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Transcript

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Corporate Participants:
John Books – Executive Vice President and Chief Marketing Officer, Canadian Pacific
Maeghan Albiston – Assistant Vice President Investor Relations and Pensions, Canadian Pacific

Other Participants:
Kevin Chiang – Analyst, CIBC World Markets, Inc.

QUESTION AND ANSWER SECTION

Kevin Chiang
Analyst, CIBC

Alright. Well, hopefully, everyone had an enjoyable break there. We'll kick off this 10 AM session. It's my pleasure to introduce CP Rail. To my right here is John Brooks, Executive Vice President and Chief Marketing Officer. I'm assuming everybody knows the CP story well here, so I think John's going to have a little bit of an opening remark and then we'll jump right into Q&A. If anybody has any questions, please raise your hands, I'll get to you. We also have an app if you want to ask questions through the app there.

So, John, I'll leave it to you.

John Brooks
EVP and CMO, Canadian Pacific

All right. Great. Thank you, is this on? Thank you, Kevin. It's certainly an honor and pleasure to be here. Maybe just start off a little bit talking about the health of the railroad. I'm quite pleased with our operating performance as we sit here today. July and August, as I really look across all of our key operating metrics and, certainly, I'm a little more focused in on those metrics that really mean something to our customers in terms of how we're performing for them. And as I look at our car miles per car day, our trip plan performance, I looked this morning was about 94%. I'm really pleased with how my team and our operating team are really rightsizing our assets in what are, no doubt, a little bit of questionable or turbulent times right now being the true Precision Scheduled Railroad, we're good during these times of uncertainty. So the operating leverage, the operating metrics that we've seen July and August and we'll finish out here September have been quite strong, certainly despite some of the revenue and volume challenges that we've seen that I think particularly in the month of September are frankly a little more episodic in some areas. When I look at the potash situation and the Canadian grain situation, I think we truly believe the fundamentals of our bulk franchise remain quite strong and the outlook into 2020 and beyond are quite positive in those areas. We got to get over some of the near-term speed bumps. And I think maybe the other point is I want to sort of reconfirm, we see a clear path to the double-digit EPS guidance that we've provided. And moreover, when you get in these competitive, sort of maybe volume-declining environments that we're in today, I can't stress enough and I think it's what you've come to learn from Canadian Pacific, our sales and marketing discipline in these types of environment is equally strong versus the up times. And all that to be said, customers will want to commoditize our business, it's just how they react in maybe constricting time periods. But we have a high level of discipline in our strategy, our growth strategy.

<Q – Kevin Chiang>: Maybe turning to the customer. What are you hearing today maybe, versus what you heard 6 months ago? Is it more cautiousness in terms of what they're thinking over the next 6 to 12 months looking out to 2020 or is there still some level of optimism that seemed to have been present maybe earlier this year even though we're going through some trade – trade tensions and a little bit of a softening global economy?

<A – John Brooks>: Yeah, no doubt. Look, I remember sitting with the team, looking at our projections in June for what the back half of the year was going to look like. And frankly, we were coming out of a Q2 that set records on all standards, our operating ratio to our revenue growth. And look, we've been coming off 2, 2.5 years of industry-leading growth. So, we thought the second half-year runway was there. We've seen those sentiments obviously change pretty quick on us. But again, I think there's a mix. There's certain customers and business units that I think are very short term by nature. As you look at maybe the more truck competitive trade war impacted-type areas, maybe directly the intermodal area to some extent where you saw pretty strong inventory pull ahead earlier in the year and you still got a pretty decent divergence, I think, both in the US and Canada between overall inventories compared to sales. In some of those areas, yeah, I think the sentiment is a little bit more around caution. I'd make though another comment like we are the dominant retail provider in domestic intermodal, so we're talking to the majors every day. And I think the general feeling is maybe that the economy in both US and Canada is not as bad as all the rhetoric you see. Maybe the peak period won't be certainly as strong as prior years, but I still think there's an expectation of some peak volume.

