NEWS

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Transcript

Q1 2016 Earnings Call
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Corporate Participants:

E. Hunter Harrison, CEO
Keith E. Creel, President & COO
Mark J. Erceg, CFO
Nadeem Velani, Cp Investor Relations

Other Participants:

Chris Wetherbee
Fadi Chamoun
Scott H. Group
Walter Spracklin
Thomas Wadewitz
J. David Scott Vernon
Ken Hoexter
Jason H. Seidl
Justin Long
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MANAGEMENT DISCUSSION

Operator

Good morning. My name is Blair, and I'll be your conference operator today. At this time, I'd like to welcome everyone to Canadian Pacific's First Quarter 2016 Conference Call. The slides accompanying today's call are available at cpr.ca. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I would now like to introduce Nadeem Velani, VP, Investor Relations, to begin the conference.

Nadeem Velani

Thanks, Blair. Good morning, and thanks for joining us. I'm proud to have with me here today Hunter Harrison, Chief Executive Officer; Keith Creel, President and Chief Operating Officer; Mark Erceg, our Executive Vice President and Chief Financial Officer.

Before we begin, I want to remind you this presentation contains forward-looking information. Actual results may differ materially. The risks, uncertainties and other factors that could influence actual results are described on slide 2, in the press release and in the MD&A filed with Canadian and U.S. regulators. This presentation also contains non-GAAP measures outlined on slide 3.

The formal remarks will be followed by Q&A. In the interest of time, we would appreciate if you limit your questions to one. It is now my pleasure to introduce our CEO, Mr. Hunter Harrison.

E. Hunter Harrison

Thank you. Thanks, Nadeem. And thanks for everyone for joining us this morning. I'm extremely pleased with the result of the quarter. I've been doing this for a long time and I have some appreciation for what it takes to achieve an operating ratio, which was a record for us at 58.9%, particularly given the soft economic conditions that we're faced with. So real congratulations should go out to Keith and his operating and marketing teams for producing these type results in very difficult conditions.

And then, I guess it really bodes well for the future in that when we see the economy strengthening a little bit, it will come back. Just it's not a case of if, it's when. It's certainly going to put us in a position to have some really record result that you have not seen before.

We have announced a new share buyback program and an increase to our dividend. And more on that later from Mark. So once again, just congratulations to the team for a job well done, particularly those of us that our shareholders. And so with that, let me turn things over to Keith for a little more granular look at what we experienced the first quarter.

Keith E. Creel

Okay. Thanks, Hunter. Thank you for the comments. I echo your remarks. Overall, I'm extremely proud of this operating team, and this operating model demonstrates the power of this model. You see the metrics. At the end of the day it's all about solid execution by what I consider the best routers in this industry to produce our best ever first quarter operating ratio.

In this current very demanding environment that we're living in today, it's all about focusing on and controlling what we can. It's leveraging this operating model to succeed. The metric you see certainly speak for themselves.

Double-digit improvements. Speed, dwell, locomotive productivity, car miles per day. Train length and fuel efficiency both improving about 5%. So all fruits of the hard labor and the execution day in and day out, while we improve service and deliver for our shareholders.

We've surpassed our operating targets that we set back at our multiyear plan for 2018. Certainly, train speed, velocity, a key to our success. But we are certainly not stopping there. In fact, last week, myself and Hunter, we had the senior operating team in Chicago for three days discussing our next level operational improvements, focusing on how to execute better, how to lower the cost, how to improve safety, and also improves service for our customers.

Also with an eye on the future, we continue to grow and develop our team, preparing for an eventual transition with Hunter and I next year. We've got some organizational changes that we approved yesterday with the Board of Directors that we'll be announcing today, I'll go ahead and brief our shareholders on. Effectively, what we're going to do right now, we operate with three regions. We have a Western

Region and Eastern Region and a Southern Region, each run by a senior vice president of operations.

Effectively immediately, we're going to consolidate those three regions to two. There'll be a West Region and an East Region. Of course, the U.S. operation will fall under the guidance and the direction and leadership of the Eastern Region. We've got Guido De Ciccio, who is currently the Senior Vice President of the Western Region, will remain the Senior Vice President of the Western Region. Tony Marquis, who is the Senior Vice President of the East will pick up the U.S. operation.

Each of those from a development standpoint and from a coverage standpoint, we'll get a vice president. So we're going to take two of our talented general managers, promote them to vice president. Steve Nettleton will be in the East, located in St. Paul. And in the West, Mr. Mark Redd will be Vice President located in Winnipeg.

So we're very confident with that operating team. It's going to allow me the capacity and time to continue with working with them to continue to improve this operating performance, as well as focus, spend energy and time developing the other parts of the company, be it the marketing team as well as working with the finance team and the balance of the support staff at CP. So very excited about that. Again, effective immediately.

Robert Johnson, in turn, will become the Executive Vice President of Operations. Robert's going to move from St. Paul to Calgary. Again, effective immediately. So with all those changes, feel very, very – a very solid team. We'll continue to drive and improve our record performance.

On the revenue side, obviously a very demanding environment. Freight revenues for the quarter we're down 5%, but that's effectively in line with our expectations. And our comps are going to continue to be a challenge heading into the second quarter, particularly with the bulk commodities negatively affecting volume and mix. Lower fuel prices and a weaker U.S. dollar certainly puts further pressure on the yield in the near term as well.

So that said, the Canadian economy, though, on a positive note appears to be stabilizing and recessionary fears seemed to be subsiding. So we do feel that the second quarter is going to be the bottom. Q3, Q4 obviously are going to be stronger on a demand standpoint. Q2 last year, I'll remind you, very strong [ph] month (07:16) as far as demand in April, and then it eased off in May and June. So we've got some pretty challenging comps in the second quarter to work against this year.

But with that said, this railroad is running, to Hunter's point, better than it ever has. We set up a strong foundation so when these volumes do come back, that's when you truly see the leverage and the power of this operating model as it kicks in and springs back with some pretty dramatic performance, bringing that revenue to the bottom line.

So that's it. Let me pass it on to Mark, and I'll let him provide some more color on the financial performance.

Mark J. Erceg

Thanks, Keith. Let me start this morning by quickly walking you through a few of our first quarter financial highlights.

