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Transcript

CIBC Whistler Institutional Investor Conference

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Corporate Participants:

Nadeem Velani, EVP & CFO Canadian Pacific

Maeghan Albiston, AVP Investor Relations Canadian Pacific

Q&A

Kevin Chiang – Analyst, CIBC

All right then. We'll kick off this 8:35 session here. Thank you very much and good morning to everybody. It's my pleasure to introduce on my right here CP Rail, one of the greatest corporate transformations we've seen over the past half-decade or so. The company is now entering the next chapter of its story, focusing on selling service and growing the top line.

It's my pleasure to introduce from CP, Nadeem Velani, Executive Vice President and CFO; and Maeghan Albiston, VP, Investor Relations. I think most of us are pretty familiar with the CP story. So we'll keep this as a fireside chat. If you have any questions, please raise your hands and I'll get you. There's also – you can ask questions via the app, and I can get them over the iPad here.

Thank you, Maeghan and Nadeem, for joining us on Whistler this year.

Maybe I'll kick it off and maybe we'll kick it off with NAFTA, which has become more of a headline story to start 2018. We have these negotiations being held in Montreal this week. How do you see the rest of the U.S. withdrawing from NAFTA on CP's operations? Is it just simply your U.S. revenue exposure or is there more granularity you could provide?

<A - Nadeem Velani>: Sure. I'd say that there's a few different ways we're looking at the potential impact. Number one, obviously, being a transportation company, what we move cross-border is pretty significant. So about 30% of our total revenues are trans-border. But if you break that down a little bit more to kind of delve into it, about 9% is south coming up north and then 21% going from Canada to the U.S.

I would say that if you looked at that 21% going south, the majority of what we move is grain, fertilizers, potash, which we don't see a huge amount of risk from NAFTA impacting those volumes or potential repeal of NAFTA. I'd say that if you look at some of the other elements like crude, energy, even forest products, some of those, if NAFTA was to be ripped up and you go to Canada-U.S. Free Trade Agreement or WTO tariffs, some of those commodities wouldn't be impacted.

So from our perspective, certainly we're watching it closely, and Keith Creel, our CEO, has been involved with discussions with Minister Freeland in terms of Canadian CEOs offering their take, and I'd say that our overall exposure is probably a little bit more on the automotive side, but again that's less than 3% of our total business, of which a lot is even within the U.S. movement from point to point in the U.S. So, overall, our exposure is pretty limited from a revenue point of view.

I think secondarily we look at what it could mean in terms of the macro environment, what it could mean for investments, decisions by corporations, and I guess, thirdly, what it could mean for the Canadian dollar. So the Canadian dollar has been appreciating pretty significantly, and that has an impact on the translation of our revenues, number one, but also the competitiveness of our customers. So we're looking at it kind of in that context and what it could mean. So we're watching it closely. I wouldn't say it keeps me up at night, but certainly it's something that we're very mindful of.

<Q - Kevin Chiang>: That's great color. You did report solid Q4 results last week and laid out your 2018 guidance calling for mid-single-digit top line growth and low-double-digit earnings growth. I think the general view is that it was pretty conservative given, I think, the outlook most people have for your company this year. Where could you see potential upside when you look at your volume portfolio? And thoughts on pricing

accelerating this year given a very tight trucking market in the U.S.

<A - Nadeem Velani>: Sure. It's always nice when you put low-double-digit EPS growth and it's considered conservative for a 135-year-old company. But we're in a good position for – as you pointed out, our plan is to turn around CP from a cost and service point of view and then look to take that low-cost and industry-leading service and grow faster than the rest. And so the plan is working. I mean, we have a significant amount of opportunity still on the intermodal side. Reminder, we had looked at shifting away from international intermodal and focus more on domestic, which is more catered to the strength of our network, number one, but also from a margin point of view and from a service point of view, it fed really well into to our game plan and our strategy of selling service and not just being dependent on price.

At the same time now, we see opportunities on the international intermodal side. We had lost contracts early in the transformation, and it's not really a surprise when our operating ratio was 80% and we didn't have the best service. We needed to fix the engine first before we could compete, and that's typically your lower-margin business. So, by design, we shed some of that business or we couldn't compete with our major rail competitor.

