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Transcript

RBC Capital Markets Canadian Automotive, Industrials
and Transportation Conference

May 13, 2019

Toronto, ON

Corporate Participants:

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

Chris de Bruyn – Director Investor Relations, Canadian Pacific

Other Participants:

Walter Spracklin – Analyst, RBC Capital Markets

QUESTION AND ANSWER SECTION

Walter Spracklin

Analyst, RBC Capital Markets

Okay. I think we'll get started again here and shift from automotive back into my expertise, which is refreshing. My name to any of you I haven't met is Walter Spracklin. I cover the transportation sector here at RBC Capital Markets and very pleased to have Nadeem Velani here with me today. He is the Chief Financial Officer, EVP and CFO of Canadian Pacific Railway. Little bit of background on Nadeem. He has held this role since October of 2016. I remember it because, I think I've told this many times, but it was at our conference in Vegas where Nadeem, you know, joined us as the Head of Investor Relations, but left as CFO. So, it was a interesting day. So that was great. And he had spent 15 years before joining CP at Canadian National in variety of positions from Strategic and Financial Planning to Investor Relations, Sales and Marketing, Office of the President and CEO, so good 20 years of railroading experience. So happy to have you here, Nadeem. Appreciate it.

Nadeem Velani

CFO & EVP, Canadian Pacific

Thanks for having me Walter.

<Q – Walter Spracklin>: So, let's start with the – I've been saying the last few sessions, I've been marketing a lot, and one of the first questions I always get as the undertone of the overall meeting is, is the economy and that a lot of the companies I cover and you guys would certainly fit this is you are on the frontline of the economy and it'd be interesting to hear your thoughts as to are we going in a recession and perhaps, you know, I'd ask it by saying how you feel about the next 6 to 12 months? Purely from a macro perspective do you feel better, do you feel worse or the same compared to what you might have felt at this time last year?

<A – Nadeem Velani>: Sure. So, first of all, thanks for having me. It's always great to attend RBC's conference. You guys do a tremendous job and we value your partnership and I apologize for my voice, yelling a little too much at the Raptors game yesterday. So, feeling – voice is feeling the effects of that. It's an amazing win. You know, I'd say that it's interesting time. So, you know, last fall Q4 when there was a lot of uncertainty around the macro environment, you know, and there's fear of a freight recession, et cetera, we weren't seeing it. We didn't feel, you know, from our vantage point that we were going into that by any stretch, and in fact we announced a share buyback program, pulled it forward with the support of our board, et cetera, to take advantage of the weakness in the equity markets and turned out to be a very good decision in hindsight. So, as we entered – as we exited 2018, you know, volumes were extremely strong, you know, high-single digit, double-digit type of volume growth. January continued that momentum. We were up 7% in the month of January. And then we had winter hit, pretty challenging conditions which hurt our network, hurt our ability to move traffic in an efficient manner. We had a difficult incident as well that claimed the lives of three of our railroaders and that was a challenging operating environment. But from a macro point of view, you know, we had the confidence that things were still very good from CP's point of view. And so when we announced our results in April, we were extremely optimistic and, you know, we've seen the underlying trends be very supportive and, you know, we've seen the volumes come around, in fact April was one of our strongest months on record in the history of 130-year-old company – 138-year-old company. So certainly we haven't seen the effects of a negative macro environment. Now some of this has been self-help.

We've certainly, you know, taken on a number of initiatives that have helped us grow faster than the economy, faster than the industry. But when you look at the underlying macro environment, we still see it as being pretty robust. You know quarter-to-date volumes are up high-single digits and, you know, it's broad based strength from our perspective. Six of our nine business units are seeing double-digit growth. Revenues are up low-double digits, which is certainly not reflective of a weakness in the economy. You know, it varies depending on where you are and what segment you are, but when you look at kind of the intermodal fundamentals, domestic intermodal, you know, lot of talk, you know, a lot of worry about excess trucking capacity, it impacts the trucking rates, et cetera. We're still seeing strong growth and we're still seeing supportive pricing as a whole. So we're not seeing, you know, – certainly we're cautious and some of the trade anxiety, some of the tariff anxiety and uncertainty that that creates. You know, we're not out of the woods at all by any stretch in terms of what that could mean to the economy. But where we see things over the next 6 months to 9 months is still cautiously optimistic I'd say, you know, I'd rank it kind of a 7 from where we are today.

