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Transcript

Barclays Industrial Select Conference

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Corporate Participants:

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

Maeghan Albiston – AVP Investor Relations, Canadian Pacific

Other Participants:

Brandon Oglenski – Analyst, Barclays

QUESTION AND ANSWER SECTION

Brandon Oglenski

Analyst, Barclays

I'm Brandon Oglenski, airlines and transport analyst here at Barclays. Again, I'm going to emphasize this every time. But welcome to our 36th Annual Industrial Select Conference. Very happy to have Canadian Pacific joining us next here. And from the company, Nadeem Velani, CFO, for what, the past two years…

Nadeem Velani

CFO & EVP, Canadian Pacific

Two and a half years almost.

<Brandon Oglenski>: … Yeah. And a lot of folks who remember you were involved Canadian National Investor Relations CP, joined the company in 2013, right.

<A - Nadeem Velani>: Right. Exactly.

<Q - Brandon Oglenski>: So that was the transition period. So definitely have a lot to discuss. And you know arguably more of a true precision scheduled railroad, and I know a lot of your competitors are now adopting that phrase too, but we'll talk about that. If we can just go ahead and queue up question one for the audience. Do you currently own CP? I'm sure everyone knows the choices at this point. Maeghan, you can vote if you want. And then question number two, please. What's your current bias towards Canadian Pacific? Right now positive, negative, or neutral? And then question number three. In your opinion through cycle EPS growth for CP will be above peers, in line with peers, or below peers? All right, Nadeem. Well. Thank you again for joining us. We've had a lot of your peers up here at this conference - or competitors I should say. But CP's obviously got a well-running operating plan right now and you guys laid out a very, what I would argue, a pretty compelling growth strategy at your Analyst Meeting last fall. Can you just tell us how are you delivering against those objectives and there any miscues here starting out the year because we have heard there's always weather but apparently it got pretty cold in Canada last two weeks?

<A - Nadeem Velani>: Yeah. So first of all thanks for having us, Brandon. This is certainly one of the highlights of the conference tour, and as you know, and this is such a well-attended event and a great event run by Barclays and certainly always nice to get out of the Canadian winter for a few days. So thank you for the invitation. I'd say that things are running extremely well. So we had our Investor Day in early October of 2018. Laid out our multi-year plan with a certainly a focus on growth. But not forgetting, you know, the strength of our franchise and the opportunities from a margin point of view and to generate strong free cash flow. So I think with a focus on how we're – how we measure ourselves which is very much on return on invested capital point of view. I'd be remissive if I didn't point out we finished the year 2018 with 16.2% return on invested capital which is I think best in the industry. So what is – what has happened since then, since we've laid out those targets and obviously it's very early to that plan. I think we were increasingly positive, increasingly bullish about executing on that plan and what we can deliver. With an emphasis on improving our overall transportation product, not just the rail piece, and strategically investing in some of those growth opportunities, and we can get into that some of that a little bit later, but really above average revenue growth beyond our peers and bringing that to the bottom line. That's kind of our story. And, you know, we've had some contract wins even since then that we feel very good about. And so we feel very positive on being able to meet those targets and beat them.

<Q - Brandon Oglenski>: I definitely want to keep this conversation focused long term, but we have seen February volumes look a little bit soft. Is that all weather related and is there a backlog of traffic that we think that comes back pretty quickly in the spring?

<A - Nadeem Velani>: Yeah. So I'd say January was kind of above trend and we kind of carried on that strong growth that we had in Q4 and the back half of 2018. We carried that through in January. February has been a severe challenge. I mean we had a very impactful incident, which claimed the lives of three of our fellow railroaders, which was a very unfortunate incident, and beyond the human side of it, it had a very negative impact on the network. And so, in a key component, key area of where we move a lot of our grain, and potash, et cetera to the – to the West Coast, so that that incident was very impactful overall, and it's it also combined with a very challenging winter. I mean we're – we are pretty tough up north in terms of our ability to deal with the climate. But even for – for us, this has been a very challenging February, more so on the temperature side. So that's when we have to shorten our train lengths and it effectively just takes out capacity. So that's what we've been dealing with. Now the good thing is some of this traffic, we feel very good about recovering that that traffic. It just means that the majority of it is delayed. We'll see that kind of come through later in February and then into March as well. So it's not lost volumes, it's delayed traffic. From a demand point of view, we don't see any – any sort of softness there. We've seen some impact from the curtailments on crude on production and what that's meant to crude volumes, that's also impacted February. But beyond that we're – we're increasingly positive about the overall demand environment.

