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Transcript

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Other Participants:

Seldon Clarke – Analyst, Deutsche Bank Securities

QUESTION AND ANSWER SECTION

Seldon Clarke

Analyst, Deutsche Bank

All right. So, just by a way of introduction, my name is Seldon Clarke. I work on the transportation team here at Deutsche Bank, lead analyst on the Canadian rails. Just with that, I'd like to introduce Nadeem Velani, the CFO of Canadian Pacific. This is their first time at our Industrials Conference. So really happy to have you guys here. I'd like to just kick things off with, similar to how we started with some of the other rails, just curious as to what you guys are seeing with regard to the macro, and maybe just how exposed you are to – obviously you're a Canadian rail, but how exposed you are to some of these like U.S.-China, U.S.-Mexico trade tensions, and kind of high level view of the economy would be helpful?

Nadeem Velani

EVP & CFO, Canadian Pacific

Sure. Yeah. So, first of all, thank you for having us. It's great to attend the Deutsche Bank Conference. It's our first time and thanks for covering us. So, certainly, it allows us to present ourselves here and work together. So, I appreciate that. Things are going well for us. I mean, clearly, our volume strength is – has been evident through post-Q1. So, we're very confident about our ability to recover the network and our ability to grow our volumes faster than the industry, which is – you see the weekly cartloads and weekly RTMs. I think quarter-to-date, we're up 8%. Now, a lot of that has been self-help as well, whether it's market share gains or opportunities unique to CP. So, from a macro point of view, I'd say, it's kind of lukewarm, it's not negative, but some areas are – we're watching closely certainly on the intermodal side. But for the most part, it's held in there pretty well. So, our growth, for example, has been pretty broad-based. I think only one segment in our book, which is U.S. grain, is down. Everything else is up, Canadian coal is flat. And the U.S. grain, it's really tied to some of the trade tensions and some of the China-U.S. kind of dynamics. Our exposure to some of those dynamics really around kind of uncertainty that that can create for our customers to – for the economy from a capital investment point of view. You know customers, some of their decisions that they make tied to what could happen from a macro point of view, it does impact us, but there is a bit of a lag. So, to this point, we haven't seen too much impact outside of U.S. grain.

<Q – Seldon Clarke>: Well, that's helpful. And then, like you said, volume is trending up 8% quarter-to-date, I think you're up closer to 3% year-to-date. You obviously had a pretty challenging first quarter with the derailments and I think one of the toughest winters in recent memory. Can you talk about just like what's – is there any benefit to the 2Q volume numbers maybe from pent-up demand or backlog of traffic that wasn't moved in the first quarter, it's maybe aiding some of the growth in the second quarter? I mean, 8% is obviously impressive regardless, but just curious to get a sense of what the actual kind of right underlying growth rate is...

<A – Nadeem Velani>: Sure. I'd say that there was a little bit of volume still to be moved on the grain side, a little bit on the bulk side from the impact of the winter. But for the most part, this is underlying strength. I'd be remiss if I didn't mention as well we had some easy comps from a labor point of view. A year ago, we had a one-day strike and that's – so the comps are easier from that perspective. But nevertheless, the absolute levels of workload, April was the strongest month we had and second strongest month in the 138-year history of CP, and May has been even stronger. So, the absolute numbers irrespective of being pretty impressive, and again, it's been very broad based. It's part of the reason we had such confidence coming out of Q1 where despite not having the usual kind of CP

performance that investors have come to expect, we were very confident in our ability to deliver not only near-term but for the year. So, yeah, it's – we're in a good spot.

<Q – Seldon Clarke>: All right. Good. So, just touch on some of the commodities for a second. You mentioned, I think grain, overall grain is up about 8%, but you mentioned some weakness in U.S., I assume that's being offset by stronger Canadian volumes. Can you just talk about that, what the potential mix impact is from a yield and maybe a profitability perspective?