As expected, we did face a challenging demand environment as both Hunter and Keith commented on. But in keeping with what Hunter has always taught us, we did take a very hard look at the levers within our control, and we pushed exceptionally hard to find efficiencies and take out non-value-added costs, which allowed us to produce a record OR of 58.9%, a 430 basis point improvement versus a year ago. And while I realize that I made a similar comment last quarter, I still think it bears mentioning that because fuel surcharge lag added nearly 1 point to OR, achieving a sub-60 OR in the first quarter, at least on my own view, is particularly impressive.

Moving to a few specifics, operating expenses were down 11% as reported and down 15% on an FX-adjusted basis. And since FX remains volatile, I'll be speaking on an FX-adjusted basis for the remainder of my commentary. I should also mention that we provided some slides in the appendix to give you some additional details which you might find helpful.

So with that understanding, comp and benefits were $329 million this quarter. That's down 16% versus last year. It's driven by lower head count, lower stock-based comp and positive pension income. And for all you financial modelers out there, two quick reminders related to comp and benefits going forward that you might find helpful. First, pensions will be a $22 million benefit next quarter. That's versus a $33 million benefit this quarter, because, as you may recall, we had a one-time $11 million pension-related gain, which we recognized during the second quarter last year. Second, stock-based comp is likely to be a significant headwind in the second quarter because based on last night's closing price, we're already facing roughly $30 million of incremental cost on the quarter on a year-over-year basis.

Turning to fuel, fuel expense was $125 million, which was down 41% year-over-year. Lower volumes accounted for $11 million of the

reduction and fuel productivity accounted for an additional $9 million. But as with last quarter, lower fuel prices themselves accounted the majority of the decline at $67 million. Purchased services declined 13% to $221 million, largely due to casualty costs and efficiency savings.

Land sales, despite relinquishing the Arbutus Corridor to the City of Vancouver for $50 million, were actually a headwind during the quarter, given $50 million of the land sales we recorded during the first quarter of 2015. And since we're discussing land sales, I should take this opportunity to mention that we remain on track for total land sales of approximately $75 million this year, which is in line with our guidance. And we expect that this level of activity will continue for the next several years as we work to monetize our significant real estate portfolio.

Moving below the line, other income and charges reflects the change in value of U.S. dollar-denominated debt on our balance sheet. Interest expense was up 35% to $124 million, due to the additional debt we issued in 2015 to repurchase shares. And our effective tax rate, excluding the FX translation on U.S. dollar-denominated debt came in at 27.5% on the quarter. But because of our ongoing tax planning efforts, we now expect a full year effective tax rate of 27.25%.

Bringing everything together, recorded net income came in at $540 million. But if you remove the noncash gain of $181 million on U.S. dollar-denominated debt and look only at adjusted diluted earnings per share, you would see that they were up 11% at $2.50 per share.

So all things considered, this is a very strong quarter. And because we remain confident in our ability to deliver meaningful increases in both free cash flow and shareholder value going forward, we are, as Hunter indicated earlier, implementing a new share repurchase program and increasing our quarterly dividend by $0.15 to $0.50 per share in order to continue returning significant capital to our shareholders.

Since the start of 2014, we've returned $5.3 billion to our shareholders. $4.8 billion was in the form of share repurchase, and a little over $0.5 billion was returned via dividends. During that same time period and net of shares issued under our stock plans, we've seen shares outstanding reduced by 22.4 million shares or 12.8%. Our most recent NCIB application is currently under review by the TSX, and we hope to receive approval and be back in the market over the next couple of weeks.

And with that, let me turn the call back over to Hunter.

E. Hunter Harrison

Thanks, Mark and Keith, for those very helpful presentations. And with that, Blair, we'll be happy to answer questions the audience might have.

QUESTION & ANSWER

Operator

Thank you. [Operator Instructions] The first question comes from the line of Chris Wetherbee from Citi. Your line is open.

<Q - Chris Wetherbee>: Hey, great. Thanks. Good morning, everybody. Wanted to ask a question just sort of on the outlook for this year, so a couple of moving parts, we have currency kind of coming back the other way. Some tough comps, I guess, in the next month or so, Keith, that you highlighted but fantastic operations from the business. And as you think about that and maybe an improving Canadian economy, how should we think about the potential for double-digit EPS growth this year and what the sort of prospects are for the business?

<A - E. Hunter Harrison>: Well, Chris, that's a good question and one that we talk about internally a lot, given the moving parts that are taking place right now. But bottom line all-in, I think we are still very comfortable with the guidance that we have previously provided. And if something, obviously, makes a change there, we have an obligation to certainly disclose that. And you'll all be the first to know, but second quarter is clearly going to be challenging to us, but third and fourth look much better in our crystal ball. So I think all-in, I am pretty comfortable right now with the guidance that we have previously provided.

<Q - Chris Wetherbee>: Okay. That's helpful. I appreciate it. And if I could sneak one follow-up, just thinking about sort of the cap structure a little bit when you think about your buyback and maybe what you guys are comfortable with, so getting about 5% of the

shares outstanding. How do you think about sort of where you want to be in terms of the capital structure now that M&A is off to the side? How should we think about that?

<A - Mark J. Erceg>: Yeah, as we sit here today, we finished last calendar year around 2.8 times leverage. With the 5% share buyback that we announced today and assuming that that is affected by the end of the calendar year, we'd be probably around 2.7 times coming to that effect. That places us comfortably as an investment grade company, which is something we've always said is important and that we're committed to. We obviously have the opportunity to kind of revisit that as the year unfolds. As both Keith and Hunter indicated, we expect Q2 to kind of be the bottom. So as the third quarter and the fourth quarters are dialing around and if we see some additional momentum out there, we can obviously go back and revisit that decision. That's similar to what we did in 2015. In the fall of 2015, we bought about $2.7 billion worth of shares, but we did that in two tranches. We came out initially with the program that we later upsized, and certainly that's something that we do consider and have available to us this year as well.

Operator

The next question comes from the line of Fadi Chamoun from BMO. Your line is open.

<Q - Fadi Chamoun>: Okay. Good morning.

<A - E. Hunter Harrison>: Good morning, Fadi.

<Q - Fadi Chamoun>: So I wanted to sort of ask a bit of a bigger-picture question. Now with sort of the M&A on the backburner or whatever you want to call it, behind us a little bit, how should we think about what comes next? Like, are there things that you can do outside of Class I mergers that would maybe improve the CP network connectivity with U.S. consumer and industrial kind of activities, which is probably a good sort of growth for you longer term?