I think the tide is turning now. I think if you look at their performance the last 12 months or so, their margins are slipping and their service is slipping even further whereas we are going the opposite direction. We've set record OR this past quarter, continue to improve our margins, have an outlook on that, and our service continues to improve, we're getting closer to the customer. So I see a huge amount of opportunities on intermodal as a whole. We gain share in the merchandise side and in some of the chemicals and LPG products. We're gaining share and continue to gain share in intermodal as I described and even more recently on the potash side.

So is there upside? Yes. Are we counting on it? Have we baked in all the positives into our guidance? No. I don't think it's prudent start of the year to assume all the upside. So we're very encouraged with what's laying on the table, and it's a matter of executing. I think if you look at our volumes so far, we're up double-digit RTMs at the start to the year. We're facing the same weather challenges as other rails in Canada and we're not missing a beat.

<Q - Kevin Chiang>: That's excellent color. And you spoke of this market share gain and some of the de-marketing you did as you shed unprofitable revenue as you were trying to improve your service. Are these market share gains all organic or can you speak to repatriating some of those lost contracts or those things you can come back to your network because they should naturally be there over the next few years?

<A - Nadeem Velani>: Yeah. I mean, our game plan has always been to partner with strategic customers that fit our network. You can't be everything for everyone. If you try to just take on market share for the sake of taking on market share, you fall into the trap of what we're seeing in some of the other railroads today. I think our view has always been sustainable, profitable, controlled growth. So take it on with the right returns, think of it long term as to how it's going to support your investments. Capital is a precious thing. You can't just be putting capital in a high-cost, high fixed capital-intensive business such as ours. The tendency can be to overinvest and chase kind of short-term business.

We're trying to be very disciplined utilizing price to get the proper returns and thinking about the business in a long-term manner. So, so far we think it's working. I think the market is starting to understand our approach and appreciate our approach. We're still trading at a discount to the other rails which creates opportunities for us to buy the stock back cheaper is the way I look at it.

<Q - Kevin Chiang>: I guess that is a silver lining. Maybe turning to, I guess, a commodity that's received a little bit more headline in recent months, crude-by-rail. On your Q4 call, I think you intimated that the run rate you saw in the fourth quarter is probably a good run rate for the rest of the year. Given where differentials are now, what would it take for you to increase your exposure in crude-by-rail? What exactly are you looking for - from the shippers in that commodity bucket?

<A - Nadeem Velani>: Sure. I mean, as I described, when we look at the business in long-term, we have customers that are – we know grain is going to be there for decades. We have strong partnerships with our coal customer, with Teck. We have strong partnerships with the potash companies. We've got a new one coming online that we've built into with K+S. So, already long-term kind of commitments to major bulk customers.

Crude, it's one of those markets that's very volatile. We've seen its peak in 2014, 2015 and then all of a sudden fall off a cliff. Railroads like consistent volumes. We like some predictable volumes. It allows us to plan much better, and as I mentioned, invest our capital in a much more disciplined way, tie up our resources, or allocate resources in a more prudent fashion.

Now, not all markets can be predictable, but what we're looking for kind of short term as to build in some commitments with customers to either commit on a certain level of volumes or have a take-or-pay arrangement where they would pay damages if they didn't meet those minimum volumes, and kind of put some skin in the game on both sides. I think if we're going to take on additional resources, it takes six months to train people in our industry. If we're going to put that commitment to hire, which we are doing, if we're going to take the commitment to add on locomotives or to upgrade locomotives, we need commitment from a customer. So we're having good conversations to work with our customers and potential crude volumes that could come on, but they need to be kind of in a consistent manner or have some sort of take-or-pay mechanism.

<Q - Kevin Chiang>: Is there a sense of – or if you can remind us what those crude volumes look like today, and what would you be comfortable taking it up to? Is there a sense of you go from one train a day to two trains a day, or it's a pretty fluid situation that'll play itself?

<A - Nadeem Velani>: Yeah. I mean, I think our crude volumes are year-over-year. I mean, it's from easy compare a year ago but they've effectively doubled. Could they be higher? Sure. But again it's a matter of having the resources and having the commitments from customers and being able to increase your resources to match the demand.