<A – Nadeem Velani>: Yeah, I mean, Canadian grain and grain as a whole is the largest component of our business, about 25% of what we move. And so, we've been doing this a long time. And Canadian grain in particular, we have a couple of key initiatives, so we've been investing in new hopper cars to be CAD $0.5 billion investment over three to four years. And so, we're – I think we have 1,100 of those cars on the network today. We've also announced a number of initiatives with customers to look at building our 8,500-foot model. And if you combine those two initiatives it allows us to kind of potentially move up to 40% more grain per train. So, that's hugely beneficial to mix, hugely beneficial to capacity for the Canadian farmers. It helps us on maintenance costs, on fuel costs. It allows us to move more with less. So, it's a very strong story. In terms of the mix, Canadian grain, U.S. grain, certainly, Canadian grain is an area that we get strong returns, but it's a longer length of haul and so forth. So, I think it's a positive mix impact overall. U.S. grain has been kind of slow for some time and very tariff-based. And again, you get uncertainty in the market and you get this pent-up demand. So there's a lot of inventory that's built up. It's been impacted as well by near-term with flooding issues, and it means that we've seen how much of that inventory can still be moved, but we've taken an approach to that market that it will move at some point. And we've raised rates, we've increased rates on our tariffs with the intent, so if you can't holdback capacity for a market for so long, at some point you need to move; and when it moves, you need to be able to handle it and accommodate it. So, that does bear some costs. So, with that in mind, we've increased rates since the beginning of the year on U.S. grain.

<Q – Seldon Clarke>: Got it. And just because it is such a big piece of your business, can you talk a little bit more about those initiatives? You have your competitor talking to, they've signed on 20 of the next 25 grain elevators on their network, but it seems like you're putting a number of initiatives in place regarding these new grain hoppers, you're running longer trains, I think you're expanding the loop track for where you load the trains. Where are you at some of these investments and, like, how do you kind of offset? Where is the growth, I guess, coming from for CP?

<A – Nadeem Velani>: Sure. Well, I mean, first of all, I think both railroads can win when it comes to Canadian grain. In terms of overall, yields have improved. My first job in the railroad was in Canadian grain in Winnipeg a little over 20 years ago. And that's the time a good crop was 50 million metric tons. I think we're seeing crops in in excess of 70 million metric tons. We've seen 75 million metric ton kind of crops in Canada. So, overall yields have improved and overall grain volumes have improved for both railroads. Now, that being said, I mean, our strength of our franchise is our grain franchise. I've heard a lot of rhetoric. I think at their previous Investor Day they talked about 55% market share is their new goal. They were very silent on that yesterday. I think they've learned their lesson. I'd say that we are very strong competitors. We have strong relationships with our grain customers. And I think our model of increasing capacity, increasing fluidity, doing what we say we're going to do from a service point of view is helping us maintain share. And so, we are very confident in our ability to – in the strength of our grain franchise.

<Q – Seldon Clarke>: Got it. That's helpful. And then, just a couple other, just because volume story is so important to the Canadians right now, I just want to walk through a couple more segments, so

like the next – you still are confident in your guidance for mid-single-digit RTM growth this year. You talked about the grain opportunities. How has – obviously 1Q was a lot weaker than you expected, how do you feel about the back half of the year now relative to kind of how you felt about it earlier in the year?

<A – Nadeem Velani>: Sure. So, let me take you back, the second half of 2018 was an extremely strong performance by us. I mean, I think our operating ratio was about 57% in the back half of the year. We led the industry in growth and volumes. And so, we continued that in January, we had a tough February, tough March, but we've kind of picked up back where we were, April, May. So, we have a strong, high level of confidence of what we can achieve in the back half of the year. At – during the Q1 call, I talked about every quarter for this year going forward from Q2 on, we'll start with a 5 – the operating ratio will start with a 5. I'd say, I've been even more impressed by our operating team, their ability to recover from that challenging winter and their ability to get the network back up and running at such a high level. I don't think I've seen the network as bad as it was in February, kind of early March. It was a difficult environment to operate in. That being said, I don't think I've seen the CP network as running as effectively as it is now in terms of our operating metrics, whether it's our train length, our train miles, our car miles per car day, our GTMs per horse power. I mean, our operating team has done a tremendous job of getting the network back up and running, and allowing us to move the volume growth at a low incremental cost and to bring that to the bottom line. So – and there's been some challenges. Obviously, there's been some flooding in parts of the Midwest, in Kansas City. And so, there's still things to overcome. But the resiliency of the network and the depth and strength of our operating team is certainly going to shine through.