And maybe also refresh us on what kind of margin opportunity do you think you still have ahead of you at CP right now? After all these improvement you've done so far, it looks like there is some room to keep growing there. But if you can sort of put some quantification around that it would be great.

<A - E. Hunter Harrison>: Well, let me address it at this point. Number one, that we're continually looking for opportunities strategically for this organization to grow and take advantage of our strengths. Now having said that, we just got cut off at the pass with the M&A activity. But look, that's not the end of the world. There's other opportunities for this organization that we'll be continually exploring. And for obvious reasons, I can't get in the level of detail of what they might be at this point.

If I understood the question right, more on the margin side, operating margin or operating ratio, again, how low can we go. I think that if you go back to originally the full year 2018 plan where we kind of basically said we're not obsessed with the operating ratio and we'd like to convert that to growth and we no more got that out of our mouth and then we got slapped upside the head with crude, which made us kind of refocus on the next steps. But I think if you look at this operating model we've got, I think that you're looking at an organization right now that's gone from, not by my estimate, but others, particularly the media that has gone from worst to first in a rather short period of time.

I get asked the question all the time, what's the difference here. We all operate on the same gauge, affected with the same locomotives, same signal systems. What makes one railroad different than the other? And I continually turn back to the strength of this organization and others that I've been associated with, and it comes down to people. And I think that I was extremely delighted to spend three days with Keith's team and look at the bench strength that he's just announced, that he has brought into the organization and blended with the glue that sails this together. And the new players that are coming, I think that if we see a little bit of step-up in the economy, we're really positioned to take advantage of it and – people get nervous when I start talking about OR and how low can we go. But certainly, if you break down the 58.9%, that's not the ultimate we can get. If that's our desire is to get as low as we can go, we can certainly get to the mid-50%s.

<A - Keith E. Creel>: If I could add a little color to that Hunter. This operating team effectively gets stronger every day. We're not perfect, though, Fadi. Obviously, this is an outdoor sport, and I tell you I can get up every morning and find as many things wrong as I want to find wrong. But this is about teaching and developing, so I've got the best coach in the world I've worked with for two decades and continues to be a coach. I'm obviously – developed a lot of those skills myself. Certainly don't hesitate to teach and develop, and that's why this operating team have – came together.
The esprit de corps, the chemistry, the remaining general managers, the superintendents we have across this railroad are all solid operating officers and getting stronger every day.

The difference now, we've got a service we're putting out in the marketplace combined with a marketing team that in their own, they're maturing and developing with a level of accountability, a level of professionalism. This market has caused them to get stronger. Certainly, they understand the pressure they're under to perform. We've got a lot of visibility with our compensation system, with our commission system that we've put in, I guess, a year-and-a-half ago. Certainly, we know the high flyers, the ones that are making lemonade out of lemons. And we know the ones that are than the ones that aren't. They don't earn their keep and they don't jeopardize the team, they don't stay in the company. And that's our obligation to the shareholder, that's our obligation to the customer.

But what they're doing now that I'm extremely encouraged with that CP never did before, we talked about this, converting service. Becoming part of our customers' supply chains, part of our customers, business offering, help them grow so that we can grow with them. To a point, this past quarter we did over 3,000 cold call sales. 3,000. I bet CP never did 3,000 cold call sales in the last decade. So that's how hungry this marketing team is. And as a result of that, we've got customers that never experienced CP. We've got customers that are under their own pressures to control cost that are taking advantage of this low-cost transportation service we can provide.

So if you look at the RTMs, we're down, obviously. But if you look at the industry – relative to the industry, we're down one of the least. We're doing quite well. That said, that this service that we're selling, to me, is gaining traction. So to Hunter's point, when this market comes back, the opportunity for growth, the opportunity for return to drive strong EPS growth for the future, it's strong. It's extremely strong. It's very encouraging. So this story is not anywhere close to done, Fadi.

<Q - Fadi Chamoun>: Great. Thanks for the great color. I wanted to also just follow up. How do you think about second quarter volume? Is it sort of your best guess at this point? Is it consistent with what we saw on the first quarter as far as decline or maybe a little bit worse?

<A - Keith E. Creel>: Yeah. Year-over-year, it's a little bit worse. Right now, we're running around 7% from an RTM standpoint, but that's going to get a little better next month. My best guess, I think we'll finish the quarter about 6%. And then we'll pick up, obviously, in the third quarter and the fourth quarter. We've got some opportunity. There's a lot of grain out there that's not moving, especially on the U.S. side. At some point, those farmers are going to move that grain to make room for the crop that's coming in. So I'm confident that as we start to see or the farmer start to see how the crop is coming in, they've got to make room for it. We're going to start moving that in the third quarter. So there's some opportunity for tailwinds to help us in the second half for certain.

Operator

And the next question comes from the line of Scott Group from Wolfe Research. Your line is open.

<Q - Scott H. Group>: Hey, thanks. Morning, guys.

<A - Keith E. Creel>: Morning, Scott.

<Q - Scott H. Group>: So Keith, wanted to follow up with you there. You've talked a couple of times about some visibility to the back half of the year getting better. And maybe what gives you – outside of grain and the inventories, what gives you confidence in the second half pick up in volumes, and maybe if you could talk specifically about what end markets you're seeing improvement and/or expect improvement in, in the second half?

<A - Keith E. Creel>: Several. Grain's part of that, Scott. Obviously, there's some opportunity there. Automotive for us is doing well. We're being rewarded with additional business because of service. Lumber products, with the housing starts in the U.S. We're helping paper, we're moving more which is a positive. I do think at some point domestic intermodal, there's a lot of capacity out there. But we're starting to see some gains. Our quarter performance is better than our year-to-date performance so that's getting better. Obviously, we still have some challenges there. But overall, I think that I feel confident given we're sort of getting out easy. We're walking out or crawling out of this recession fears. I think that, that turn start favoring those market fundamentals and the service. We're going to continue to grow the business.

<Q - Scott H. Group>: Okay. And then also, if you could just talk about the pricing ahead in the first quarter and what kind of pricing – maybe the price and mix impact in the first quarter, and then what kind of price you guys are expecting for the year?