<Q – Kevin Chiang>: Okay. You spoke about maybe some of the competitiveness in intermodal. Maybe just looking on the pricing side. We've seen US spot rates come in pretty nicely here over the past 9 to 12 months. Are you seeing that impact to broader pricing strategy in intermodal and maybe across your commodity base?

<A – John Brooks>: Yeah. So, I just looked this morning at our Q3 same-store pricing and we're going to land in our 3% to 4% guidance, so I'm quite pleased there. There's no doubt though that we certainly on those future renewals, we're seeing some increased pressure there that may drive that in the more of a – more inflation plus, 2.5% to 3.5% sort of range. I think we're a little unique in Canada, both rails. Our domestic intermodal franchise is an average length of haul anywhere from 1,500 to 1,700 miles versus the Eastern roads in the US or even UP and BN in the West where it's a quite a different dynamic. And I think the trucking industry in the US did a quick job in bouncing back when ELDs came in the production. And you take that with sort of declining volume and no doubt they're feeling the crunch, but I think we're a little more insulated in Canada, at least in our longer-haul market.

<Q – Kevin Chiang>: Okay. Any questions in the audience? Maybe turn to the competitive environment. Your main competitor here in Canada, a little bit more of a more capital-intensive strategy, one that's maybe a little bit more predicated on top line volume growth longer term. As we walk through the – as we walk through this where there's an episodic period of softer volumes on certain timeline, are you seeing any change in their behavior as they maybe look to more aggressively onboard volume or has that competitive environment stayed basically the same as volumes have come in?

<A – John Brooks>: Yeah. So, let me answer that on maybe a couple fronts. I think what, first of all, you've come to expect from our growth story and we've been again talking about it for 2.5 years now, simple as I can say it, we're not going to grow for growth's sake. There is just like in the operating side of PSR, there is a discipline that needs to be deployed on the sales and marketing side and that means particularly when you're in these tougher environment, you can't be commoditized, right. You got to have that intestinal fortitude on the sales and marketing side also to maintain price discipline, whether it is new customers you're going after or renewals that are underway. And certainly, I think there's real-time instances where we're seeing that burning desire for growth – for growth's sake. We're just not going to be pulled down into that. I think it's the margin we've been able to generate – the incremental

margin we've been able to generate is what you come to expect from us and there's enough opportunities that we see not only in the resiliency of our bulk franchises. Some of these episodes get resolved, but also as we continue to put new opportunities in the top end. I'm extremely pleased with the team's effort to not only go out in early contract a number of pieces of new business as we look into 2020, but – and you got me excited, Kevin, because this is an area where I think not only our discipline and how we sell is completely different than maybe our competitors. But the other point is our capacity to grow is unique to Canadian Pacific. It's easy to add capacity from A to B to get over the road, that's sidings and double track. Where it's not easy to add capacity is in the inland terminals. We all know how hard it is to buy property and develop in the GTA or in the Montréal area or Vancouver. And we've got a unique opportunity at CP where in the major metropolitan areas of Canada, our growth footprint not only to grow operationally so we can handle more in those terminals, but our ability to use that sales tool to co-locate and work with our customers, I think, is honestly a tool on our toolbox that our competition can't replicate.

<Q – Kevin Chiang>: When you think of longer term and as maybe some of that capacity gets filled in with some of the structural growth opportunities, how does the acquisition or purchase of non-rail assets play a role longer term? And I knows it's not the strategy now you have the capacity on your network. But arguably, there are some scarcity value in that if these assets come up for sale and you're not buying them today, they don't necessarily come up for sale 5 years from now. Are these things you may need in your tool chest 5, 10, 15 years from now to extend out your sales marketing reach? Or do you think your rail assets today provide you enough runway looking out that timeline?