<Q - Brandon Oglenski>: Okay. You know a lot of times we sit behind the desk, we forget this is a real business with real consequences. So but on your point on crude, can you help us out with what's going on in Alberta? I think there was a recent announcement by the government, so can you talk through where you thought the crude business was going to be, now spreads have collapsed a bit, what's the go forward outlook for crude?

<A - Nadeem Velani>: Sure. So number one, I'd say we went through that challenge from crude in that 2015 timeframe. You know we've learned our lesson. So we set up a lot of contracts with to protect any sort of downside on top of that, you know, at our Analyst Day I mentioned in October was not focused on crude. Certainly, our guidance for this year does not dependent on crude. So, you know, we've taken the approach that the crude comes at the upside, let's protect the downside. And if it doesn't come, well, we've got opportunities elsewhere with remember put it in context crude is 5%, 6% of our revenues, it's not a meaningful component. So there's going to be some ups and downs and certainly how you protect the downside is important for us. And as we see kind of the how this unfolds, I mean they took they put in a curtailment, put in a production cut, forced many of our customers, larger customers to reduce their overall production, and that was a way of managing the kind of supply gut and supply glut and the challenge in terms of takeaway capacity. They recently then lowered that production curtailments and took out 25% of that curtailments so with a potential to reduce that further through the – through the spring. The most recent announcement this week was the governments', and this is an election year, so this government will be facing an election in the next few months. They came out with an announcement that they had made deals with us and our Canadian competitor, who, that they're investing in railcars that they're investing in terms of buying crude from suppliers and bringing it to market. And so, they cut deals with railroads, cut deals with some of the, some of the loading sites in order to get Canadian heavy crude to the marketplace. And so, we see that as a positive in the sense of it's potentially has the impact of maintaining spreads at a more economic level for supportive of crude by rail, and it gives some certainty to volumes so that deal is second half 2019 through till end of 2022. And so, it has volume commitments et cetera, beyond that, you know, it is a confidential deal, so can't get too much into it more than that, but that's kind of the latest news. And...

<Q - Brandon Oglenski>: And on the take or pay side, should we be thinking you're fully protected on revenue or if you're not moving volume, it can't be one for one swap right?

<A - Nadeem Velani>: Right. So the deals that we've set up, you know, at the tail end of last year or in 2018, the deals we set up with our crude customers. Yeah. It's not fully take or pay, it's set up to protect, kind of, what we're advocating was, if we got to hire crews and we have to take on locomotives and invest in track infrastructure et cetera, we want to generate a return on that. So you can assume that, the downside protection is making sure we get a return on hiring of employees, and potential investment in sidings et cetera, make sure that we have the capacity that we're keeping aside for those volumes that we get a return on that. You know, I'll point out again our returns are in excess of 16%. So keep that in the back of your mind.

<Q - Brandon Oglenski>: Okay. You did guide to mid single-digit, I think RTM growth this year, and for those who don't know, RTM is revenue ton-miles, a good way to track demand as opposed to just carloads. Was that in your guidance though this is crude outlook or...

<A - Nadeem Velani>: So again our guidance is a very conservative view on crude. So we feel very confident in our ability to grow mid-single digit RTMs irrespective of what happens in the crude environment short-term so.

<Q - Brandon Oglenski>: Okay. We have seen – you know – if we can talk about intermodal, which I think is a big part of the growth outlook for you guys. There's been service challenges in Vancouver and I think CP has been very aggressive to say actually it's not us, but can you talk through where the network is seeing congestion and what CP has done to address it and where you've got these contract wins or the opportunities going forward?