<A - Keith E. Creel>: So the price mix as we stated on the chart for the first quarter was 1%. So effectively, a lot of that fuel is going to continue to be a headwind for us. The help from FX is going to become a headwind for us as well in this quarter. We certainly lapped any benefit from that in the third quarter. But overall, if you exclude grain, pricing came in closer to 3% for the quarter. And we expect that to be maintained for the balance of the year.

Operator

The next question comes from the line of Walter Spracklin from RBC. Your line is open.

<Q - Walter Spracklin>: Yeah. Thanks very much. I just want to keep on that pricing, Keith. Some of the bulk customer, I want to zero in on bulk and intermodal here. Bulk customers seem and feel like it's some of the pressure they're getting is less cyclical, more structural. When you're coming up against renewals among some of your bulk customers, are you getting the pressure now on pricing that would pressure that down below that 3% that you were guiding, or are you still able to get that kind of 3%-plus or inflation plus even with core customer or bulk customers that are seeing some of those structural headwinds?

<A - Keith E. Creel>: Yeah. Well there's obviously some headwinds out there, Walter. I'm not going to suggest there's not. But overall, we're able to maintain that pace. It's a very conservative number. We've always maintained that conservative approach for delivering service and providing value. The key is converting that value and service, and teaching and educating the customer how they're actually saving money, not actually spending more money. That's been key in some of the contract negotiations we've had as of late. There is one particular customer that we've just won a contract with that effectively, that's how we sold.

Our cycle times, our network, our speed, our route effectively – and this is a car owner – is about a half a day shorter than the competition. If you convert that to the bottom line in the car savings and their capital cost savings as opposed to rate savings, it's pretty compelling. It wins the argument every time. You've just got to get a team out there that's educating, and understands how to sell that in the marketplace.

<Q - Walter Spracklin>: Okay. And just follow-up here. Looking back, I guess, Hunter, you'd reaffirm your guidance. If I look at your assumption for foreign exchange when you set he guidance, it's about 4 cents lower than where the CAD has moved. I think the sensitivity and Nadeem, correct me if I wrong, is around $0.08 to $0.10 per penny. So I think looking at about a $ 0.35 to $0.40 headwind versus that core assumption, did you have buffer in your guidance that gives you comfort to reaffirm that? Is there something that's changed in the first quarter that came in a little bit better, or are you looking into back half of the year and just feeling a little bit better about your guidance that will allow you to offset that sensitivity on the foreign exchange side?

<A – Nadeem Velani>: Yeah, Walter. I'll just clarify on the sensitivity; we do give disclosure in the back of the presentation. But when we gave our guidance back in January, the dollar was closer to 1.45; I think it's 1.26 today – and for that $0.15 to $0.20 swing range, it's about a $0.05 sensitivity [per penny] on EPS annualized. So just so we're all talking off the same numbers.

<A - E. Hunter Harrison>: And Walter, I'd go further. Number one, as Keith mentioned earlier, the costs are coming down every day as we speak, so that's turning the other direction. I think it's safe to say that from a bulk standpoint, we feel a little better than we did when we did the original forecast. Not any record setting, but given that there were some doomsday projections out there. For an example, with our largest customer, Teck, and that situation has improved. We think the finance situation will stabilize and improve. So there's a lot of puts and takes, but I think we're still all in pretty comfortable with the bottom line get.

Operator

The next question comes from the line of Tom Wadewitz with UBS. Your line is open.

<Q - Thomas Wadewitz>: Yeah. Good morning.

<A - E. Hunter Harrison>: Hi, Tom.

<Q - Thomas Wadewitz>: Keith, you talk about you're taking some steps to – you mentioned the organization changes and going from three regions to two, and you guys are always focused on continuing improvement. How would we think about the levers? I guess in simple terms, I think of train length was something you've expanded a lot, car miles per day, velocity, those are some the metrics over the last couple of years you've driven hard against. Are those still the right metrics, and are those the things you're still focused on? Or as you revisit, are there other things that we should be thinking about and that you're focused on to drive improvement in cost and productivity?

<A - Keith E. Creel>: Yeah, Tom, those are certainly key metrics for us. But the kind of quantum leaps that we've produced over the last three years, obviously, you only have so much opportunity there. So we'll see more continued improvement, but not those kind of quantum leaps. But the real focus, if you think about where we actually can save a lot of money, it's the highest cost centers, which is our terminals.

So a lot of discussion last week about leadership, about process management, about taking additional cost out of the terminals just by

being better operators and railroaders. Another phase we're about to kick in and I think is going to be a game-changer for us both on the marketing side, as well as on the cost side, managing assets as trip plans. We're on the verge of implementing trip plans into the marketplace, where we'll have car measures to the hour, we pull the customer until we deliver the product.

So essentially, that does two things. For the marketing team, they can sell the service. They can tell the customer, quoted in hours, when we're going to get a product from point A to point B, which helps them plan better which adds value in the marketplace. And from the operating side, when you're measured against that every single car as opposed to just the train, it's a whole another level of expectation. It's a whole another level of performance. So it's part of the chapters of how we become better operating railroaders and how we roll out this operating plan. And that drives out significant synergies and cost.

And finally, one other point I'm extremely excited about, we're rationalizing this physical plant. You'd be amazed how many main track switches we still have out there that effectively aren't paying for their keep, so to speak, that we put in over the years. A different operating philosophy, we think you can do more with less. Obviously, our predecessors felt more was better. Well, more costs a lot of money. And more, when you've got main line switches in that you don't need, they're also safety challenges.

Every switch that's in the main line's a potential derailment, which obviously is not in any of our best interest. So we're effectively going to eliminate what we went through last week in excess of 300 main line switches, and about the same number as far as backtracks and yards. And taking out about 70 miles of track, which can be cascaded, and obviously minimize and reduce our future capital costs.

So there's still so much left to do here, Tom, that I have extreme confidence in our ability to continue to drive cost out of this operating network.

<A - E. Hunter Harrison>: Keith, let me add to that just a minute. We've talked about already that – look, the M&A activity for now is dead. We understand that. I still want to believe that in the future someday, it's going to take place or it's going to happen. And where some people missed it here was this; the real opportunity to rail to make a huge breakthrough market share-wise, vis-à-vis the competition, the truck, is that we have to provide a service that is consistent and we can quote to the customer alone. We try to make a sales call today and the customer wants to know what the service is from Toronto to Texas. I don't want to get too specific here. Well, what we tell him is what we can do to Chicago. Well, he didn't want to know about Chicago, he wants to know about Texas.