<Q – Walter Spracklin>: So I know when you first talked about the volume opportunity, which your guidance officially is mid-single digit for volume roughly for this year, you felt – like I felt like okay you're saying mid, but, you know, I hear a lot of confidence in that. And then when April or sorry of when February hit that confidence didn't wane. You were – it was not a – well, a challenge, it didn't throw you off that – those targets. So, do you think that we're – can you give us comfort that you're still in that target range for volume as this displays at all the tough winter where you could be in terms of what you're hitting? And is there any – is there still potential that you could exceed that target if the current conditions persist?

<A – Nadeem Velani>: Sure, and you know, and we've been – you mentioned been in this business a long time and it's never easy to predict. But you give yourself a bit of a room for the unexpected. It's an outdoor sport and its – things can go unexpected at times. So, you know, when we laid out our guidance and our view of what we can achieve back in January, you know, we put some – it was a risk adjusted view, if you will. So, you know, crude can be volatile and you know, we saw what happened with the curtailments and the impact that that had on crude volumes for us in February. You know we were very intentional not to set our guidance based on a certain level of crude volumes underpinning it. You know, so, we were mindful of that. You know, winter does occur. So we were mindful that there is always some risk to volumes. Now, was it more difficult than we expected? Absolutely. But since then we've also had some strong positives. I'd say that we've seen a lot of positives from a market share opportunity, what we've been able to gain from the rail market share, from our chief Canadian competitor. You know, I'd say that we've seen some strength from some of our other segments, particularly in the energy, chemical, plastic space kind of non-crude. We've seen, you know, supportive volumes from our auto franchise. So, you know, if you look at the economic fundamentals of auto, it's not the most robust, but we've done some specific initiatives like we've built a new compound in Vancouver that allowed us to take market share with Ford, take on the new customer. Those are things that can – you can do to kind of offset any sort of economic weakness. So all of these kind of, you know, near term gains that we've had from the top line point of view has certainly given us that confidence that we will overachieve on our guidance of double-digit EPS. This isn't a level of guidance that's dependent on any one commodity or any one segment of business. But that being said, you know, like I said earlier, across the board double-digit type of growth in six of our nine segments and we don't see that slowing down in the near term.

<Q – Walter Spracklin>: Why don't we go through a few of those to start with? You mentioned crude. You know, there was some noise built in with curtailments. You said you didn't bank your guidance on any level of crude. Perhaps where did you, was it just assuming a zero growth in crude and then, you

know, you can get single-digit there, maybe high-single digit there and then if it comes in, then that's additive, is that the approach you took with crude and how is that now shaping up now that we've seen a new premier and perhaps some of those – of the other gyrations that happened in that market?

<A – Nadeem Velani>: Sure. So, you know, I think we exited Q4 with about 100,000 carload run rate for annualized run rate. I think in Q1 we were about 17,000 carloads for the quarter. So almost 68,000 run rate. So certainly a significant decline. That being said, we're kind of getting back to that 100,000 run rate here as we enter the second part of Q2 and there is strengthening demand. Now spreads have helped a little bit here and this is also the time of year where there's greater demand for Canadian crude, you know, as construction projects ramp up in the spring and you get the demand for asphalt, et cetera. So, I think that some of the curtailment that's been – it had a near term impact, created uncertainty, et cetera, but it didn't affect the overall inventory levels. We've seen them ease the curtailments and that's helped with the spreads. You know, I think the Alberta government were positive, were very supportive of the new government and some of what they've said in terms of being open for business, et cetera. They're going to take the time to review both the curtailments, I anticipate, as well as any decisions they have on the rail contracts that they inherited. You know, we're looking to – we've reached out to see if we can kind of get together and talk about initiatives of how we can work together, how we can develop that relationship because ultimately everything that they've talked about is going to support the Alberta economy. You know, we're largely dependent on the Alberta economy. We're also a big driver of the Alberta economy being such a Calgary based employer. And so we think that there's a lot of opportunities to work together, work collaboratively and help get more products to the market, not just crude, but beyond crude. And, you know, as the Canadian economy and the Alberta economy improves, that's only going to be supportive for all the lines – all of our lines of businesses, whether that be automotive, whether that be some of our industrial products or intermodal goods, those are all part of our growth opportunities as well. So we're excited.

<Q – Walter Spracklin>: So moving now to intermodal. You pointed some share wins. You got Dollarama. You know, a lot of the customers that I speak to that are your customers, that are CN's customers, have indicated there's certain dissatisfaction with CN in terms of service and certainly that's allowed you an opportunity to not necessarily need to go after a customer in order to get them over into yours, so you're getting a little bit of a – some of them coming to you. What opportunity is that creating for you to grow your intermodal business? I know in a previous meeting you talked about getting back up to your natural market share. How much growth could you or would you get in intermodal over the next couple years that would tie in with the service opportunities that you're getting from a competitive standpoint and getting you to your more natural market share, what kind of growth rate are we looking at?