<A - Nadeem Velani>: Sure. Yeah, and I think, you know, with some of the facts are coming on the table in terms of the government's request for information on what's happened in Vancouver and, yes, it has not been our issue and I think our competitors spoke to some of their challenges yesterday so I'll let them speak for themselves. But we see kind of a longer term, you know, our perspective on Vancouver is longer term, there is a lot of traffic that wants to move there. All of our export traffic for, a lot of the bulk traffic, intermodal is a huge component of Vancouver. Now they've increased our key partner from a – intermodal point of view is GCT Delta Port. They've recently increased capacity some 30%. And they're set up for success. There are challenges if you get to Vancouver. I mean it's our – it's a northern Chicago for us and it's a -it's a fragile environment in terms of a lot of growth wants to go into that place. And you're limited by – by some of the local infrastructure. So we're going to be big advocates longer term for how we can work with the supply chain as a whole to make sure that we're set up for success in terms of both import and export of traffic and working with our customers to build the right facilities in the right locations that are set up for what rail can serve, what they can do from a labor point of view, et cetera. So the near-term challenges I think were disruptive and I leave it at my earlier comments that I think are our competitor had some on-going challenges, some of the data will point to that very clearly.

<Q - Brandon Oglenski>: And that's part of the opportunity here, right, that CP's build capacity and resiliency in the network, is that what the team is selling today?

<A - Nadeem Velani>: Absolutely. So, you know, our growth strategy that we outlined and that we've been executing on for the last couple of years I mean we grew 6% two years ago, 12% revenues last year. That's industry leading. And so we could have grown more and quite frankly. But we've set up our growth strategy to very deliberately to grow in certain areas with the right strategic partners. Now, we are very clear that we won't try to be everything for everyone, if we've learned nothing from our competitor's failures that is try to be more than you can actually handle. Then you lose that credibility

with your customer base. And we're very careful not to fall into that trap. So we're targeting. We've been working with very strategic partners to say your network – our network fits your volume demands and your traffic kind of natural flows. And so we can be a better partner for you. And work with us and we'll give you a fair price that reflects our industry leading service. And we can grow together and you can take out costs of your capital investments by turning your assets faster. You can get a better service and it's a service that you can count on. And that's been our focus as a whole. So we're not – we're not trying to grow more than we can reasonably grow.

<Q - Brandon Oglenski>: And by the way if there's any audience questions raise your hand, we'll get the mic to you. Along those lines, I mean if we look back at your former employer, I know they have some challenges recently, but that formula seems to be a similar part of their prior strategy, a lot of growth. I think investors sometimes confuse the idea that oh! we're going to take market share from one carrier to the other. But there is actually a large conversion opportunity from truck freight, is that – it's not just intermodal business. Is that correct?

<A - Nadeem Velani>: Right. I mean, I think it's a good dynamic in the North. I think there is growth opportunities on a number of fronts, that I think both Canadian railroads can grow with a strong return. I don't think this is a tit for tat, you know, they take some market share, we take it back, that's not what we're trying to achieve. I think that there is they've got some advantages that they can grow in some key areas, and we have our own advantages that we're going to grow. And truck is something that a big market that's strong for us. As you pointed out, you know our domestic intermodal has grown double digits the last two years. And we've seen strong conversion opportunities there. But beyond that we're still early in our cycle in terms of growth. And one thing that we've focused on beyond the rail is our total transportation product. And what that means is how you can get more truck traffic onto the rail network by building transload facilities, for example. We've invested in the last few years and we're going to invest this year in transload sites in Montreal, Toronto, Southern Ontario, other parts of the U.S. network in fact, but Vancouver as well, which is a key automotive compound that we just invested in and we're going to start seeing some traffic move with Ford in the next few weeks here. And those opportunities are very unique to us and they do have a larger bend to taking on truck traffic. And so, that's – that touches traffic like fuel, like forest products, energy non-crude, autos as I mentioned. The kind of key merchandise areas that CP previously hadn't focused on, and those are strong margin opportunities, good margin traffic and it's what gives us confidence we can grow faster than our peers.

<Q - Brandon Oglenski>: I mean, and I forget, at the analyst meeting, did you guys provide a long-term outlook and what you think you can do in revenue or RTMs?