Well, if you've got two or three roads involved, you cannot provide a consistent service or commitment to the customer. And when you can provide that, at the same time guard against and have the appropriate amount of regulation in place, then you're going to see rail make quantum leaps with market share gains and bring a lot of things that are on the highway with our friendly competition, the truckers, that ought to be on rail, that will be if we can ever break through the sole issue with consolidations or mergers.

<Q - Thomas Wadewitz>: Okay, great. Thank you for that. Just as a follow-up, Keith, I know you've been asked about – or Hunter, you've been asked about market fair bid and optimism on second half. What about within specifically domestic and international intermodal, would you expect those two to pick up? And if so, is that just an economy view or is that a pace of share gain in again both domestic and international intermodal?

<A - Keith E. Creel>: For domestic, it's both, Tom. I think the economy is going to help us a little bit, but share gain certainly from truck, most specifically. We've got some initiatives that we've put into play that they're just now starting to bear fruit that I'm confident is going to help us the second half versus the first.

International, it's sort of a wild card. We had a pretty strong start to the year before the Chinese New Year, but things have fallen off a bit since. We're starting to see some signs of increased demand though from the west. So that's a big question mark. I feel much more confident about the domestic piece. But we're going to do well in the marketplace. We're doing some things form a service standpoint, from a marketing standpoint so that we can create a lot of success in that international space as well. We expect a lot of that to unfold next year. Just stay tuned on that front.

Operator

The next question comes from the line of David Vernon from Bernstein. Your line is open.

<Q - J. David Scott Vernon>: Hi. Thanks for taking the question. Mark, just a couple of follow-ups for you. As far as the timing of the repurchase and any additional debt, are you expecting to get that done this year and is that going to be from operations or more leverage? And the second kind of question just on the modeling side, should we be expecting any dollar savings from the consolidation of the operating divisions from three to two?

<A - Mark J. Erceg>: Let me take the first part of that. As we sit here right now, we do have our application in. Those tend to get turned around in relatively short order. So we would think just within a matter of weeks we could be back out in the market buying shares.

As it relates to your question about whether or not we would need to raise any incremental debt to affect that, I think the short answer is no. We did finish the quarter with a fair bit of cash on hand, a higher balance that what you would typically have seen. That's because during the overtures that we were making, we obviously suspended any share repurchase activity so we're holding much larger cash balances.

And then during the course of the calendar year, we're very confident that we're going to generate close towards $1 billion of free cash flow. So between self-generated cash and the cash we have existing on hand, we're confident we can buy those 5% of the shares as part of the new NCIB program by the end of the calendar year without having to take on any additional debt and still end the year around 2.7 times leverage. Now, as both Hunter and Keith indicated, if the second half ends up being stronger, we always have the opportunity to go back and taking a second bite of the apple and revisit that program. But at this point, we don't have any expectations of having to raise any debt. In fact, you look at our debt maturity ladder, you'll see that we really don't have any debt maturing until 2018. So we're in really good shape as far as the balance sheet is concerned.

<Q - J. David Scott Vernon>: And then the second part of the question was really around any dollar savings or numbers that you can point to in terms of financial benefits from consolidation of the operating divisions.

<A - Keith E. Creel>: Not material. No, I wouldn't say that. It's not about saving M&A, those kind of costs, this consolidation. It's about affecting and developing the team and just being better railroaders in executing.

Operator

The next question comes from the line of Ken Hoexter from Merrill Lynch. Your line is open.

<Q - Kenneth Scott Hoexter>: Great. Good morning.

<A - E. Hunter Harrison>: Good morning, Ken.

<Q - Kenneth Scott Hoexter>: Your employees were down kind of double-digits. Your carload's down about 4%. How do you feel about head count now? And Keith, you intimated there was still more room to go, but you also restarted employees. Maybe you could just walk us through what was there, and any difference that means to targets or how we should think about that going forward?

<A - Keith E. Creel>: On the employee side, we've got it. We said 1,000. There is an opportunity that we see maybe increasing that, maybe 1,300 year-over-year. So I think that's the difference. What was the second part of the question?

<Q - Kenneth Scott Hoexter>: Just to walk through the different – because you restated, does that change your targets as far as what you plan on reducing? And then how do you feel about head count now? Because Keith, you said there's still room to go, so does that change your targets in terms of head count that you could continue to take out.

<A - Keith E. Creel>: Yeah. I'll let Mark speak to the financials but the room to go, to clarify my answer, is yeah, we do see an opportunity to go around 1,300 instead of 1,000.

<A - Mark J. Erceg>: Yeah. Hunter had indicated we thought we'd be down 1,000 employees by the end of the second quarter. We're on pace for that. And then we think there's some additional reductions that maybe on that, that Keith just alluded to so maybe in the 1,300, 1,400 range. You'll notice that workforce numbers have not changed. We did make a slight adjustment to some of the other numbers that we provide. That was done just to drive consistency in our approach. We had been using mid-month numbers instead of end month numbers for certain type of conventions and certain employees where they're classified as part-time or full-time. So there isn't a little bit of things in there that we wanted to clean up and we've done that. But the workforce numbers haven't changed at all, and it hasn't affected the commitments we've made this year.

<Q - Kenneth Scott Hoexter>: That's helpful.

<A - E. Hunter Harrison>: Yeah. I would run something to your attention. When we were talking about the M&A activity, we were getting accused that we're going to slash and burn and cut off the world and get rid of jobs and so forth. Well, none of that's taken place, but it looks like these are – our friends in the East are both adopting our plan, and they're consolidating divisions and closing the terminals and taking the headcounts out. And I ain't seen a load from a sundry yet that are raising issues about it, so it's not a level playing field.

<Q - Kenneth Scott Hoexter>: Appreciate that thought. Can you talk about using price, Hunter, a while ago for improving flows in

days of the week? I just want to understand as you look back on that, has that filled up or are you still working to balance that out? And is that still something that gets discussed every now and then in terms of the price for balance?

<A - E. Hunter Harrison>: Well, I think that's kind of maybe phase 2 or phase 3 of this model that Keith talked about earlier with what we call the trip plans. When you develop that site precision and the customer can depend on it, then you can then take advantage of some of these data, the weak pricing, the leveling of your workload out. We're not there yet where we'd like to be, but it's just another opportunity with some pruning out the trees that we'll get to when we can.

Operator

The next question comes from the line of Jason Seidl from Cowen and Company. Your line is open.