<A – John Brooks>: Yeah. You know what, I sort of look at it like this. We certainly are open to all sorts of various vertical integration that can help feed Canadian Pacific in terms of growth opportunities. Do I see anything obvious on the near horizon? No. It's – we're not sort of in that, I don't know, level of development or maturity in our growth story. Frankly, we see a ton of organic opportunity that is sitting out in front of us. Just when I talk about our capacity to grow and co-locate. I can tell you, there's a lot of customers in Canada that are faced equally with, I think, what our competitor is faced with, but how do you expand your footprint in a lot of these metropolitan areas during sort of today's various environmental and NIMBY issues that we face. So, having this tool and be able to develop this gives us sort of that long-term runway. But I don't – I'm not minimizing the opportunity for us to look. I think we would just consider maybe more rail-centric type opportunities as we think about extending our reach.

<Q – Kevin Chiang>: Okay, okay. And I think over the near-term here, you've committed to a capital and – or, at least, a CapEx dollar that's kind of in and around current levels given some of the excess capacity you have on the network to onboard volume. And at what point do you think you reach a point where the network has – needs additional CapEx, that the capital intensity of your business takes a step higher because you need to spend to commensurate with the revenue growth you see in front of you?

<A – John Brooks>: Yeah. So, we're going to – we'll finish out 2019 at about CAD $1.6 billion. My – I think our initial expectations are a similar type level next year. But let's not forget, that includes a pretty aggressive hopper car redeployment program. It also includes a number of remanufactured locomotives that we're working on. So, as those begin to tail off and with the inland capacity, the over-the-road capacity and, frankly, increased operating leverage that we have that will create more efficiency in our network, I could even see a scenario where, frankly, our CapEx declines a little bit in those out-years.

Maybe not in big quantum's, but certainly I don't see the near term opportunity or need to change that sort of CapEx profile to be able to bring the growth on.

<Q – Kevin Chiang>: Okay. You talked about the long-term positive outlook you have for your bulk franchise. And I think the general view is a lot of bulk commodities are exposed to the Chinese economy either directly or indirectly. Given the tension between the US and Canada and China, does that change your long-term view of your bulk franchise? And is there more a concerted effort to maybe diversify into other commodities that may be less exposed to that part of the world?

<A – John Brooks>: Yeah, a couple points in that, Kevin, is, first of all, as I look at our sort of multiyear plan and growth strategy, I see our growth really pretty diversified. So, honestly, it looks like a third, a third, a third between our bulk, our intermodal and automotive and our merchandise energy business. So, I think we've got good diversification in terms of runway in our growth. The other point is don't ever underestimate our bulk franchise. It is strong. It is something that I believe differentiates us against a lot of the industry. Canada is rich with these natural resources. CP has been long time the leader in that supply chain, so the metallurgical coal, the potash, the grain business is core to us. As it relates specifically to China, probably the biggest area in our bulk franchise we've felt some pressure is in our US grain with certainly the lack of buying of soybeans from China that has impacted our North Dakota and Minnesota movement of those beans. Nonetheless, we've worked hard to create other markets. Now, most recently, I think in the last 24 hours, China come in and has bought 18 cargoes. So, maybe there's some movement and opportunity yet in that space. Our focus remains in our bulk franchise to how do we continue to drive greater efficiency and supply chain certainty in that area.

<Q – Kevin Chiang>: Maybe turning to some of the opportunities within bulk. Maybe I'll start with potash. You have the ramp-up of the K+S mine. A little bit of near-term softness in the potash market with the Canpotex-Chinese negotiations and maybe some of the curtailments from some of the producer. Maybe give us an update on how you see potash ramping up here maybe over the near term and maybe over a multiyear time horizon as well?

<A – John Brooks>: Yeah. So honestly, the – some of the changes in the potash have been fairly significant from what we saw just a few months ago and our expectations were – it's probably the single biggest driver in terms of when we were looking at our expectations full-year around mid-single digit RTM growth versus low-single digit RTM growth. We've taken out close to about 1.5 million metric tons of potash out of our Q4 plan and it's really centered again on the contract negotiations with Canpotex, between China and also India. K+S has also lowered their production targets just a little bit here as of late. Again, I think we believe this is going to get resolved probably sooner rather than later. And I think we're trying to be a little conservative in our Q4 plan by sort of assuming it's gone. We've been candid with our customers, the potash customers, that we're going to plan that it's not there. And if it comes in, we're prepared to work with you to ramp up as soon as we can. But the long-term fundamentals in terms of Canpotex's growth platform and Mosaic and Nutrien, for that matter, I think remains positive and strong. We've got to get over this speed bump.