<Q – Seldon Clarke>: Got it. So, is it fair to say maybe there was some conservatism in the mid-single digit volume growth guidance and, like, things are a little bit softer than maybe we initially expected, and so, like, still comfortable with that mid- single-digit range?

<A – Nadeem Velani>: Yeah. Yeah, we're comfortable with that.

<Q – Seldon Clarke>: And just continuing on that, auto volumes up 7% quarter-to-date. If you look at the rest of the auto industry, you really wouldn't expect a railroad to be – have auto volumes up 7%. Can you talk about some of the various customers you have ramping up there? I think have Toyota switching over from a Corolla to a RAV4, you know you have this plant opening in Vancouver. Just, can you talk to those opportunities and how that should help CP kind of continue to grow faster than the rest of the industry?

<A – Nadeem Velani>: Sure. So, I mean, automotive has been a very positive story. I mean, early in the transformation, we lost some business. We – in 2013, 2014, automotive traffic had come down to, I think, 3%, 4% of revenues. We've worked hard to improve the product, we've worked hard to improve the service, and to take on revenues and take on business at a reasonable level of return. And so, some of the things that we've talked about, the evolution of CP is our product offering and our expansion of our network and capabilities to service some of these customers. So, a few of the initiatives, for example, Glovis, this was a customer that left CP, went to another railroad, and then shortly thereafter came to us and said, we miss the CP service, how can we work together? And so, we've said, we can work together in a certain way. We talked about our strategic capability of having room to grow capacities and ability to grow with customers from a land point of view, real estate point of view. So, with Glovis, for example, we looked at some land opportunities in Montréal and Southern Ontario, and we built automotive compounds with them with a guaranteed return, guaranteed kind of volumes which allowed us to gain market share back. And that's been a very positive story, that's part of the reason why we grew automotive traffic double digits last year. Why? To your point, we're growing – you're seeing the strength in the volumes this year. And

that'll be a full ramp-up starting – coming through in 2020. So, you'll continue to see volumes there. We opened up a new automotive compound in February in Vancouver, which Ford has taken over half of the capacity. So you saw those volumes starting to ramp up and that's going to be a positive story of moving F-150's into the Vancouver market. And the great thing about that is, it allows us to kind of have a complete cycle. So, as traffic comes into Vancouver for Glovis, into Eastern Canada, we can return that traffic, those cars bi-levels back to Vancouver with full – full with Ford traffic. So, not only do you get additional volume growth, but you get profitable growth by cycling the assets in a roundtrip way. So, those were some of the key stories. I'd say you touched on Toyota with an opportunity to move from Corollas, which are moving in tri-levels to RAV4s that are moving in bi-levels, so that creates another opportunity. So, we're still excited. We still see a number of initiatives. We think in 2020 we're going to have a strong automotive story as well as we continue to sell our automotive compound in Vancouver and some of these initiatives I mentioned start to continue to ramp up.

<Q – Seldon Clarke>: Got it. So, how – just to clarify, how many cars can you fit on the tri-level versus the bi-level?

<A – Nadeem Velani>: It's two to three.

<Q – Seldon Clarke>: Well, I guess, that...

<A – Nadeem Velani>: Oh, sorry.

<Q – Seldon Clarke>: In the total cars.

<A – Nadeem Velani>: In terms of the absolute train or...

<Q – Seldon Clarke>: No. Just a single car, like, how many fit on a – got it. That's right.

<A – Nadeem Velani>: Yeah.

<Q – Seldon Clarke>: I think it's in one of your slides, but...