<A - Nadeem Velani>: Yeah, we talked to mid-single digits RTM growth over the planned period, so over through the end of 2020 and double digit EPS.

<Q - Brandon Oglenski>: And should we be thinking that pricing is also contributing a good bit to top line over that same period of time?

<A - Nadeem Velani>: Absolutely. So I mean pricing has been sequentially improved over the last five quarters, including the quarter, we're in right now, we're seeing continued strength in pricing. We've changed our incentive plan on our account managers, our sales team is very much variable based and commission based, they're measured quarterly. We've increased their percentage weighting on pricing. We've raised the bar on pricing. And, you know, the good news is bars increased, but we'll pay them more. And so, we've got the right culture within our sales and marketing team that those that want to be the "A" type players that want to contribute and want the ball in their hands, and that's been a key driver of our recent revenue growth as well as developing that culture with the right team in place, led

by our Chief Marketing Officer, John Brooks. And so pricing is going to be a key driver of earnings growth as well.

<Q - Brandon Oglenski>: Okay. If there's any audience – sorry.

<Q - Unverified Participant>: Thanks. Could you talk about the capital intensity of your growth?

<A - Nadeem Velani>: Sure. So, we're – you know this year we guided to CAD $1.6 billion of capital, and next year as well as kind of our view of capital. If you look at the makeup of our overall book of capital over the last few years and next few years, I mean the basic capital doesn't change, that's CAD $800 million or so. And I'd say about 60% to 70% is kind of your drive capacity, drive – your maintenance capital et cetera. Beyond that we've had a few specific capital investment opportunities for us over the next several years. So, we went through our transformation, and that took out a lot of the need for take on locomotives and assets as a whole. So we didn't invest much in the need for new locomotives and so forth. But what we did was we accelerated our investment in the base infrastructure. So you know ballast and ties, and extended sidings et cetera. So you know our capital is shifting a bit now. So we had one key initiative or opportunity for us was/is covered hoppers on the grain side. So recent change in the regulatory environment in Canada the past year allowed for the bifurcation of rates within from the railways. So instead of one set rate on the movements in regulated grain that was given in both Canadian railroads, it was dependent on what you invest amongst a whole host of other factors, but what we invest in moving grain allows us to generate a different type of pricing and return. We have a very old fleet and also government owned fleet within our grain traffic and given 25% of what we move is grain. It's a key opportunity for us. So we're replacing some of these old hopper cars that take a long time to load take a long time to unload, don't have the same capacity as today's covered hoppers. And so, we're replenishing that fleet over the next four years. So that'll be about a CAD $600 million investment. So that CAD $1.6 billion I mentioned has a significant piece with capital investments toward hopper cars. One area we're also investing is modernizing our locomotive fleet. And so, that's something that we think is an efficient use of capital. And so, beyond that, if I look at what it looks like beyond 2020 et cetera I think we see a steady state of about CAD $1.5 billion dollars of capital. So we're kind of at our what we think is our current peak of capital intensity but it's very strong returns. So I mentioned 16.2% last year I think I mentioned three times now on our return on invested capital is something we're proud of and something that we're very focused on. And so, when we look at what we're how we're investing our capital and the returns we're going to get. It's a key driver of how we look at our business.

<Q - Brandon Oglenski>: Well, actually this is a good segue to ARS question number four. In your opinion, what should CP do with excess cash both on M&A, larger M&A, share repurchase, dividends, debt pay-down or internal investment. M&A is queuing up there a little bit. On the CapEx question though this is interesting because we do have some of the U.S. roads now suggesting that we can run CapEx below 15% of revenue long term, CP and your competitor up north has obviously outgrown the U.S. business the last five plus years. Is that just a different view that look we have the opportunities to grow? And so we're going to put the capital on the ground and drive those returns?