And so are we comfortable adding additional volumes? Absolutely, but we need to have some sort of skin in the game as well from our customers. And it does take time. You can't do it overnight. So we have a multi-year plan that we built about nine months ago in terms of our locomotive game plan going forward, and that has – we've taken the approach rather than buying new locomotives. We wanted to modernize and retrofit existing locomotives that we have in storage. So, we have a four-year game plan to bring on those locomotives and invest capital back into them to get them to a much better capacity and condition and efficiency level. So we are doing that as we speak. We have a game plan over the next two to three years to increase that. Could we pull forward some of that? Absolutely, but again, if we're going to spend that precious capital, we want to have commitments from our crude customers and other customers as well.

<Q - Kevin Chiang>: Makes sense. Any questions in the audience? Yes?

<Q – unknown participant>: Yes. Question for you. What was the duration of a contract that you look for [indiscernible] (13:07)?

<A - Nadeem Velani>: They vary, but typically we'd be more shorter-term-focused. But again, if we're going to ask customers to commit and commit volumes, we would have that appreciation for what they need in terms of capacity from us and also what we need in terms of investment and capital. So you'd probably look at more multi-year, two-, three-year kind of contracts.

<Q - Kevin Chiang>: Any other question in the audience?

<Q – unknown participant>: You started doing that with oil producers would you start thinking of adding and expanding take-or-pay contracts with other customers as well?

<A - Nadeem Velani>: Well, we do, we do have some. I mean, we have customers in other lines of business like potash, like some of our coal customers. I think we have some commitments in terms of volumes and so forth. I would say that even in the case of some of our other merchandise traffic, so chemicals and so forth, we have take-or-pay. So we're not just targeting one industry and saying, do this. It's something that aligns our self with commitment in volumes and capital.

So, yeah, it's kind of the – the way we look at it is if there's certain lines of business that you know are going to be pretty consistent like grain, for example, you're going to have pretty consistent volumes that is going to grow whether the yields are up 5% over a normal crop year or down 5%. You're still going to have that base volume of traffic that's going to go. You don't necessarily need to have the same level of take-or-pays.

<Q - Kevin Chiang>: Any other questions? Maybe turning to grain, you mentioned there is a little bit of volatility there. It seems like the 2017-2018 harvest is coming a little bit stronger than we would have thought last summer. Can you provide us an update on how that's looking, how you see that volume trending through 2018, and maybe how you see your natural market share? I think there's been a lot of discussion around what the right market share is between the two rails as they move western Canadian grain. If you can comment on that as well.

<A - Nadeem Velani>: Sure. I'd use a different word for – rather than discussion. I'd say there's been some rhetoric about us losing market share in grain, and I think we'll let our performance speak for itself. I'd say yes, the Canadian grain crop is coming much better than kind of initially feared back in the fall. Rather than 67 million metric tons, I think it's closer to 71 million metric tons which is a strong number, a little bit higher than – kind of flat over the previous crop year, but higher than the five-year average or longer-term averages.
I think so far this current crop year our market share is 52%, which is in-line with where we've been in the last probably 5, 10 years. It usually moves plus or minus 1 point or 2 points from there. I'd say that there are some pockets where the northern catchment area is probably stronger than the southern catchment area. So we might see some of that market share potentially go back closer to 50% rather than 52%.

But from a service point of view, we see huge opportunities to maintain or improve our market share in Canada. So that rhetoric I mentioned of us losing market share in grain, we're not the least bit worried about those comments or those predictions that are failing to meet the predictions from Montreal already into crop years.

<Q - Kevin Chiang>: And when you look at intermodal, you mentioned domestic intermodal has been a great growth vehicle for you. Maybe we're turning a little bit of a focus towards international intermodal. Your reach isn't as broad as that of your peer. When you look at longer term, how do you ensure that this continues

to grow above GDP? Is this primarily a truck conversion story taking market share from truck and that's the primary driver? Or are there other things we should be aware of?