<A – Nadeem Velani>: Yeah, sorry.

<Q – Seldon Clarke>: No worries. We'll move across from autos. So, before we get on to what everyone wants to talk about crude-by-rail, just want to touch on intermodal for a second. You guys are crushing it there as well, volume is up 13% quarter-to-date, you just announced a new Yang Ming contract. Can you just talk a little bit about that and some of the recent developments with your recent business wins? What this Yang Ming contract means? What is the service offering that is attracting this additional international customer, and then also some of the more domestic opportunities you have ramping up with Dollarama and some of the stuff like that?

<A – Nadeem Velani>: Sure. Yeah. So, not too dissimilar to the automotive story I mentioned. During the transformation, there were a lot of contracts that shifted over. We couldn't be everything to everyone. Our cost structure, we couldn't compete. We didn't have the service, the capability, that roundtrip economics kind of supports taking on business. So, we didn't have that ability to stuff containers, for example. And so, as we've taken our cost structure down to be able to compete with anyone, as we've improved our overall service, we fixed the engine. The opportunity was there to kind of repatriate traffic. So, in the past year, we've opened up an office in Asia, we've developed relationships. Certainly, our service has been second to none. And so, we've been selling our capabilities, and with the mindset of not overselling what our capacity can allow us to maintain our service excellence. And so, Yang Ming, we announced that the customer

is going to come on starting in January 1. It's about 2% of revenues, so about CAD $150 million worth of revenues. And the great thing about that is, now it's the third key player of The Alliance that's going to be on CP. So, we – Hapag-Lloyd has been a customer of ours for decades. We took on the ONE business a year ago, a year ago April, and now this is the third leg of the alliance. So, what does that do? That allows us to have better service for the three customers, not just one. It allows Global Container Terminals in Vancouver to offer better service and more efficiencies by having all three members on – running on our trains. And so, that overall kind of efficiency, the capacity, the ability to service the customer is not lost on each of the customers, it's a key driver of the service proposition as well. And so, we're going to start seeing those volumes starting in January. And more importantly, I think you're going to see a very strong service for – in the Vancouver area for each of the steamship lines and also Global Container Terminals. So, our market share was down to about 20% at one point. And when you're not the gorilla, you get impacted by being the smaller player from a rail service point of view. GCT couldn't serve us as well as they could have when we were the smaller player. Now, with this change, we'll have about two-thirds of the market share there and allow us to provide a better service to our customers. So, it's a win-win-win, if you will, and we're excited about it.

<Q – Seldon Clarke>: And then, you hear a lot about just like the Port of Vancouver being almost at 100% capacity. How do you continue to grow from there? Like, are there couple expansion projects maybe at different terminals? Do you have some inland capacity that's maybe undeveloped? How do you grow from 100% capacity at a land-locked port?

<A – Nadeem Velani>: No, there's no doubt. Vancouver is high on our radar in terms of throughput and capacity and, I'm not going to say it's a problem area, but it bears watching. It's something that we're very vocal about with the industry, with the supply chain members of how can we do things to create more capacity, how can we do things to improve service for all of our customers, for each of the stakeholders. And a lot of the investment decisions that take place need to think not just near-term, but over the next three, five years if, as a nation, we're going to grow and drive value through the Port of Vancouver. So, the port itself is looking at expansion opportunities. Some of the infrastructure investment that's going into Vancouver will help near-term. But I think, collectively, we've been vocal and we'll continue to be vocal, and Keith has taken a leadership position in that regard to say, how do we think about Vancouver as a whole? Whether that's grain or whether that's potash, whether that's – it's intermodal, and how do – what role does each of the supply chain play to do this for the greater interest of the entire supply chain and the greater interest of the Port of Vancouver as well. So, don't have an answer for you right now, but it's something that – it's not going to take just the railroads, it's not going to take just the port, it's going to take collectively the entire supply chain to drive that and drive the efficiencies.