<A – Nadeem Velani>: Sure. So, you know, – and we got to look at it in a couple manners, so whether it's the domestic intermodal which has been a huge growth area for us, since the turnaround as we kind of focused on getting that truck conversion and getting our natural market share, as we bring our service to where it should be, we did that over the turnaround and were able to take advantage of our shorter route miles and natural competitive advantage in key lanes of Vancouver to Montreal, Vancouver to Toronto, Toronto/Calgary, et cetera. And so that's been a huge growth driver for us the last four years. You know, it's running double digits as we speak. We've been able to again convert lot of truck share, take advantage of that service offering and some of the challenges that the trucking market is having and be able to grow faster than our peers. On the international side, you know, it's a bit of a different story. We shed a lot of business that we couldn't compete back in 2013 when our cost structure wasn't competitive with our natural peer and we've been able to now get that cost structure down and compete with anyone, you know, you've got to build credibility with your customers. You got to – it

takes time. You can't do it overnight. You've got to build those relationships. I was pleased to hear even today. We were announced, as part of the – there's an award in Asia for best logistics provider and we were nominated, shortlisted as the only railroad in North America to be nominated as best supply chain partner in Asia at this logistics awards session. And those things just don't happen overnight. They take time and you've got to build the credibility with your service. That's the only way to do it and our team has been driving hard to build that, re-establish our credibility in the marketplace. So when we look at what opportunities lie ahead, you know, last April we were able to secure the first international intermodal win that CP has had in some time. And that was the ONE contract. So, it was meaningful to us. And we highlighted at our Investor Day that there's a number of additional opportunities that are coming to the table that we want to be a part of. And so you know, since then I'd say that we're increasingly confident that we'll be able to take market share. And I mean some of these contracts are in a magnitude of 2.5% of revenues – 2% to 2.5% of our revenues for one contract alone. And so we're optimistic that we'll have a role to play and that we'll be able to gain market share from our Canadian competitor.

<Q – Walter Spracklin>: You made some pretty big investments in the covered hoppers. You know you're able to move in less train length more volume. I mean that's good news for you guys. Can you talk a bit about – perhaps explain how that works here and what has that meant for your capacity in the ag market where look if you don't have the capacity, it can be a nightmare right, and the farmers can be fairly vocal and make a lot of noise? So, perhaps you can talk a little bit about what these new covered hoppers have done for that business?

<A – Nadeem Velani>: Sure. So we're quite excited to be able to – we were at a bit of a disadvantage from a hopper car point of view versus our rail competitors given we had such a tired and aging fleet that didn't have the same level of capacity, you know, the amount of grain you can load per car. And so, you know, we wanted to invest, but we needed to have some certainty in terms of not sharing the investment we made with our rail competitor. So, as the maximum revenue entitlement, some of the changes by the CTA allowed for the bifurcation of rates, nonetheless allowed us to invest and get certainty that we would get rewarded for it, I'm not share that benefit with CN. So for example, last year, we started our investments. We invested and bought about 500 cars. And we're able to get a different rate than our rail competitor. Our rate, I think, was 5.6% increase versus theirs was closer to 2%. This year, they announced the rate increases for the new crop year starting in August. Our rate will be increased by about 3.8%, I believe, which is close to double what they'll be able to price. So you know, certainly, it allowed us to get validation for our investment, get a return on that investment. We plan on spending about CAD \$0.5 billion on acquiring about 5,900 new hopper cars. I think as of today, we have about 830 cars online, which allows us a better product for our customer. And to your point about capacity, well, these cars allow us to put about 25% more grain per train and allows us on our current grain model. We're also looking to expand with some rail infrastructure, the 8,500 foot car model – 8,500-foot train model, I beg your pardon, with our customers, that would allow us to get about 40% more capacity per train. So all that allows better service to our customer. They can load the cars faster, they can unload the cars at destinations faster, so you get better asset turns, you get better fuel efficiency, better product overall for the customer. In terms of capacity, as you highlighted, as you're having a better quality railcar and you turn those assets faster, it creates natural capacity for the farmer. And so it's a win-win situation. We get the potential with visibility to a strong return, they get a better product that they can compete better and get product-to-market more efficiently.