<A - Nadeem Velani>: Yeah. I think it's both. Certainly we've been more focused on converting trucks just given our opportunity is much larger. It's an area that as fuel prices increase, as driver shortages continue to peak or increase, it takes away a lot of the capacities that's available to trucks. As our service continues to improve, it creates opportunities. So from a domestic point of view, I think we closed out last year up double digits. We're double-digits-plus so far. I'm also very excited about the pricing opportunity there with capacity constraints in the trucking market. So, yeah, we see a good opportunity for domestic intermodal for all of those reasons.

<Q - Kevin Chiang>: And when you look up your network, thoughts on interline agreements with other railroads such as CSX? And I think with CSX, I think they've talked about shutting certain Canadian assets that may not be core to them. Would that be something that would interest you to add to your network?

<A - Nadeem Velani>: Yeah. I mean, so to your earlier comments, putting more dots on the map, we have extended some partnerships with GWR and Bluegrass Farms to extend our reach in the Ohio Valley. We've partnered with CSX to have industry-leading service from Vancouver into the Detroit area. And these are areas that you can put more dots on the map without spending the precious capital I mentioned earlier. You can extend your reach, you can work with other railroads and provide a strong service. It's a great way to extend your reach overall without long-term investment.

And so in terms of other opportunities, I mean, CSX has talked about some of the Canadian assets. We've looked at them, we continue to look. I don't see a lot of complementary kind of connections there that really makes sense for us at this point. But we continue to work with all of our Class 1 partners to see where we can work together and extend our reach. We're also having a refocus with other short line partners that we can work to do the same. So in our business, it's one that – the more you can work with your partners, the better. We are collaborative as a whole as an industry. So it's in all of our best interest to work together to manage our networks and extend our reach.

<Q - Kevin Chiang>: It makes sense. Any question in the audience? Up front.

<Q – unknown participant>: We hear from a competitor about their technological superiority, and it would be nice to [indiscernible] (20:34) technology and what you see is the future in [indiscernible] (20:39).

<A - Nadeem Velani>: I didn't hear the first part, sorry.

<Q – unknown participant>: I'd like you to comment on your technology competitiveness which is often put up as a question [indiscernible] (20:50).

<A - Nadeem Velani>: Relative to other industries or...

<Q – unknown participant>: Relative to your competitors.

<A - Nadeem Velani>: Well, I don't think we are at a disadvantage, technologically speaking. Let me give you an example. So we just rolled out Auto Gate, it's a FastPass app on your phone where truckers can enter our intermodal facilities. Just with a touch of their app, they can get access to all their preclearance, allow them to pick up a container in our facility and be in and out of there probably saving 45 minutes versus our competitor. So to me, we can we can kind of preclear them, we can find opportunities to take truckers that are aligned with us or customers that are aligned with us, give them superior service and reduce their costs, allow their

truckers to have increased turns, take down their costs, improve the ability of their capacity for their turns. And to me, that's a competitive advantage. It's why I think we're also growing double-digit in domestic intermodal late last year and early part of this year and why we're so bullish is looking at other ways beyond just the rail service that you can improve your overall service for your customers.

So I really don't see us as being disadvantaged. I won't use that R word again, but certainly I think that we have a very good story from a technological point of view. More to come in our Investor Day in June. We'll lay out some more concrete examples as to why we think we're not disadvantaged, but actually it's a competitive benefit to us.

<Q - Kevin Chiang>: Sure. A lot to be done in June for that Investor Day. Up front here.

<Q – unknown participant>: It's hard to generalize the capacity utilization, but could you talk a little bit about how much traffic you could add before you have to start accelerating spending on things like sidings, double track [indiscernible]?

<A - Nadeem Velani>: Yeah, from a network point of view, we don't have significant pinch points or areas that we have to invest immediately in order to take on volumes. It's the beauty of having – looking at this from a multiyear perspective, and the ability of planning kind of over the years rather than just kind of looking at it in a very short-term basis. So we've been spending capital on sidings. We've been spending capital in some of our pinch points. We've been spending capital in some of the RTC areas that improve our overall throughput. Our predecessors as well had also spent a fair amount of money on network improvements as well and network sidings.

So from our point of view, we don't have significant pinch points there. I'd say where you'll see some accelerated investment, as I mentioned, is maybe a little bit more on the car side and locomotive side and the assets. Reminder, we haven't bought a new locomotive since 2011, and I was working for a different railroad back then. So we are investing in that. That's probably where we don't have pinch points there, but over the next several years, if the growth comes on like we planned, we'll be able to match up our power resources with our volume growth.