<Q – Kevin Chiang>: Okay. And then, I can't let you off the stage – before talking about crude by rail, so...

<A – John Brooks>: Of course.

<Q – Kevin Chiang>: Your outlook there, that's also been one that's been a pretty fluid situation. So, if you can give us an update on how you see the volumes ramping up there and the provincial government's push to privatize some of the contracts that were signed under the previous administration.

<A – John Brooks>: Yeah, so fluid is an understatement. There's a lot going on in that space as you can imagine. Frankly, the working environment with the Alberta governor has been very positive. Just I would say in the last couple days we've got a pretty good indication that we think the privatization of our contract is looming. It – actually, I expect we get more guidance here within the next couple weeks, I hope. And I think with that, again, we've been pretty conservative in our crude estimates for Q4. But if we can see some movement here in the next few weeks around that, and I think our expectation is that would come with some sort of one-to-one credit, so the more crude by rail that you can prove that you're going to move, maybe you get a credit against the curtailment. If those two dynamics play out how we expect over the coming weeks and there may be some crude by rail upside as you look towards the back half of November and December. To give you some perspective, in Q2, I think we moved about 25,000 carloads of crude. Q3 here, I expect to land in the 27,000 to 28,000 range. And then Q4, I could see that sequentially bumping up to maybe 30,000 carloads. And frankly, there's the contracts we have in place. There's significant upside to that, but it all just sort of depends on how this issue works out with the government.

<Q – Kevin Chiang>: Okay. And then on the grain side, a challenging condition – very challenging conditions in the US, notably trade, but very wet weather, a tough winter. Canada looks like weather hasn't been overly cooperative recently. But if you can give us an update on what you're seeing on the grain front?

<A – John Brooks>: Yeah. So, certainly, the Canadian grain front has impacted our volumes here in September. The harvest on average in really all three provinces in the prairies there are anywhere from, let's call it, 20% to 30% behind where they should be or we would expect them to be this time of the year. What that has translated for CP in particular, we've shipped or had billed about 1,000 cars less a week than we would have expected the last three weeks. We would've expected the harvest to sort of charge that elevator system by now and it just hasn't and it's simply because the wet weather, a little bit cooler weather, has kept the producers and farmers out of the fields. And it just hasn't been able to sort of charge the elevator system. Now, again, this is a timing issue. The grain companies are sold out into December in terms of capacity through Vancouver and Thunder Bay. The crop size is big. It's going to be 70 million metric tons plus. And you got a fair carry-in from last crop year. So, you know what, all this does is kind of increase the pressure and condense the peak season, but it also probably prolongs and provides us a little bit of opportunity in the tail end of 2020 as you get into the summer months because that grain will just get pushed out a little bit. So, I can tell you it's something that we're close with all the grain companies, obviously monitoring almost daily, if not hourly, with those guys. But again, I remain very bullish around the Canadian grain crop.

<Q – Kevin Chiang>: Okay. And then, I know US grain is not a huge part of your business, but has that been – is there a sense of how this was going to look over the next year or so, kind of getting to what was a very challenging 2019 for that industry?

<A – John Brooks>: Yeah. It – I'd just give you some quantums that we would typically see in a month soybean movements out of our territory to the PNW for China anywhere from, let's call it, 60 to 70 trains a month during the peak. And we're looking at maybe 15 to 30 trains...

<Q – Kevin Chiang>: Wow.

<A – John Brooks>: ...depending on what – and even less in last year. So, it – that is an area that has no doubt been impacted. But, look, just like in Canada, they can only – only so much grain can be held. There's a lot of soybeans sitting out in the Upper Midwest, I can tell you, that are going to have to go to market and it's just – it's liquid. You got to – we'll have to work – we're working with our customers to find market alternatives. I give you just a little example. We've been struggling with even corn exports last year and the team actually worked with the Southern Alberta cattle feeding market to switch the rations away from less feed barley in Southern Alberta and more US corn. So, we actually turned a pretty big market last year into importing corn into Southern Alberta from our franchise, which is something we've hardly ever done in the past. So, it's definitely a tougher market, but we're reacting and trying to get creative on how we move that grain.

