now today year-over-year in international. That's an area that's pulling back, but we'll still see a tailwind because of these initiatives. So, the Port of Saint John, we've talked a lot about the growth opportunities there and the success we've had with CMA and Hapag-Lloyd. We have CMA contract that we've yet to lap. That was a significant win for CP. We've brought on a new refined facility in

Northern Alberta and with our Saskatchewan and then we also have added a new plastics facility on our line that's recently ramped up in Northern Alberta.

And then on the last earnings call, I talked about some new Ford Motor Company business that will be starting January 1. It's a significant win. It deepens that relationship. It helps set us up for the future. That business starts January 1. So again, you take a strong Bulk franchise. You combine it with some of these self-help initiatives that we've been able to successfully win and onboard. And those two things alone, I think, create for CP the ability to start to weather if there is a big pullback, recessionary-wise.

Now, the third leg of the stool and the one – well, I'm excited about all of them, but certainly excited about the KCS. And with STB approval, which we're hopeful for, and control towards, let's say the middle to end of Q1, the opportunity we begin to bring on and realize those revenue and volume opportunities is significant. So, when you line up those three pieces, that's why I say our story is unique for 2023.

<Q – Ari Rosa>: Yeah. No, I certainly agree. I don't think anybody in the room would disagree that, CP has a unique story to tell right now. Let's stay on kind of pricing for just a moment. And so, it's been interesting to note, if I look at revenue per carload is up high-single digits last quarter. Revenue per RTM up kind of low-double digits, certainly good by any historical standard. That said, and we don't mean to sound like criticism, but if we look at some of the peers, they were kind of up 20% on some of those metrics. So maybe, I guess, some of that reflects mix, no doubt. But I'm curious, is there an opportunity to be a little bit more aggressive on pricing do you think, as we think about 2023 and kind of how are you thinking about kind of CP's ability to price above inflation in kind of a high inflation environment?

<A – John Brooks>: Well, I'm going to maybe start off by countering you a little bit here and say, I think we're the most disciplined, best-pricing railroad in the industry. We have long, not only had a very aggressive approach with our sellers out there in the marketplace, that part of their compensation is tied to pricing. And I think we've been wildly successful in capturing consistently inflation plus for our book.

Now, I'll remind you, we are lapping a significant liquidated damages headwind. Again, something I'm not going to apologize for, we were very successful in 2022 in making sure that crude by rail contracts had a very tight tie to them in terms of performance. And so, what you're seeing is some of the benefits that we captured there that are sort of offsetting some of the cents per RTM numbers, relative to the peers. Of course, we're going to close that out at the end of the year and then that won't be there.

I will say this, I sit here today, I was looking at the numbers this morning, our cents per RTM is up about a little over 18% quarter-to-date. I am continuing to see our pricing come in at that high-single digit type level. You tell me what inflation's going to do next year, but I do continue to see a pricing tailwind, which is counter – maybe counterintuitive a little bit declining if we or if we see a pressured volume environment.

But regardless how that plays out, I can assure you, we're going to stay disciplined in that area. We price for the value of our service. We believe we have the best service in the industry, and we price for the value of our capacity. And I think more than ever today, shippers with the fragileness of supply chains and some of that uncertainty, they value that, and I think, are willing to pay for some of those premiums.

<Q – Ari Rosa>: I'm curious, what are the benchmarks that you think about to know if you're doing a good job on pricing or not? Is it the level of contract renewals, or the rate of contract renewals? Is it kind of the profitability of an individual contract? What is it – what are the things you look at?

<A – John Brooks>: Yeah. So, it is definitely how we're performing on our looking-forward renewals. And again that can be very customer-by-customer, lane-by-lane, I'll give you an example. Recently, we took some pretty significant rate increases on our cross-border intermodal business. There's been some noise out there around UP taking away our EMP program and partnering with CN. I'll tell you a couple of things about that. One is we've got a pretty significant container order out there that will backfill a lot of that capacity. Number two, some of those lanes weren't – in our book, some of our most profitable lanes. So, we took this opportunity to reprice a lot of that traffic in those areas.

I think the third component is as you look to the future specific to that opportunity and this comes into your mindset as you think about pricing. Where are those areas that you want to create capacity on your trains or your terminals, as you look to the future where you see the growth being. And I can tell you we see significant growth at CP pending STB approval as you think about our cross-border business with CP and KCS.