<Q – Walter Spracklin>: Looking at pricing now. Certainly with the trucking industry allowed you to price more, get better pricing in intermodal, where trucking was often more – a little bit more

competitive that allowed you to lift the average, but overall, are you still seeing in intermodal an opportunity going into this year, given perhaps some of that trucking – truck pricing isn't as prevalent? And are you getting as good or better pricing in the rest of your business than on intermodal?

<A – Nadeem Velani>: Sure. So I mean overall pricing, we've been able to maintain about a 4% pricing in this environment. You know, we raised the prices of our sales incentive program and our account managers are compensated on, with pricing as a higher weighting to incent the right behavior. And, you know, quite frankly, we split it out by segments, where the intermodal team was pushing back saying that, you know, they can't get pricing anymore and they need lower targets. Well they do a great job of selling with our customers, didn't do a very good job of selling to our sales incentive plan target team internally, and they pushed them. And so quite frankly, we were able achieve pricing in excess of 4% on the intermodal side on domestically, you know showing the strength of our service offering, showing the strength of the value that customers are willing to pay for the value we create for them. So its been – holding in steady, we haven't seen any negative impact of trucking capacity at this point. It's been above average, like I said, relatively to the rest of the book of business. So, you know, we're watching it closely to see if we're – see any sort of negative impact from excess truck capacity or any pricing in the trucking market that could, you know, go the wrong way, but so far so good.

<Q – Walter Spracklin>: So as we – we're already two-thirds through. So I have some more questions, when we go into the expense side and your balance sheet. But anything on the kind of revenue side? Any follow up questions? No? So OR improvement, obviously, there's different types of OR improvement across the North America Class 1s. There's those that are trying to get into PSR and talking about getting to where you are already. You know, we're more of the view that with what you have today, there's a better chance for solid incremental than it is for this theoretical step function among some of the other competitors. So where can you go going forward in terms of operating ratio improvement? When you look at your pricing, you look at your volume, you know, we touched indirectly on capacity, when all those three are working, it can lead to some pretty interesting incremental margin. What's your thoughts on operating ratio improvement as we go year-to-year?

<A – Nadeem Velani>: Sure. So, I mean, you know, the operating ratio is kind of the output of all that good stuff in terms of, if you're taking on quality revenue, you know, if you're charging a fair price for the service you create, the value you provide to your customers, you're going to get paid for it. You know, when we look at our opportunities ahead, you know, we've guided to – despite a challenging Q1, you know, we still see that the opportunity to take out a point of OR per year over the next several years, and it's going to be incremental, I'd say. As we take on this growth at low incremental costs, I think our incremental margins last year, back half of the year were in excess of 70%. And I think that that's a fair run rate for us to be able to achieve. So, you know, are there still cost take-out opportunities? Pure cost take-out, absolutely, but certainly, our story is going to be more of growing at a low incremental cost. So, you know, if we're doing mid-single digit volume growth, we're not going to – you know, certainly not going to be hiring at the mid-single digits. We should be able to do that at a low single-digit type of additional workforce. But, you know, continually looking for opportunities to take out costs elsewhere. So the hopper cars I mentioned, they're going to be – come on and create fuel efficiency for us. As we spending capital on locomotive modernization, that's going to help with our cost story. We're investing in some of our terminals like Alyth Yard in Calgary, our main operating center in our Canadian network, and that allows us to run traffic more efficiently, allows us to do work in other work centers that takes work out of Calgary and allows us to do some blocking in other parts of the network. And so all of this allows us to kind of take on our growth at low incremental costs, so, you

know, it's certainly – the story is not over on the operating ratio side. It's just going to be less of an impact – less of an improvement than we've seen in past years.

<Q – Walter Spracklin>: So, you're growing – you're pricing above inflation which helps your OR. You're delivering a better service which helps your pricing. You're growing into open volume – growing volume into open capacity which means you can grow at a higher pace than your costs are growing or you're adding people and resources. Where do we then see some structural opportunities? I know Keith always talked about, even coming out from CN, there was a lot of process that still has yet to be implemented at CP that would lead to another growth in structural costs or reduction in structural costs. And the second area on the same vein is technology and to what extent does – first of all, do those opportunities still exist that Keith talked about before? And are there new ones coming up now through technology and the advancement of some of these preventative maintenance or a whole host of different things that you could bring into your mix to reduce costs from technology?