<Q - Jason H. Seidl>: Thanks very much, operator. Some quick ones here. Guys, you talked about obviously looking into the back half of the year. Can you give a little color on maybe the export call outlook, given that now it seems that China isn't that bad and might be doing some more infrastructure projects? And the second quick one is are there any thoughts on the new proposal to build a new train line around Chicago by a private party? I think they said it was going to be like $8 billion to try to alleviate some of that congestion. I know you've been a big proponent of trying to do some out-of-the-box thinking things to help Chicago out.

<A - Keith E. Creel>: Let me take the first question before I turn it over to Hunter to elaborate on the out-of-the-box. On the coal side, Teck, to your point, not as challenging as what we thought. Certainly, we're helping them win in the marketplace, I think, by giving them great service. We're lowering our costs, but from a demand standpoint, we think we'll probably finish flat. Now, is there are an opportunity for upside? Yes, but we're not assuming it. But we do think flattish volumes compared to 2015 year end.

<A - E. Hunter Harrison>: Well, I don't know about Chicago. I mean, I'd share this with you. In our former – some of this team that are former employee, we bought a railroad around the perimeter of Chicago, and we damn sure didn't say anything close to $8 billion. Like I think it was around $300,000, and it was probably one of the things you're getting a lot of credit for today.

And there were also recently was a group of well-respected, retired executives from the rail industry that were put together by all the rails to attack, for lack of a better term, the Chicago issues in congestion. And they were just asked to look at what is – if you look at it, weren't concerned about uniform you had on. Just in the interest of getting traffic through Chicago, what would be the appropriate way to do it? And I think the information I have is they came up with some excellent plans, except some of them had a big price tag and some of the rails – if this gets public and it's going to be a big price tag, we're going to get forced into it. So all of a sudden, the committee got disbanded.

So people have got to get serious about Chicago. When we had the discussions vis-à-vis the merger, it said it doesn't matter what CP does. We're such a small player. It's only 5% of the business, so who cares? Well, there's a lot of people that care in Chicago. And in my view, the industry better wake up quick about Chicago or somebody's going to do it for us. So that's my…

<Q - Jason H. Seidl>: Now, Hunter, in some past calls, you mentioned that you would probably be willing to try to purchase a built railroad and run it for the other railroads. And if you didn't do a good job, you said they could buy it back off of us. Is that an option that you still might want to explore?

<A - E. Hunter Harrison>: Absolutely. As you know, we will buy one, we'll buy both. We'll buy Chicago and give them a hell of a deal. But I don't – there's not any takers out there and I wonder why.

Operator

The next question comes from line of Justin Long from Stephens. Your line is open.

<Q - Justin Long>: Thanks, and good morning. I wanted to ask about returns. There's always a lot of focus on the OR, but looking at your ROIC, do you have a target for 2016 that you want to share? And also, as you think about deploying growth capital on the business going forward, what's your typical ROIC hurdle?

<A - Mark J. Erceg>: We do have internal hurdles that we use to train and evaluate all capital projects that we have. It's actually a very sophisticated allocation process that we use. Which probably isn't surprising given the fact that in 2014 and 2015, we spent about $1.5 billion in each of those years on CapEx.

This year, as Hunter had indicated, because we have done a lot of the catch-up work that was required, we plan to spend more like

$1.2 billion. So there should be a significant amount of CapEx reduction that we're seeing from this year going forward, which should allow us to generate more cash that we can return to our shareholders.

That said, we haven't typically disclosed our internal formal rates to folks, externally. We don't think that that's necessarily appropriate. We do adjust that for different types of risk profiles, depending what the type of project is. And we go back and do very diligent reviews in order to make sure that we've actually achieved those target levels.

I will comment though that our adjusted ROIC has nearly doubled from about 8% to 15% over the course of the last couple of years, something we're very, very proud of. And it's something that you can expect to see continuing from this team.

So, we don't disclose those numbers, but I can assure you that we will get it very, very closely. We'll also make sure that when we are out there purchasing shares, we're doing it at a value that make a lot of sense for our shareholders on a long-term basis.

<Q - Justin Long>: Okay, thanks. And maybe one quick follow-up. I wanted to follow-up on the volume outlook. You talked about expectations for second quarter volumes, but looking at the full year, is your outlook still for a volume decline in that 1% to 2% range?

<A - Keith E. Creel>: No. We said RTMs – from an RTM basis, closer to 4% or 5%. And I think that's where we're going to come in. I mean, obviously, there's some upside opportunity but I feel very confident with that number.

Operator

The next question comes from the line of Turan Quettawala from Scotia Bank. Your line is open.

<Q - Turan Quettawala>: Yes, good morning. Thank you for taking my questions. So Keith, just to clarify, that 4% to 5% RTM decline RTM decline, is that Q2 or are we talking about the full year there? Sorry.

<A - Keith E. Creel>: That's full year.

<Q - Turan Quettawala>: Okay, got it. Thank you. And I guess another quick clarification here on the employee side – sorry, go ahead. So on the employee side, I think you were talking about 1,000 to 1,300 reduction here. But you're coming in down about 1,800 on Q1. So should we just expect that to go up, I guess, in the second half with volume, is that the way to think about that?

<A - Keith E. Creel>: No. You've got capital work – the capital work that we are going to do. You'll see engineering employees that typically aren't working in the first quarter that would be deploying our capital, ties, rails, steel, that type work, during the segment or a quarter. So that first quarter number, obviously, will draw down and we'll finish the year – year end will be around that 1,300 number.

Operator

And the next question comes from the line of Benoit Poirier from Desjardins Capital Markets. Your line is open.

<Q - Benoit Poirier>: Yes. Thank you very much. Looking on the intermodal side, obviously you improved a lot your cost structure. Could you mention the opportunities for renewal, some intermodal contract this year and what's up for renewal and what is the opportunity?

<A - Keith E. Creel>: Okay. Yeah, Benoit. This year, we actually have one that we're negotiating now, which we feel very good about. Quantum is not a huge, huge contract. It's obviously one that we would care about, but we feel good about that next year. And there's more opportunity. If I remind you to go back two or three years ago, I guess it's been three years. Time flies fast. We were forced to walk away from a particular contract, which is a very large intermodal ship or international intermodal that we certainly expect to be competing for their business next year.