So, in this area, our pricing decisions were multifaceted. It was to get our rates up to compensate ourselves, create more profitability relative to what we were earning, but also in this case, to create capacity to allow us to bring on more profitable business in these same lanes in the coming months.

<Q – Ari Rosa>: Got it. So, let's talk about the merger a little bit. So, we're coming up on the date when kind of everyone's expecting the STB to come out with a decision. Maybe you could talk about kind of what are the steps in terms of the timeline to get there? And then it very much looks like the STB is kind of going to go ahead with that. I think everyone kind of expects that. Maybe you could talk about once that merger is approved, what are the steps towards integration?

<A – John Brooks>: Yeah. Well, look, we are optimistic. We also believe we're headed down the right path. Certainly, I can tell you, I participated in the hearings out in Washington. This STB is extremely careful, cautious, thorough. They're taking all the necessary steps to make sure this will be a success from their perspective. That being said, we remain very optimistic. So, all the final briefs are in. We're working under our own timeline in terms of planning and integration, towards a decision some point in January, and then we would take control of the KCS at some point in February.

I can tell you, in terms of the integration planning, and certainly on the commercial side, we operate completely independently hands-off, but from an integration planning standpoint, there's a lot – I think, over and – or close to a 1,000 employees involved at some point in that process, obviously, a lot of IT, a lot of information systems efforts going on to make, well, I'll tell you or give it to you this way, as we look towards day 1, the mantra is sort of keep it as simple as possible. We don't need to big bang or do anything more than we need to do. We're completely two separate end-to-end franchise that only touch at Kansas City. So, that makes the integration process, in our mind, and the operation cutover far easier. We don't have to go in and manage a whole bunch of overlapping lines.

I think the other pieces that we're focusing in on keenly our communication, making sure that we're set up well to communicate with the employees, the communities that we operate through, and then certainly our customers. I've spoke about this in the past, and I've met personally with well over 100 customers in preparation of this event. And certainly, my team is actively out there today, not only certainly talking to them about revenue and synergy opportunities, but also listening to

what concerns they might have as they look towards day 1. So, I feel real good, from an integration planning perspective. We will be focused on execution day 1, providing good service that KCS does today. And then it'll be a – all hands on deck to begin to layer in to that network, all these revenue opportunities and volume opportunities as we move into 2023.

<Q – Ari Rosa>: Got it. So, let's get into the weeds on that a little bit. So, you've talked about CAD 1 billion synergy target over three years. Maybe you could just update us on, kind of, how you're feeling about that target? What causes you to outperform that target? If there's any circumstance that you worry about that might cause you to underperform that target? And then as you think about, kind of, some of those revenue synergy opportunities, where do you see the biggest areas of opportunity?

<A – John Brooks>: Okay. I might need you to remind me on a few of those. Well look, I remain extremely bullish. There is nothing – as I think about a year, year-and-a-half ago, when we began to really study the KCS network and look at the various commodities and customers and opportunities, as bullish as I was a year-and-a-half ago, I'm equal or more excited about what's out there. I can tell you, every customer meeting, that 100-plus I talk about that we get into, not only is the quantum of opportunity bigger than we anticipated with most of these customers and lanes, but the timelines and availability of those opportunities present themselves in 2023 and in early in on the process.

So, customers, no doubt, went through a challenging couple of years, not only with their own supply chains, maybe with their current existing rail carriers. And they want another option out there in the marketplace, and I think they're equally excited about this idea of a three-country, north-south transformational railroad that will provide a service lane that just doesn't exist today, single-line hall. The ability to link commerce between Canada, the US, Mexico is something they're excited about.

So, I think about breaking these down in three sort of areas, Ari, these synergies. One is truck conversion. We see a strong opportunity, actually stronger than I anticipated, in that area, even with maybe truck capacity loosening up. The more we sit down with these clients, the more opportunity they've presented us to say, hey, take a look at our book. Here's what we're not only moving rail that potentially you could compete and try to take share, but here's where you could take share from the trucks.

And I think a big part of what's driving that is not only all the supply chains and the challenges the trucking industry might be facing, but also the ESG benefits. We've seen a pretty strong or an increasing desire to understand what that carbon and greenhouse gas emission benefit could be with all those trucks that are crossing, particularly the US-Mexico border on a daily basis, so the trucking business opportunity.