<Q – Seldon Clarke>: Got it. And just to wrap up the volume side, what is your outlook on crude-by-rail, like, how many barrels per day are you moving today, and how quickly can you ramp capacity? It seems like spreads have gotten back into that sweet spot of $15 to $20. How quickly can you guys ramp on crude and what is currently baked in your guidance in terms of crude-by-rail?

<A – Nadeem Velani>: Sure. I think Q1 we moved about 17,000 carloads. I think Q2 probably about a 50% kind of sequential increase. We have a contract with the Alberta Government to move additional crude starting July 1. We've built up the capacity, we've hired, we've brought on locomotives, we've – with the intent of moving additional volumes, so we're prepared to move it. We have the capacity. We don't oversell our railroad. We prepare for the volumes that we are committed to. And so, that's what we've done. So, we're in a position to continue to ramp that up. We're – we think we could do

something in the tune of 100,000 carloads for the year type of number. So, we're exiting Q2 at that level of run rate, and we expect that to sequentially increase.

<Q – Seldon Clarke>: Got it. Okay. So, in terms of – I think, the other big part of the story is operating leverage, and the back half of last year I think really highlighted what CP can do from an incremental margin perspective. I think the incremental margins are close to 60% in the back half. You had a lot of crude coming on, which obviously helped, you had a lot of volume growth. But how – you have this long-term, mid-single-digit RTM growth, double-digit EPS guidance. How dependent is that 50% – or OR with a 5 handle on it, how dependent is that on volume growth and do you think you guys can still get there where you can still drive double-digit EPS growth with low-single-digit volume growth?

<A – Nadeem Velani>: Yeah, absolutely. I mean, even if we did low-single-digit volume growth this year, we can achieve an OR sub- 60%. So it's not dependent on volumes. I mean, certainly volumes help, but you got to have the right kind of volumes. So, you got to take on the business with the right profitability as well. So, I – listen, I mean, our OR is a product of what we're doing – if we're doing things correctly on taking on the right business for moving it efficiently and we're spending our capital efficiently, the OR is a product and an outcome of all of that. So, we're not focused on the OR per se. We're very much focused on our return on invested capital, that's a big driver of how we think about the business, the contributions by line of business and the profitability of those lines of business. So, I think our overall incremental margins we've talked about, we can achieve kind of the 70% level ex-depreciation and stock-based comp. And we have high level of confidence we can continue to do that, that's what we kind of showed to your point about the back half of last year, we were in that 60% to 70% range, and I think you're going to see that continue through the course of this year. So, it's not volume-dependent, it's more – if you can resource the network and you don't get a lot of surprises. So, give you an example right now, even as we speak, volumes are leading the industry, 8% volume growth, et cetera. We're mindful of where there could be softness and we're even storing locomotives, we're storing some railcars, we're keeping a tight lid on hiring and people, et cetera. That's kind of the what we get paid to do and it's the beauty of precision railroading is you're not building the church for Easter Sunday, you're always mindful of keeping some level of tightness in the resourcing and that allows you to kind of have the strong incremental margins.

<Q – Seldon Clarke>: Got it. And, I guess, like you're talking to sub-60% three quarters of the year. I think back half of the last year is something like 56%. But it's just the first quarter that seems to be plaguing you the most. I think Keith mentioned some rifle shot investments or strategies that you guys are looking at to sort of improve the fluidity in the first quarter and maybe eliminate some of the challenges tied to weather and derailments and that sort of thing. Like, can you talk about some of those investments and how you expect to help the first quarter profitability?