So that contract would come up second quarter of 2017 is when it would be awarded or go into effect. So again, that could be a difference changer for us, certainly. We've got an improved service. We've got a lower cost structure. The market is going to set the rate. And if we can make money and it earns its cost-to-capital and it's a good business decision for us, then I'm sure that we're going to win the business.

<Q - Benoit Poirier>: Okay. That's great color. And also, you mentioned in the announcement that you see signs of stabilization within the Canadian economy and the global market. So I was just curious what are the key elements you see that support kind of a stabilization.

<A - Keith E. Creel>: What I'm seeing when I say stabilization like the coal piece, that was a big question mark for us. Some of that

uncertainty is taken out, obviously. Potash, right now, we're not moving a lot of potash but those contracts have not been settled with China yet, but Canpotex is very bullish and it's fully expected to maintain their guidance for the second half. So you're not seeing that tonnage moving now, you'll see it in the second half. And again, I'm an optimist on the grain side.

If we have a normal harvest on the Canadian side, then you're going to see pretty strong great movement the second half. And if we have a normal or maybe a little better than normal harvest on the U.S. side, given everything that's pent up in storage, you're going to see some upside there as well. So those are the main levers that I see is an opportunity for us. On the domestic intermodal side, there are services winning market share. That's very, very encouraging, especially in this very challenging environment.

Operator

The next question comes from the line of Allison Landry from Credit Suisse. Your line is open.

<Q - Allison M. Landry>: Thanks. So, I'm trying to put everything into context. Should we be thinking about 2016 as a bottom for EPS? And maybe if you could help to frame how you're thinking about the longer-term earnings power of the company when volumes do come back, just given what you've been able to do on the cost front and the inherent operating leverage that you spoke to earlier.

<A - Keith E. Creel>: Yes. I would suggest that 2016 would be the bottom, assuming the economy comes back, which is what we're assuming. So if we get modest GDP growth with this operating leverage we've created, then you're going to see stronger EPS growth. Long-term, still confident that we can, with a little bit of help from the economy, double our EPS. Maybe not into 2018, it might be 2019, but it's certainly within the realm of possibility given that the economy terms are a little bit favorable for us instead of against us.

<Q - Allison M. Landry>: Okay. And then, Keith, maybe do you have any initial thoughts on what you would want to accomplish on the marketing front once the leadership transition happens? And maybe if you could talk a little bit about some of the areas where you think you can drive top line growth over the next few years and sort of comparing across that with what you outlined back in 2014 outside of crude by rail?

<A - Keith E. Creel>: Yes. A lot of from the marketing side is developing the team even more so. Obviously, with all my operating responsibilities, I have not had the same amount of time remotely close to spend with the marketing team, which I intend to do, so developing them from a leadership standpoint, developing their ability to sell our service, to convert that service in discussions with customers, working with them to help better integrate CP with the customers to effectively drive more value for the customer, which is going to mean more value in revenue for CP top line.

We talk about a diversification strategy, trying to become a merchandise railroad as much as we are a bulk railroad. That plays right into that storyline. So we're going to continue to have discussions with customers, like the one I talked about earlier where they're car owners. They've got significant capital cost in the cars. And if I can get out and move them faster using the benefit of my shorter network versus my competitor in these key marketplaces, if I'm reliable, do what I say I'm going to do, I'm going to convert that business. So all those things are going to help us continue to drive the top line and obviously, with this operating team, it's going to be brought down to the bottom line.

Operator

The next question comes from the line of Steven Paget from FirstEnergy. Your line is open.

<Q - Steven I. Paget>: Good morning. My question looks back two or three years to the information technology, your IT overall haul that CP carried out, and maybe we could just get your perspective on what you did, how you did it, why you did it and what the results have been.

<A - Mark J. Erceg>: I mean, I would tell you that that's actually a fairly large project that we review regularly with the board. The last update that we provided them was just a number of weeks ago. That was a very large project and it effectively went away from having a lot of contracted services to bringing those things in-house. We had set a rate of return threshold that we were able to deliver against as part of that project, and it also gave us a lot of additional system capabilities. So as we've been monitoring that project, we would say that it delivered against all the vectors it was designed to hit against, and we're very happy with the outcome.

<A - Keith E. Creel>: And I'd add, Steve, capability and reliability. If we don't have good data, if we don't have good systems to make decisions with, to run the railway with day-in and day-out, if our systems crash, we can't get our reports, give us gauges on how we're doing across the network on a day-to-day basis, it's challenging. So since we've

in-sourced this, we have our own people, we've been able to develop our own skill sets, our own bench strength and our own level of accountability, the results have improved dramatically and at lower cost. So again, it's a win-win situation for us.

<Q - Steven I. Paget>: Thank you, Keith and Mark.

<A - Keith E. Creel>: Thank you.

Operator

And the next question comes from the line of Bascome Majors from Susquehanna. Your line is open.

<Q - Bascome Majors>: Thanks. Hunter, you talked earlier about the benefits from a share gain perspective of a more integrated transcon rail network. But getting to that point was clearly, I guess, a lot harder than you guys and many of us had anticipated with the experience with NSC. What changes or has to change where you think the appetite from other rail stakeholders or Washington is a little more conducive to getting a large scale merger through?

<A - E. Hunter Harrison>: Well, I guess the first thing is people got to play by the rules. We've had a process since the Staggers Act of 1980, which effectively deregulated the industry, where it was mandated to the Surface Transportation Board to make decisions on mergers. And as soon as the merger comes up then, we want it to become a political process instead of a process that had been mandated effectively to the Surface Transportation Board by Congress.

Now, my view is this. If Congress does not want mergers, why don't they create a law that says you can't have a merger. So what did we hear, first of all? Well, first of all, we heard, well, it's effectively going to be what the customers want. Well, the last statistics I saw was that the customers voted in favor of the merger. Now, I think most of the customers now recognize that this transaction was pro-competitive, okay? Clearly, it introduced more players. And so this has not gone away. I mean, one of the "big four" has already kind of changed their stance to a degree and said mergers can be a wonderful thing if you can have one service from coast to coast. It's just the timing. I'm not sure when the timing is right.

People will come to their senses. One of the other ones made comments that said – if you looked at their comments in 2011 and 2013, it said mergers was their salvation. It's the way they created all of their success. But today, they don't want any more mergers, a little selfish.