The second area, rail share, how much do we really think we can take from the competing railroads out there? And I would encourage folks to think about it this way. It's kind of like managing your own money. People like diversification, and there – in some of these lanes, there hasn't been a real opportunity to diversify how you move your goods in that north-south corridor. Tomorrow, there's going to be a single-line haul opportunity that arguably is going to provide a faster, more reliable service than you get there today. That's my opinion. I just know what we've been able to do in Canada, and we feel strongly we can replicate that in this north-south corridor. So I'm not looking to win 100% of share from my competitors, but if I can win some pieces of business 20%, 30% share with some of these existing customers, I think we'll be well on our way in that area. And then the third leg as you think about these synergies is sort of what I'd just consider like these new markets or new initiatives where there really might not be a whole lot of existing movement today, but we can create something unique.

I'll give you an example. Typically, we – Canada is a major exporter of potash. We talked about it earlier, lot of growth potential, particularly with the unrest in Ukraine and in Belarus. And so, when you look at the growth profile of Canadian potash, it principally gets exported out of Canada today. Some of it goes down into the Pacific Northwest. But to open up potentially a new lane to where this potash can export through the Gulf and hit South American markets or be an alternative to get potash on the water to service really any market, if you have outages or concerns in the West Coast, is a whole new market that doesn't exist today, but can exist with CPKC. It's very similar to what we created when we developed our DRU product and in the crude by rail that we're shipping out of Northern Alberta down to Port Arthur today.

So longwinded, but I think you can tell by my enthusiasm I'm super excited. The synergies, I think the opportunity is as big or bigger than we initially thought it would be. And it's going to be more about strategically how we layer it on to the network starting in 2023.

<Q – Ari Rosa>: Got it. And as we think about those buckets of opportunity, is there any way to think about kind of what share each of those three represent?

<A – John Brooks>: Well, I knew you're probably going to push me there. I don't know if I can give you a number, but maybe I'd say it this way. When we started the analysis, I would say we put a little more heavy weight in the rail conversion share. So, maybe taking share or taking a percentage of share from our competitors. What's actually unfolded is the truck opportunity and the new initiative opportunity has been bigger, and have grown, which gives me comfort and should give you comfort in that we're less reliant in going and beating the UPs or BNs or the CNs of the world. They're good railroad operators and they're going to compete for their traffic. We think we'll have a better product. But it's less about that than we initially thought than being able to compete and take trucks and also create those new opportunities. So, I didn't directly answer your percentages.

<Q – Ari Rosa>: It's okay. We'll see how it plays out.

<A – John Brooks>: But I'm feeling better about those other areas.

<Q – Ari Rosa>: No, and that's helpful. So, look, can I ask you a broader industry question? Because we've seen some of the rails over the past decade kind of struggle to grow volumes. And there are a lot of reasons for that, obviously, have been kind of – had PSR conversions underway. At the same time, I think CP is running the highest volumes on its network that it's ever run in history, which certainly isn't the case for the other rails. As we think about kind of the next decade, what do you think about kind of the overall rail industry's ability to kind of grow volume and how important is service to achieving that goal?

<A – John Brooks>: Yeah. So service is what we are. It's what we do. It's – I go back to Ari, when Hunter and Keith came to CP – just put it bluntly, we weren't focused on growth at really all. We were focused on riding the ship, creating the best service product we could create as job one. And I think that's where the industry needs to be right now. Now again, I think we're ahead of the game. We've provided a good service. Not that we don't have our own issues, not saying that, but we feel quite confident in the service we provide today, the service we're going to provide with CPKC. So, it's job one. If you can do that, that sell to that customer, the value you can create. And particularly, today, I think more than even the past two or three years, the value of that consistency, reliability, knowing that that supply chain works is greater than ever. I think customers really value that now.

So, the success of the industry, as you look ahead 5 years to 10 years is, we got to get back as an industry to providing a really good service product. And if we do that, I think the volume opportunity, whether it be from trucks, whether it be from near-shoring and companies wanting to

relocate back into North America or even just competing against each other, the volume will be there.