<A - Nadeem Velani>: Yeah, I think we're in different stages of the cycle right. So some of those – some of our U.S. peers are going through their PSR transformations and so, you know, they should have – should have a case where they probably have spent too much money on locomotives and assets and they should – I would expect them to not invest in that space and – for a number of years, I think that those – I think you've hit it well, I mean there are natural growth opportunities like the hopper cars that they don't have that we have, there are natural opportunities where we are in our cycle in terms of, as I mentioned, investing in our total transportation product. We're investing in some of these transloads that are key growth drivers that they may not have those opportunities. So it's a very different time in

the cycle for the U.S. peers versus where we are and where – or even our Canadian peer is. I just say that I think we're right in the middle of the pack. We're very focused on how we invest our capital and I think we do a fantastic job of internally, Keith as our CEO, driving the right culture. Where operations, marketing, our asset management team, and market strategy, as well as our finance team we're kind of joined at the hip in how we look at our business. I mean, this is week, our Chief, our Head of Operations, our Chief Marketing Officer and myself, and our Head of Asset Management, you know we're talking about 2020 and to say we need to revisit some of the recent wins and making sure we level set that we're set up to succeed and move the business that we've committed to. And this is something that we've committed to on an ongoing basis, this isn't something where we just kind of wake up one day and say, kind of what have we done. We have very kind of detailed internal planning, make sure that we're up to speed on what each of our teams are accountable to deliver against. So I think it separates us. I think it's – it puts us in a position to succeed for our customers and generate the right returns.

<Q - Brandon Oglenski>: And no offense, Nadeem, but Mr. Creel does seem pretty intense. I'm a little intimidated when he's up here…

<A – Nadeem Velani>: It dosen't offend me at all.

<Q - Brandon Oglenski>: … But at the analyst meeting, he did bring up frequently constructive criticism.

<A - Nadeem Velani>: Tension.

<Q - Brandon Oglenski>: Tension. Sorry, yes. And you've brought up ROIC quite a bit. Should we not focus on the operating ratio, or is there still more to go from efficiency or the cost standpoint?

<A - Nadeem Velani>: So, I love working for Keith. I think what he's done is to kind of rebuild the culture at CP to something we had at the other place that kind of went away from my perspective when Hunter retired there. And so you know if you we're all accountable, you know, we all have this sense of family, but I know if I'm not doing my job, he'll still love me but he'll get rid of me. And that's what we've signed up for and it's a fun place to be because you're given that opportunity to have the ball and drive your own success and the success for the team and it's a very special place. And I think that's why people want to come there, why people want to work at CP that culture that's being developed. And so constructive tension is a great way to kind of ensure that we're all accountable for what we have to deliver. And so I think it's a huge positive. As far as the operating ratio, I mean we drew down a 56 and change in Q4. And we're not fixated on it. But I think that we can – we should be the industry leader in the operating ratio department. And, you know, it's something that we definitely pride ourselves and being able to move traffic at a low cost and generate strong returns. So when we're driving incremental margins of about 75% that bodes well for what we should do on the operating ratio. So it's not something that we're fixated on and it's not something that we look at the business of whether we take on traffic on an operating ratio basis. But it's an outcome of all the factors that I described in terms of picking the right business, moving it on at a lower incremental cost and having the right capital planning in place, so that should be a positive outcome.

<Q - Brandon Oglenski>: If we can you queue the last two questions as we wrap up. In your opinion, what multiple of earnings should Canadian Pacific trade? And Nadeem, I think at the analyst meeting you said Mr. Harrison had left you with a money clip, right.

<A - Nadeem Velani>: Yeah.

<Q - Brandon Oglenski>: And you want to fill that up with a lot of money, right? Question number six, what do you see as most significant investment issue for Canadian Pacific, more growth, margin

performance, capital deployment, execution of strategy. And as we poll the audience here Nadeem, just real quick as we wrap up, you did have some land sale gains last year though, right. So is that going to be optically hard to get margin improvement in 2019 as we discussed…

<A - Nadeem Velani>: No, I mean we guided to no land sales for this year. Now, realistically we'll probably have some benefits there but we're assuming no land sales in our guidance, and we guided to improving our operating ratio this year. So we're excited. I mean, we're excited about 2019 and we're getting increasingly excited about 2020. So this isn't a short-term story by any means, and I think, there's a huge opportunity for CP to both grow and take out cost.

<Q - Brandon Oglenski>: Well, Thank you, Nadeem. Really appreciate it.

<A - Nadeem Velani>: Yeah.