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Transcript

Wolfe Research 13th Annual Global Transportation and Industrials Conference

May 20, 2020

Webcast

Corporate Participants:
Keith Creel – President and Chief Executive Officer, Canadian Pacific

Other Participants:
Scott Group – Analyst, Wolfe Research

QUESTION AND ANSWER SECTION

Scott Group

Analyst, Wolfe Research

All right. Let's keep going, everyone. Really happy to have Keith Creel, President and CEO from CP. Keith is on the line, just on audio-only. Keith is going to make a couple of quick comments and then we're going to get right into questions. I've got a bunch but if you have questions as well, submit them and I'll make sure we get to them. So thanks for being here, Keith. Appreciate it.

Keith Creel

President and CEO, Canadian Pacific

All right. Thanks, Scott. Well listen, I would be remiss not to start my comments by continuing to thank the 12,000 strong CP family that continue to serve society today with a tremendous amount of pride but they also continue to fuel this unique performance that we've produced at CP for our customers and our shareholders. I can tell you the culture that we've worked hard to create at CP is unique in the industry, and it's times like this that you truly see the power of it in the most challenging times. It's my honor to be able to serve with these men and women every day. So far, the quarter – as I mentioned last week, the quarter is unfolding well for us. I'm pleased with how we're operating, how we're executing. Obviously, we entered the quarter with a lot of momentum from our record first quarter performance. The halfway through the second quarter were tracking ahead of our expectations. Our volumes were down about 10% – 10% to 11%. Revenue is tracking about 3 points better than that. The bulk franchise, obviously, a differentiator in our business mix, it's provided a very stable business, book of business for us to offset some of the challenges in the normal macro space that everyone else is facing. In fact, in April, as we've reported already that we set records in both potash movement as well as grain, and I fully expect this trend to continue. I can tell you our operating team is one that loves to be challenged, and I love to be the one challenging them and they're already working extremely hard to break another record when it comes to grain movement in the month of May. So in the quarter, I expect the revenues to come in stronger than our volumes liquidated damages from moving less crude will more than offset any negative mix that we're seeing from softness in autos and merchandise. Our operating metrics to the margin side remain a strong testament to the talent and the depth of this team. It drove a record operating ratio for this company in the first quarter. It drove a record operating ratio for the company in April, and we continue to make gains, setting new strides and operating metrics. And again, this PSR operating model as you learn the power of it, it's obviously very compelling from a value creation standpoint with the wind at your back when you've got revenues pushing you. But it's even more compelling in the middle of a storm like we're facing now. You truly see the value that it represents come out. I look at and then we're eight years into this, but we didn't start this just recently, Scott. And I look at the ability for our team to flex resources and lockstep with the demand. I'll just give you a couple of key points here. I look at it this morning, month-to-date RTMs are down a little bit less obviously than our quarters. We're about 13% on RTMs month-to-date, train miles are down 22%. Crew starts are down 22.5%. If I get to people starts which is a more accurate number, 23%, I look at the quarter, 10% on the RTM, 17% down on train miles, 17.5% on crew starts, 18% on people starts. If you look at train lengths, they are hitting new records. You look at locomotive productivity, new records. Fuel improvement, new record. It's just the power of the testament of what the story and what this

operating model has an ability to produce, in good times and especially in bad. And on the marketing side, again, we're running counter-cyclical to what the industry is. Our business is down, but it's not down as much as others and yes, the bulk side itself but also our self-help initiatives that we've started to create for this railroad with our customers that drove industry-leading growth in the last two years and what drove industry-leading growth in the first quarter is what's doing us now. So, we're keeping construct attention. You would think that with people working from home that perhaps the tension is less. I would suggest that it's more because the team has been challenged and incented to go out and search for new business. We know at times like this, it's an opportunity for us to get more integrated with our customers. Our customers are struggling just like the world is struggling. And every opportunity as they've got to save money and do it by creating and depending upon a very productive and reliable transportation service, it's truck-like reliable. If we don't convert that and create that opportunity, we've missed it. So, they're doing extremely well as they convert opportunities. And you'll see it in singles and doubles now. It helps obviously offset the downturn of business. But when the economy comes back, those singles and doubles, when you've got your normal business, the regular economy is going to give us, with the wind at our back, it's going to be very compelling from value creation standpoint. So, with that said, let me stop, Scott. I'll save the balance of our time for any color that comes up with the questions you might have or any of the investors or shareholders might have.