<A – Nadeem Velani>: Sure, yeah. So we've – so as far as we've come along, it's only been six years, it's been a long six years, it feels like, and a lot less gray hairs back then, but certainly, you know, we're far from perfect. We can run the network faster. We can turn the assets better. You know, we have a cascade of opportunities still in front us from a cost point of view. It just takes time to get through them all. And a lot of times you got to do the groundwork and the pre-work before you can get to those next level of opportunities. You know, it's one area that we're spending a lot of time and effort in this is leadership development, you know, developing, you know, – investing back into our people. You know, we've had a lot of new railroaders come into the network and come into the property and investing in them. It may not be as tangible as say investing in locomotive, but it's what's going to create this long-term sustainability of what we've achieved. And so, I think that's going to allow us to get a whole host of opportunities down the road. As far as what we are doing kind of near-term in terms of structural opportunities, like I said, you know, when we close down these hump yards – with the early days in transformation, we haven't had a chance to reinvest back into the facilities and get the full value out of them. So Q4 of last year, we invested CAD \$50 million in the Alyth Yard. Those types of investments, you start seeing the value of what it means in terms of both your overall operating efficiency in the yard and in terminals and upstream on the service you're providing to the customer as well. So still a lot to occur and I can tell you that Keith is never satisfied in terms of what we can achieve. You know, you can find opportunities, if you look far enough and believe me, he knows how to sniff them out. The second part of your question...

<Walter Spracklin>: Technology.

<A – Nadeem Velani>: Technology. Yeah, so one area that we're focused on, we talked about at our Investor day, I think you saw firsthand some of the examples that we – we were on display in on the first day of our Investor Day. But one area is robotic process automation, so we dipped our toe into taking out, you know, a lot of the menial clerical work out of our shared service center in Winnipeg that allows us to do more value-added work. And, you know, so for us, a small investment that allows us to kind of revisit these processes and get rid of some of this menial clerical work, and at the same time, it does take head count out. The end goal wasn't to get rid of all the people, but rather improve the process and get value added. And so we let attrition do its job, and as – we don't have to replace some of this work, you don't have to replace and backfill some of these jobs, you get the benefits of headcount reductions. One of the other areas that we just invested in is our track asset management. So we have a central database that collects all the information from our track access team that effectively – you know, a matter of – it's big data utilization of big data from our test cars, and it captures a lot of this information into a central depository that allows the team to review the track health of the network, and so it allows

us to kind of longer term have better safety, better efficiency of our network, so some of the areas that we're investing in as well as our overall wheel inspection technology, so more to come on those initiatives, so.

<Q – Walter Spracklin>: So my last question is really on your balance sheet. I know you've got a big CapEx, a relatively big CapEx spend with the hopper cars that's going to come off now, that will lead to a nice inflection – a little bit of an inflection here in free cash flow. You're going to become more free cash flow generative. When you look at your balance sheet, it looks fine. I mean, I would even argue that there is a few peers in the U.S. that are starting to let leverage grow a little bit as a means of providing shareholder return. Could you look at any of that? You're seeing free cash flow grow, you're seeing the potential for leverage to grow, can we see a more accelerated buyback? We saw a great dividend increase. How are you looking at shareholder returns over the next year or two?

<A – Nadeem Velani>: Sure. So, I mean, we've worked hard to get our balance sheet back in order at – we were BBB minus. We committed to get it back up to investment grade, which we did. You know, that same time back in 2015, we got caught with currency, et cetera, and our leverage grew as high as 3.2 times. When I took over in this role, I committed to the rating agencies to get that down back to the 2 to 2.5 times range, which will be at this quarter despite Canadian dollar depreciating significantly. And a reminder, a majority of debt is in U.S. dollars and that's how it hurts us negatively. But we'll be at 2.4 times. We did do a healthy buyback as I mentioned in the fall, we announced a 4% program. We did a 27.5% dividend increase last week. We announced it – and, you know, we're targeting kind of a balanced approach of about a 25% payout ratio which we think we can achieve over the next couple of years. And we'll continue to reward shareholders through buybacks. We're obviously conscious of what the price of the stock is. We want to buy it below intrinsic value which, you know, we see intrinsic value higher than where we're trading today, so, we'll continue to buy back stock. I think we're comfortable to kind of be at that high end of that 2 to 2.5 times range, it's where we're comfortable being. And I think we'll continue to take a balanced approach and maintain that level of leverage.

<Walter Spracklin>: I've gone over time, but there is lots of interesting stuff going on at CP. So, thank you very much, Nadeem, for your time.

<Nadeem Velani>: Thanks Walter.

<Walter Spracklin>: Yeah, appreciate it. Thank you.