<Q – Ari Rosa>: Got it. Got it. So, I do want to open up the floor to Q&A. If folks have questions, I think a mic will be passing around. But, in the meantime, maybe I could ask you one of the things that since we were talking about Hunter earlier as kind of a mentor, and I think, it's notable that Hunter had always been kind of hesitant to do a deal in Mexico. And I think, he'd spoken about some of the operating challenges in Mexico.

What kind of gives you comfort around some of those issues and why is it kind of right under the current leadership, whereas maybe it was something that Hunter would have been seemingly more concerned about kind of entering Mexico?

<A – John Brooks>: Yeah. I would say, certainly, as we entered into this journey to acquire the KCS, Keith has been very adamant that we do our diligence around that issue, and certainly, probably his learnings and from working with Hunter for all those years.

The amazing piece to that is the KCS team, and Pat and his executive team have done a tremendous job managing Mexico and their relationships down there. I would say arguably, and I think Pat would say it, they're in as good a sort of operating environment down in Mexico as they've ever been. So, we feel there's comfort in that, to begin with.

The other thing is we've quickly realized the amount of employee or national pride in Mexico relative to that rail operations is really exciting. There is a sense of pride to want to be something bigger or provide something broader to North America with that rail network. And I think they see the opportunity too. As more and more industries look to bring their products may be closer to North America, the ability for Mexico to really embrace that opportunity and become sort of that, I don't know, a little bit of economic engine to North America or supporting that as part of North America is exciting.

So, I think it's as simple as that. I am not suggesting there won't be challenges. There will be. I think about Lazaro, the port down there. There's been challenges over the years down there. We're super excited about the reception we've received from the port, from customers as an alternative to LA, Long Beach, and other ports to use Lazaro. And I think the more we can build momentum with some of those opportunities, that pride builds, and it takes away a lot of those other – not noise, but other issues that have plagued maybe Mexico in the past.

<Q – Ari Rosa>: Got it. That's very helpful. Let me see if there are any questions out. If not, I can keep going. So, one of the things I thought was really notable was I remember at your Investor Day, I think you guys talked about 75% incremental margins on new volume, which certainly is just a wildly impressive number. Do you guys still feel comfortable with that number? And we talk about kind of some of these business wins that you're looking at. Is that how we should be thinking about new business coming onto the network?

<A – John Brooks>: Absolutely yes, Ari, that is still where our line of sight is to that 70%, 75% type number. And as I think about the power of CPKC in that equation of that incremental margin, the ability, I think today the number is over 80% of their volume interchanges with an interline carrier. And it's a function of their scope and scale of their network. But you think about as CPKC, the ability for us to kind of use the breadth of our networks to create these single-line haul, long haul opportunities, all that fits right into the wheelhouse of that incremental margin. So short answer is, yes. And I think CPKC only sort of underlines that thesis.

<Q – Ari Rosa>: Got it. Got it. That's exciting, and certainly will be fun to watch. Let me ask you a question on kind of the cost side, because we've obviously seen a lot of issues around the US rails, and then labor negotiations and having a lot of kind of pressure on wages. To what extent do you worry that that carries over to CP. I know CP has kind of been able to kind of slide under the radar a little bit, but do you think that's something that should be on our radar for 2023, 2024, in terms of a continued pressure on wages?

<A – John Brooks>: Maybe a couple of quick points. Yeah. Number one, you're right. We're not part of that collective bargaining process. So, we are outside of that. We have hourly agreements with our employees, highest paid in the industry. We are setup well, not that there wouldn't be some impact. I think our – it's public information, our training engineman I think we're at 3.5% type inflationary wage increase. We're pretty comfortable with that number.

And honestly, we see opportunity as you look to CPKC to work with those unions and the leadership on that property to see if we can't move and certainly setup a platform similar to potentially what's on CP that could drive further success with those employees on that property. So, not that we're not cognizant watching it closely, but certainly feel we're in a pretty good position as you look to the future.

<Q – Ari Rosa>: Got it. Got it. So it sounds like a lot of exciting things going on at CP. I see that we're at time. John, thank you so much for joining us today, it's certainly an interesting and broad ranging conversation, and we'll be watching closely to see for continued success in 2023.

<A – John Brooks>: All right. My pleasure. Thanks, Ari.

<Q – Ari Rosa>: Thanks so much.