<Q – Scott Group>: Okay, fantastic. That was great, Keith. So, just a couple of follow-ups. You talked about RTMs tracking down in that 10%, 11% range. At this point, Keith, do you think that we've seen the bottom for the RTM trends that you're going to see or anything that tells you it may be takes a little bit more of a step back the rest of the quarter?

<A – Keith Creel>: I think, in the quarter, we're at the bottom. I mean, it might move 1% or 2%, Scott, and there's going to be some ebbs and flows. As we get to the end of this month, the ONE contract is going to shift to our competitor. But, at the same time, we've got automotive, obviously, they're starting back up for us. And as I remind our investors and remind you, in the first quarter, we were experiencing industry unique growth in the automotive sector given our partners, the growth that we had then. We expect, when Toyota comes back online, which they're doing next week, and as Chrysler comes back online, Honda comes back online, we're starting – start to get shipments as well coming in at Vancouver. We see that sort of offsetting. So, second quarter we're at the bottom and then we'll climb – start to climb out in third and I think get back to flattish in fourth and we're going to see a lot of strength in the first quarter and even in the second half, especially in the automotive sector which is going to be unique to us with Ford Chrysler coming online. We've sold out the auto compound in Vancouver. So, we've not only now got Ford going there July 1, we're going to have long-haul business coming from factories in Ontario, all the way to Vancouver, which as we move to September, that's the second part of the value creation story. That empty supply becomes – those loads going up there to become empty becomes empty supply for all Glovis business that switches or shifts 100%, September 1, to CP. So, our automotive story in the back half again is going to be counter to the industry and is pretty compelling from a value creation we're pretty excited about.

<Q – Scott Group>: Okay, great. And then I just want to clarify something. I thought I heard last week when you were at a different conference say that revenue was tracking 4 to 5 points worse than RTM, and I thought I heard today you said 3 points better and maybe there's – maybe I misheard it or maybe there's sort of apples and oranges there, but maybe if you could just help clarify that?

<A – Keith Creel>: Yeah. I just wasn't looking at the offset from price and liquidated damages. So if you sort of break it down, Scott, 10% to 11% when the RTM is down. Fuel and FX were an offset for us. We've got a negative mix with the automotive which is going to come back for us obviously, but that's offset by positive price and our liquidated damages. So they get you to a delta of 10% to 11% down on RTMs and we're going to be down about 8% on the revenue.

<Q – Scott Group>: Okay. That makes a lot of sense. Okay. And then you talked about record operating ratio in April. Obviously, that implies that April's OR improved year-over-year. Is it fair to start thinking about margin improvement for the full quarter for you which would obviously be just different than, I think, everybody else?

<A – Keith Creel>: Well, listen, I'd say this. There's some ebbs and flows. I'm hoping, anticipating that we have the automotive come back online. We think it's going to be three or four weeks. So depending on how those things play out, if it plays out the way we see it now with a little bit of jumpstart that we've got in the quarter exceeding our expectations, I'd be disappointed if our second quarter OR didn't start with a five. And if you play that out for the year with what we expect is going to happen based on what we know, which is the same assumptions that everyone else is applying in our business mix, we obviously see margin improvement for the year as well.

<Q – Scott Group>: Okay. And that's why you're sort of starting to say at least that last week that there's upside potential on the flat earnings for the year.

<A – Keith Creel>: There is. Yeah. Obviously, there's a lot of railroading and things to occur between now and then. But certainly we think our guidance is not only achievable, but with things going our way a little bit, I think that there's definitely some upside in the guidance.

<Q – Scott Group>: Okay. And so when I see in the month of May, RTM is down 13% and, if I heard right, train starts, people starts, I think you said down 22%, 23%. When volumes start to recover, do we have to give some of that back so the train starts grow more than volume or do you think we benefit from train productivity on the way down but we can also benefit on the way back up so when volumes grow, recover 5%, 10%, train starts grow less than that. Can you win on both sides?