<Q - Kevin Chiang>: That's great. Any other questions in the audience? Maybe on that front, you did lay out your CapEx for 2018 of between CAD 1.35 billion to CAD 1.5 billion with the delta potentially spending on grain hopper cars as it relates to maybe passing of Bill C-49. Should we think of that spend happening regardless if that bill passes? It may not happen all in 2018 but it'd get spread out still because you need to upgrade these hopper cars. And is that range you gave for this year a good run rate longer term for CP?

<A - Nadeem Velani>: Sure. So, yes, our guidance is CAD 1.35 billion to CAD 1.5 billion with the delta being hopper cars. I'd answer it this way, Kevin. I'd say when we went to the board last year to say we want authority to spend CAD 0.5 billion to upgrader our hopper car fleet, or invest in hopper cars, there's got to be a return. And so as it stands today, we have to share that potential return with our rail competitor which, unless you have a bifurcated index where we can have transparency to get a return on that investment, I don't – Keith and I, we wouldn't feel comfortable going to the board saying we're going to – we want CAD 0.5 billion. We're not sure what the return is because we're not sure what the MRE and what the index is going to give us on that investment.

So, long answer to say, no, we probably would look at alternative strategy as opposed to investing and asking our board to allow us to spend CAD 500 million, CAD 600 million on hopper cars. So we're hopeful that it goes through and that we have this ability to improve our capacity, improve our service, and improve the customer

experience. So we're optimistic that this spring we'll have good news to report there.

And in terms of a run rate for CapEx, that's probably a good run rate where we are today in terms of that CAD 1.3 billion to CAD to 1.5 billion. We talked about some of the locomotive spend. PTC will roll off. One thing to also consider is what the Canadian dollar does. I mean, that can be pretty impactful to overall CapEx spend. So the majority of our CapEx is in U.S. dollars. So depending on where that goes, that could have an influence on our capital, but that range is a fair one.

<Q - Kevin Chiang>: That's great. We have about two more minutes here, and there's a question off the app. How would autonomous trucking impact rail competitiveness over time?

<A - Nadeem Velani>: It's a good question. If you think about our average length of haul, if you look at domestic intermodal, it's closer to 1,600 miles. I think the autonomous trucking and where we've seen it kind of already in Europe and other parts of the world, it's more shorter-haul trucks. We have a pretty strong, pretty high investment in trucks or partnership with trucking companies. You look at your First Mile-Last Mile strategy, working with trucks is important. And could it be an advantage to us to be able to improve our point-to-point service and origination-destination kind of service to work with autonomous trucks and see it as a potential opportunity? We'll wait and see. We are again watching it closely to see what kind of threat it could be. Certainly, some markets it could be an opportunity for us as well though to look at improving our overall origination-destination.

<Q - Kevin Chiang>: Okay. And maybe last one here, when I think of your dividend, you're paying out roughly 20%, maybe just a little bit over 20%, give or take of EPS. I think other Class 1s have targeted in the 30% to 35% as your free cash flow matures. How should we think about that dividend payout ratio? Is that something we should be thinking of migrating to the 30% range?

<A - Nadeem Velani>: Yeah. We don't like getting stuck in kind of set targets, I'd say. Our free cash generation is in that CAD 1 billion to CAD 1.2 billion range this year probably. If you look at our approach, it's always been the one that we are going to get back to shareholders. We are going to whether in the form of buybacks and dividends. I think you need to know where you are in your story. You got to be sensitive to the price of the stock. And so given low-double-digit EPS growth – your words, not mine, Kevin – is conservative. I'd say we're in a growth mode. And if we're being somewhat unfairly penalized with a with a low P/E relative to our industry, we're probably going to see more buybacks than dividends in the near term. But our approach really is look at your free cash flow, give it back to your shareholders and do what's right, and so, mindful of the price.

<Q - Kevin Chiang>: That's excellent. I think we've run out of time. Thank you both very much.

<A - Nadeem Velani>: Thanks, Kevin.

<A - Maeghan Albiston:> Thanks for having us.