<Q – Kevin Chiang>: Okay. And then maybe when I think of your coal franchise, you've got a large customer in Teck that provides a level of stability. How do you think of the trajectory in coal longer term? I think there is an opportunity for a potentially new mine opening up on your network...

<A – John Brooks>: Yep.

<Q – Kevin Chiang>: ...when looking out a few years, if you can provide us some updates there.

<A – John Brooks>: Yeah. I mean, two points on that is we're – we – Teck is our largest customer. We've got a very good working relationship. And as we look towards that ultimate contract renewal, we're working closely with them on that. I think ultimately for them and us, diversification of how they think about their export terminals is important, but I'd also say that I think the reputation that Teck and CP have built with our – with their customers in Asia is impeccable, and it's impeccable not only because of the quality of product that Teck produces, but also the supply chain resiliency and consistency that we've developed with Teck. So, at the end of the day, how I look into the future with that opportunity, I think the signs for metallurgical coal remain strong and coupled with that our supply chain that can't be replicated, that is honestly a conveyor belt of coal. You don't want to add complexity to that because if you add complexity to that supply chain, it brings risk and we don't want to destroy that product and that reputation in Asia. So, that's where we stand with Teck and, yes, there is – we're currently working on a new mine with Riverdale Resources that we're targeting maybe 3 to 4 million metric tons of production. That would be online on CP in the 2022 timeline.

<Q – Kevin Chiang>: Okay. When you think of – and maybe I'll lump them together, when you think of the negotiations with Teck, it was a longer-term contract that is set for renewal, I believe, in 2020 – I believe the current contract expires in 2022. You also have a long-term – sorry, you have a long-term contract with Canpotex that also expires in 2022. Would your strategy be to renegotiate these as another 10-year contract both under the Teck and Canpotex deals? Or is the preference to be shorter deals, which is more typical of CP deals, that are kind of in the three-year range, four-year range?

<A – John Brooks>: It's not a maybe direct easy answer. I think what we typically do is depending on the size and the strategic nature and certainly the investment required to build a world-class supply chain,

all those factors go into sort of the blender to come out with what is the most logical timeframe. Certainly, those are big long-term strategic customers and their product reliability in the world from Canada is largely been built on our ability to give them consistent reliable service over this past contract term. So, if that translates into sort of another long-term deal because that's the best way to sort of solidify that, then that will be our direction. But certainly, more to come on those files.

<Q – Kevin Chiang>: Okay, for sure. And with a couple minutes left here, maybe if I could just turn to international intermodal. You obviously have a strong presence in Vancouver, presence in Montréal, your competitors building up Prince Rupert and Halifax. How do you see that impacting your intermodal franchise – your international intermodal franchise? And maybe Vancouver and Montréal are positioning within the broader port network in Canada. Do you think they're disadvantaged here as those other two ports grow?

<A – John Brooks>: You know what, look, we're going to sell to our franchise advantages. And at the end of the day, you look at our domestic intermodal franchise, particularly from Montréal and Toronto to Calgary, Vancouver. You look at our international franchise and our partnership with GCT and our route from Deltaport into Chicago. We have natural advantages in those lanes. And what I will not allow and I'm telling you, I've seen real-time examples today in those areas where there's a desire to just grow for growth's sake whether it be with new customers or contract renewals and we're not going to be commoditized in those lanes. So, we're going to drive for what you expect and that is we're driving value for our service, for our product. And in those areas where we've got a distinct competitive advantage, we're going to leverage those areas to grow our franchise.

<Q – Kevin Chiang>: Alright. I think we've run out of time here, John. Thank you very much.

<A – John Brooks>: Great. Thank you.

<Q – Kevin Chiang>: Thanks, everybody.