<A – Keith Creel>: Yeah. We'll have to give some of it back, Scott, because obviously we're consolidating trains and we're doing some things that once normal business comes back, we won't be in a position to be able to do and protect our commitments on the customer service side. So some of it will be given back, but the way I look at it if we finish negative 5% on the RTM basis, which is what we're guiding to, we're probably going to be about that same number when it comes to head count and however you translate that into the productivity numbers. So we'll get some of it back, but not all of it back.

<Q – Scott Group>: Okay. I think that makes sense. Why do you think intermodal for you and for the other Canadian rail, why do you think intermodal is holding up much better for Canadians and the other rails?

<A – Keith Creel>: Well, I think a big piece of it, Scott, or I know what a big piece it is, its just a different business model. Our length of haul on the domestic side, our moves are not as suspect or as exposed as a shorter haul US move would be – especially with excess truck capacity in the marketplace. So, that helps us a bit. The model in Canada for the DCs are in a few places and you got to go across those long 1,700-mile average runs, drives us, and then CP specifically, some of the big box retailers, the Home

Depots of the world, the Loblaws, Canadian Tire, some of those players today, they've got strong balance sheets. They've got a big, broad breadth of business and they're benefiting from this demand when it comes to the e-commerce and the product that's moving, serving the needs of Canadians. So, I think it's just a geographic difference and a mix difference.

<Q – Scott Group>: Okay. So, a bunch of questions have come in online. I'll see what makes sense to go through here. So, one question about, we've got Canpotex signing deals with China and India. Is there any way to sort of think about the volume trajectory that we should start thinking about with potash here?

<A – Keith Creel>: Yeah. I think that you should expect – we've had some strength, obviously, we moved a lot of potash this quarter. So next half or second half if I think about last year it was suppressed, the demand was suppressed. So, I would go back to the year before and look what normal demand was and expect that or a little bit better second half of this year. So, we definitely see from a compare standpoint, it's favorable for our business mix given that those two contracts have been finalized. It would maybe be a bit of upside.

<Q – Scott Group>: Okay. And then so there are a few contract shifts and someone is asking if you can sort of quantify the net of it. So, we've got some nice wins on the auto side. We've got one of the intermodal contracts going the other way. We've got Teck next year, I guess they're asking anything else contract-wise that we should be aware of and when you think about the net of it, how the net shakes out?

<A – Keith Creel>: Well, the second half, obviously, we're going to see a negative compare on Ocean Network but it sort of offset by Yang Ming. So, those are washed the way I look at it. And as far as the autos, those are positive for our business mix. And if I look at next year from an automotive standpoint, there is nothing exposed from an intermodal contract standpoint. For us, there is nothing exposed. There may be some opportunities and then the other piece, obviously, we've said this, we've said it all along we're working hard to create a win and an opportunity for a steamship line in Saint John. And there's a lot of work still left to be done. But that's certain within the art of the possible for this company to see that and I certainly expect and hope, if not, in 2021 and 2022 – I'm sorry, if not, in 2020 and 2021, to be putting a steamship flag in Port of Saint John which gives us an opportunity obviously for growth.

<Q – Scott Group>: Sure. I think you just got STB approval on the CMQ transaction. Someone is asking sort of what's the initial sort of day one impact to CP and then what's the longer-term contribution potential from CMQ?

<A – Keith Creel>: Well, obviously, from a materiality standpoint, the margins there is not as compelling as ours. We take over the 4th of June. I'd have to let Maeghan or Nadeem talk to when you're going to see it in our numbers and all that work is ongoing. But operationally, that's what I think about; and commercially, that's what I think about it. And I can tell you now we've already been hard at work with the Canadian properties providing guidance. Legally, we didn't have the same requirement as the STB so we could exercise ownership control on the Canadian properties. However, obviously, in Maine, with the STB, we had a trustee that was managing the business. But I can tell you I did go out and visit. And I think that the team that turned CMQ around and that we purchased CMQ from. They've been working hard through this transition period. Some of those will stay with us, a handful. The majority not, but a handful will once we take it over. I think it's in very good shape. We've got capital work that's ongoing