So I think that we thought we had a model that opened up competition that introduced more competition into, gave an opportunity to have better service to the customer and create some shareholder value. We thought that was all good, but other people see it differently.

Look, I'm not worried about my legacy of creating some lasting merger. That's not what I'm about. I'm much more about creating shareholder value. Is it frustrating? Yeah, it's frustrating. But I would predict post-Harrison, it's going to happen, and it'll happen and it'll work very well.

A lot of people were against the transaction, some of the customers that I visited with. And what they were against was not mergers. They were against how mergers were executed in the past. So if people didn't execute very well and they lost equipment and they didn't know what was in their systems and they played havoc with the customer, then they don't want any merger. But it's kind of like I used to say, I used to hate to get a spanking for something my sister did. There's only so much we can do. So it's going to happen. We just to have to develop a little patience, which I'm not greatly endowed with, but it'll happen one day, soon.

<A - Keith E. Creel>: If I could add to that, Hunter. If business sense and service sense doesn't carry the argument, eventually survival will. I don't care what railroad you run, we are all faced with the challenge that freight revenue is going to double over the next 10 years in Chicago. It's not going to change. So we can stick our heads in the sand today. But I plan on being around 10 years from now. It's a problem that's not going away so we certainly have to solve it for the better of the industry, as well as the U.S. economy and the Canadian economy. Both are connected.

Operator

The next question comes from the line of Jeff Kauffman from Buckingham Research. Your line is open.

<Q - Jeffrey A. Kauffman>: Thank you very much. Keith, earlier you talked a little bit about some of the opportunities, taking switches out, track out, could you give us an update on the capital program looking out next few years? Where are you on a locomotive storage basis? Where are you in terms of that siding extension program? And rather than focusing so much on the cutting, maybe talk about the

opportunities on the capital project side and what you think that spending looks like over the next few years?

<A - Keith E. Creel>: Yeah. On the locomotive side, we're in extremely good shape with the productivity we've improved, speeds that we've improved. We've got somewhere around 600 locomotives that are stored. So I can take a capital holiday well 2018, 2019 before we go back in the market on locomotives is what we expect. As far as the siding extension program, we have a – all of our key lanes for the demand that we have today were caught up and we've installed long sidings. We've put in order of magnitude over the last three years, somewhere around 30 siding extensions or additions.

Now we have a plan in line with the multi-year plan based on demand, based on growth that we can obviously kick back in if and when it comes. And it will come. It's just a matter of timing. I just don't know the answer to the land piece. But in the meantime, even part of what we assumed that we will spend by what we're doing taking these switches out and cascading this material that reduces our demand as we optimize that that work in pace with the business at a lower cost because we're going to be able to cascade those assets. So short-term we've got a more reliable plant. It's a safer plant that requires less maintenance. Long-term as we grow and expand for business, then it's going to be at a lower cost.

<Q - Jeffrey A. Kauffman>: Okay. So to tie it all together, Keith, where do you think the capital budget is for this year and what do you think you need to spend based on the growth plan you're envisioning over the next couple of years?

<A - Keith E. Creel>: Well, I think over the next couple of years, you're going to see it very similar to where it is now. In the out years, you might see it pick up, adding those sidings, doing that kind of work, $100 million, $150 million order magnitude. I guess it all depends on where the exchange rate because we're talking about conversion with Canadian and U.S. dollars. A lot of that material we buy in the U.S., the new stuff.

So order of magnitude, that's where it's at. We expect the model similar numbers over 2017 compared to 2016. Maybe in 2018 and 2019, it upticks a couple of hundred million.

Operator

The next question comes from the line of Brandon Oglenski from Barclays. Your line is open.

<Q>: Good morning. This is Eric on for Brandon. Thanks for taking my question. I just wanted to follow up on grain real quick. You mentioned the potential for a normal harvest. Is that your expectation right now, or is it still too early to tell?

<A - Keith E. Creel>: Well, that's what we always assume in our models. It is too early to tell. There's no assurance for a normal harvest, but certainly that's what we assume. We think that's the rational and prudent assumption to put in our business demand models.

<Q>: Okay. And then I guess, how has your operation changed to deal with backlogs on that network similar to 2014 as the stockpile reduction kind of coincides with a new harvest?

<A - Keith E. Creel>: Well, obviously, we'd rather be moving over the 12 months of the year not condensed and consolidated. So yes, it will create some congestion when the farmers all want to move at the same time. It's not just that, it's also handing off to our partners in the business. But what we've done since then, actually last year and this year, which has been received extremely well in the marketplace, we have dedicated trains where we sell dedicated capacity to our customers. So it's sort of a take or pay thing. They commit to us and they get the assets, a certain percentage of our overall fleet. It's around 50% of the fleet. They get dedicated assets, they can plan on the product that they need to move. But at the same time, if they lock those assets up and they don't move the product, then we get a payment for that as well. So we both have skin in the game.

And I think another thing that a lot of people don't realize that's happened since 2014, especially on the Canadian side, our partners in the business, the grain companies have spent significant capital to help some of their congestion issues on the West Coast port, which, given the same size crop, obviously, there's still going to be some challenges and they've got to, I think, work closer with us to work 24/7, 7 days a week the same way we do. But if they do that, given their capacity that they've created, match that up with our dedicated train which reduces cycle times, they're going to see capacity for the railroads can move much more grain at a lower cost.

Operator

Mr. Harrison, there are no further question at this time. Please continue.

E. Hunter Harrison

Thank you. Thanks Blair. Let me make a couple of comments. First of all, it's with mixed emotions that I am kind of looking at the twilight or end of my career. And one of the reasons why is what you've heard today. I mean, this organization that we collectively have put together has some exciting challenges ahead of us that I know they can step up to. I think they're clearly going to establish their self even deeper as the number one railroad in North America. The thing that Keith has talked about today, building a bench strength to new opportunities with trip plans. The achievements that we talked about today with the operating ratio and some of the other things were achieved without some of these tools that we're talking about today.

So this group is extremely bullish on the future, rightfully so. And I just wish I had a few more years ahead of me to be a part of it. But I failed retirement once and I can't fail again so – but I'm excited to watch from the sidelines what this group produces. And I still reserve the right to – if they don't perform like they can and should, I might have a few tips for them from time to time as a shareholder. So thanks for joining us and we look forward to seeing some of you this afternoon at our Annual General Meeting. Thanks.

Operator

That concludes today's conference call. You may now disconnect.