on the Canadian side already. We'll start with the capital work on the US side at Maine, we intend. Our plan is it's about a three-year rollout to get it up to a Class III standard, to get it to a CP standard so we can enjoy CP transit time, CP reliability and safety, and CP margins on that business. So the way I look at it, it's a USD $40 million US railroad. We've already started to get commercial wins. CAD $20 million, CAD $30 million already that we'll see in 2020 when things normalized, 2021. And I'd be disappointed over the next 24 to 36 months if that USD $40 million is not CAD $120 million or north of that, Scott. It's CP-like margins. So, there's some work to be done. But I can tell you, the optimism, the enthusiasm, and the opportunities are exceeding my expectations when we made the decision to purchase the railway. Super excited about the opportunities long-term that that strategic acquisition represents for our shareholders and for our customers.

<Q – Scott Group>: Is that a – or was that a unique opportunity or are there other short-line opportunities where you have opportunities to buy them, double or triple the revenue, it sounds like, and take it from a typical short-line OR to a CP OR?

<A – Keith Creel>: Yeah. That was a very unique opportunity, especially one that's end-to-end with our railway. It takes us to an East Coast port where we've been, as a franchise, geographically disadvantaged. But if you look at the history of it, probably not much of a surprise. We used to own that railroad 25 years ago. So, we sold it, had to pay a hell lot more to get it back, but we intend to make it work. So, strategically, it gives us East Coast access and it opens up a market that has only been served by our competitor in the Eastern provinces or truck and there's a whole lot of trucks that move in those lanes. And if you look as a crow flies, it reflects the power of our franchise and the markets that we serve both truck-like competitive transit times because it's about over 200 miles shorter from Saint John to Montréal than our competitor from a rail standpoint and it's truck competitive. Just as a crow flies it's just a straight line across from Saint John to Montréal. So it's compelling from a service value proposition both in the Canadian space and also serving the US, Midwest as we start to execute and convert some of these opportunities.

<Q – Scott Group>: Okay. Great. So, you mentioned liquidated damages as one of the revenue pieces. Someone is asking if there's any way to provide any sort of color on the magnitude of that? And then I wanted to just follow up to that. So we've got a challenging crude environment now. We've got DRUs coming hopefully in a couple of years. Do you feel like the liquidated damages sort of fully, the right word is, bridge you to the DRUs? Or is next year sort of like a gap year of liquidated damages go down and then in 2022 the DRU stuff start shipping. I don't know if that makes sense. So, sort of two parts on the crude side…

<A – Keith Creel>: Let me – I'll answer that the best I can, but obviously those contracts are confidential and some of terms. I can't give you the specifics, Scott. But I can tell you this. When we signed those contracts, when this thing started, the demand started to bubble over, we above all other railroads got burned back in 2014. And the mandate that I gave our team is the pipeline is going to come eventually. We can't go out and buy assets 30, 40-year assets that we end up eating three years from now when the pipeline capacity is there once it gets built and, of course, at that time, we all thought it was three years. Now, I don't know when it's going to be, but we've got a whole another challenge with the price collapsing. But nevertheless, those liquidated damages were built to protect our capital investments and make sure that in times like this, if we didn't have the revenue, we have some cash to offset the money that we've spent to enter those contracts, and it's serving us well. The work that John and Coby and the

team did with the oil companies creating the liquidated damages is certainly offsetting this storm that we're going through now in that space. That will continue at some levels in 2021 as well and even there's liquidated damages in 2022, it just depends on the terms in the contract and, obviously, there's puts and takes in the quantums. But I think it bridges us to a point, with that said, this DRU is compelling and I think a lot of investors, if you really don't see the value in it, it's because you don't understand it. And it's full speed ahead. It's not this economic storm. It's not changed the value proposition when it comes to DRU. USD and Gibson, they're building facility. USD obviously has the facility there in Hardisty. It's going to be exclusively served or is exclusively served by CN. We think right now it's on track. In the second to the end of the second quarter 2021, it's coming online. Name plate capacity is 100,000 barrels a day. We've got a 10-year deal with COP that's locked in for half of that and we're deep into discussions about locking up the second half and it's pipeline competitive. So, it's going to be there as a revenue stream. That COP deal is a 10-year deal. So, that's CAD $100 million deal standalone just there. So, I think eventually crude disappears certainly at this 36,000 barrel. We may never get back there what we were experiencing before. I think it's going to get a whole lot better than it is now. We're assuming somewhere around 40,000-50,000 barrels that will still move in 2020. But in 2021, if you put it in context, when that DRU comes online, two trains a day is replacing sort of half of what we move today and 2019 demand. And it's scalable. Economically, it's friendly to the environment. So, it's an ESG solution. And as ESG becomes more compelling, those that value and are concerned with ESG, and at CP we are, it makes so much business sense and environmental sense that I think pipelines will always exist. I don't know when more will get built. I think demand is going to normalize and I think Canadian crude is going to need a home. And I think this is going to be a very ratable, reliable long-term supply chain option, supply chain solution and revenue story for CP, which again is expandable in the same footprint. And I think in the out-years, and I'm talking about four, five years from now, the potential is there to double that. So, it's just a very compelling long-term value-creation story that gives me a whole lot of conviction in the short term because in spite of this storm, the shovels and the dirt is being moved and the capital is being spent and it's going to go online second half of 2021. And it's going to be something that CP uniquely benefits from.

<Q – Scott Group>: Okay. That's great. Want to talk about operating ratio. So, sub-60 in the first quarter to me implies a run rate mid-50s in a sort of a normal environment. Are we thinking about that right that when we get back to a more normalized volume, revenue levels, that sort of you're demonstrating that the potential is here to do a mid-50s OR?

<A – Keith Creel>: With the CP, our story, obviously, we're a bit more advanced into the PSR story. The way I look at OR, Scott, and I've always believed this, I'm not enamored with it. It's just an output of running the business right. And we drove OR improvement when we were a margin story. We pivoted to growth and we continue to be a growth story. And we're still showing that with the wind at your back rolling or with the wind in your face contracting, we're still able to use the levers that represent the story to control our cost and to produce margin improvements. So, as the wind comes back and business normalizes, if I could do OR improvement this year, which I think this team will do end of the year based on what we know today, you can expect that you're going to see OR improvement next year. I'm not going to argue and tell you now is it going to be 0.5 point, 1 point, 2 points. We'll have to see how everything plays out. There's a whole lot of uncertainty between now and then, but I feel confident that we'll see margin improvement. If you want to rate it out and take a guess, I do see line of sight and ability to get to a mid-50s OR. Now, is that a three-year story or a four-year story? Scott, I don't know.

You tell me what the economy is going to do and I'll tell you where to put the pin but I definitely see a path to that mid-50s over the next three to four years.

<Q – Scott Group>: And then the big picture is you seem to have been able to find the sweet spot of doing volume and volume faster than others and margin at the same time. And I guess – so you're demonstrating that that's the way that railroad that's running well, that's what you can and should expect, right, and it doesn't feel like and I guess what you're saying is we're not at any sort of theoretical peak in either the growth or the margin.

<A – Keith Creel>: Well, we're not at a theoretical peak. What the theory has to assume and this is not something to be assumed. You got to understand the story and the potential of the railroad. And I'm going to speak just to CP. At CP, I realized – we realized if you overcommit your network, you destroy tremendous value because you slow all your assets down. So, you get into a place where you destroy reliability, you destroy your ability to enjoy fluid asset turns, control your costs and you're going to destroy your operating ratio. And then you get into this trap where you got to throw capital at it and what you forget if you're not careful is that while you're fixing the physical plant, you may get that fixed, but how much goodwill and trust have you destroyed with your customer base and will they trust you with the same transportation decisions that they did in the past. So, we realize and recognize you got to respect both sides. It's not growth for growth's sake. It's got to be controlled, sustainable, long-term growth. This is a marathon, not a sprint. We've got - we're uniquely blessed because of implementing PSR at CP with capacity on our main line, capacity in our terminals and uniquely positioned, especially in Canada, with capacity to expand in all of our terminals, not just switching capacity, but land capacity. So we can build things like an automotive compound in Vancouver. So we can do things like now we're building one as we speak that's going to open second half of this year automotive compound at Schiller Park which is where our intermodal terminal used to be in large part. Now, it's going to become part intermodal, part automotive and it happens to be uniquely located next to O'Hare. So those kind of things – you know the Glovis story. You look at Glovis, Glovis is coming to CP because of our service and because of our land. We created a solution to solve their problem because they have different model they forward position their cars. They need a place to park the cars. They need space which doesn't work in a PSR automotive compound. So they're building their own compound on our land. So again, theoretically, your answer is yes, Scott, but it has to be based on a railroad that understands and values that you can't be everything to everyone. You can't promise the sun, the moon and Mars because you're going to disappoint everyone. You got to understand the strength of your franchise and play to those strengths. And if you do that well, you won't overcommit yourself, you won't destroy customers' trust and your opportunity to grow your business. So, all that in a blender, your answer is yes, but it's a bit more complicated than just assuming the same theory applies to every railroad. I'd have to look at every railroad and tell you based on what they do and don't have with the potential may or may not be. Now, I would say this, the other railroads I'm extremely, extremely proud of what they're doing as they implement this operating model because it makes our industry better. It allows us to be more sustainable, it allows us to win share off the road, to take trucks when you're dependable and your margins are improved, we can win business and sustain long term. So, I'm super happy about what's going on with PSR, but for me to tell you or support that just because CP could do it this way, every other railway can. I mean, they all can create success they're showing that they can. It's up to them to depend on what their potential is based on what their franchise strengths are and what their team strengths and most importantly what their culture strength will allow.

<Q – Scott Group>: That makes a lot of sense. And then the final one and we're a couple minutes over. So, maybe this is a quick one, hopefully. Since you seem to have really figured out that post-Phase 1 of PSR, you figured out that mix of volume and margin really well. Does that argue that potentially that the value proposition of your railroad and your management team makes more sense? Does M&A start to make more sense again as the other rails eventually gets to Phase 2 and that you figured out so well, do you think this discussion restarts again at some point as all the rails eventually go to that sort of Phase 2 of PSR?

<A – Keith Creel>: Scott, I think at some point inevitably, again, consolidation in this industry is not going to be easy. The STB has created a tremendous hurdle, understandably. So, you got to be able to solve that equation. But I think short term, right now all the railroads are doing quite well. Strong industry, we're weathering this storm better than we did in the last downturn collectively and individually. They've got their own unique value-creation stories that I think are going to play out over the next several years. But whether that's a three-year tale or a five-year tale or a six-year tale, you get to a point where you're not going to build more railroads. So, we've got a holiday because we're creating a whole lot of capacity now. I would have said two years ago and I did say two years ago and I believed it to be true that just because we were going to run out of capacity, we were going to melt down and that was going to drive consolidation. Well, that thesis still exists. There's only so much track. But as we're optimizing our individual railroads to take them all to a level never envisioned before, we've created a whole lot of capacity. So, we're going to ride that capacity, we're going to bring additional business to the rail industry. But, yes, down the line, I think we do get to a point where you got the same challenge. And it's my vision and I believe that if you're the railroad that demonstrates you're bringing a whole lot of value to the table for the customers to help solve that solution or that challenge the STB puts in front of you from a competition standpoint and a service standpoint and you got a strong franchise to partner with, you're going to be invited out, you're going to be the one that people are going to want to partner with. And that's where I'm going to continue to keep this company. We've got compelling organic three to five year, what I see today, I've got plenty of things to keep us busy, to keep us creating significant value. And I can't really predict beyond that. But when we get to that point, I can predict this. This company is going to be in a strong position. We're going to have a long history of credible success that we've earned both with our shareholders as well as with our customers and with the regulators. And when that happens, we're going to be in a good position. I just feel that and I'm very convicted about that as long as we continue to do what we're doing with the talent of this team and the talent of this franchise. Whenever that dialogue comes about, I just can't imagine where CP's not involved in the discussion.

<Q – Scott Group>: Okay. We got to wrap there. Thank you so much, Keith. This is great. Appreciate you being here.

<A – Keith Creel>: Thank you, Scott. Stay healthy.

<Q – Scott Group>: Be well. Thanks. You, too.

<A – Keith Creel>: Bye.