<A – Nadeem Velani>: Sure. I mean, you're always going to have seasonality, and first quarter is always going to be challenging. I think this year was an extreme event in terms of the winter. It was a really, really difficult winter. I know my kids couldn't go out for recess; and at one point, my son was saying that – said, what would you do, and I said, well, we just watch movies. And I said, well, what movies do you watch. And then, he was complaining later in the winter that they ran out of movies on Netflix and it was – I said, so what did you do, and he said, well, we had a Justin Bieber dance party. I said, so how was that, and he goes, I don't like Justin Bieber, I'm not – I wasn't dancing. So, winters are tough and it's even tougher for the children sometimes. But – so my point is, this is a very extreme, extreme event. It was not the – not your typical winter. But what do you do, what do you learn from it? I mean, we can't just tell our customers that put our hands up in the

air and blame it on the weather. So, we've hired – we've built a predictive analytics team under Dr. Kyle Mulligan, who some of you might have met during our Investor Day, and looking at what we can do kind of proactively, what can we do, what can we learn from whether it's a track – from a track point of view, from a wheel point of view, from a network point of view that can help us kind of do things proactively to anticipate some of these events from a derailment point of view, from a network capacity point of view, from managing the overall network. What can you do in Q4, for example, to pull forward some of the volumes with customers, what can you work to do that to kind of spread some of the peak volumes that could occur. So...

<Q – Seldon Clarke>: You changed the – you hear all these railroads talking about scheduled maintenance, things like that. Is there a way anything you can do on the maintenance side, I don't know, to help some of this process, like, your biggest competitor, investing a lot in IT, several years away, I think, till you see the full benefits. But it just feels like a lot of those investments could help significantly from the maintenance side. And from my understanding, most of the derailments that happen in the winter are machine error or mechanical failure. Are there are things you can do from that front to kind of change your strategic approach to maintenance?

<A – Nadeem Velani>: Yeah. And we look at that each and every day. There's some – we've patented technology from a wheel – our – some of our ultrasonic wheel detection and track detection, we've done under Kyle's leadership. We've taken a very proactive approach there and it's something that we continue to improve on. A lot of what drives the – a lot of the derailments is problems with wheels or problems with rail. And so, we've been, from a test car point of view, from a ultrasonic rail detection point of view, we've invested capital towards that to look at ways we can improve that, ways we can increase the overall testing capability, the threshold of air, et cetera, that you can kind of spot and what can you learn in terms of big data to kind of prevent some of this. So, there is definitely some areas and we're excited about what technology means from a safety point of view and from a capacity point of view. So, that's a key part of our technology strategy, undoubtedly.

<Q – Seldon Clarke>: And then, just last question for me, we've got another 30 seconds, but on CapEx, you guys targeted CAD $1.6 billion this year, and you think that that should stay flat nominally with a potential to come down. Can you talk about what are those opportunities for it to actually decline, some of those like one-time items that might be rolling off, anything like that?

<A – Nadeem Velani>: Sure. So, obviously, we talked about the hopper car investment, which is a meaningful investment over the next three years. We also have PTC investments. So, as those – as the CAD $0.5 billion investment in hopper cars kind of rolls off, you could see us potentially lowering our capital over the next several years. So, that's something that's kind of 2022 and beyond, but holding kind of that CAD $1.6 billion at this level, you'd see our CapEx to revenue at about 20% trailing off down to the high-teens, kind of mid-teens over time, which I think is a strong story for our free cash flow.

<Q – Seldon Clarke>: And if you don't mind, we could just squeeze in one more question from Amit.

<A – Nadeem Velani>: Yeah.

<Q – Amit [Unverified Participant]>: Indiscernible

<A – Nadeem Velani>: Sure. It's a very easy last question as we're over time here. But, certainly, we've been vocal advocates for consolidation for a number of reasons. If you looked at what we tried to achieve in that 2015 kind of timeframe was, we had a view that precision railroading could apply to the U.S. networks and you could generate a great deal of value in terms of applying those

principles to the U.S. railroads, the Eastern railroads, that was a big driver of the value creation. I think we've probably been proven correct in terms of the value that's been created by CSX and applying precision scheduled railroading. And that was one kind of overarching premise to it. The other parts of the value creation as well as in terms of the capacity it creates and combining two networks, not interchanging traffic, but running two networks as one, can generate a great amount of capacity. Better service for customers and could create opportunities to grow revenues and expand the size of the pie for railroads if you can have a bit better service offering for customers. We've been – I think, the value creation is probably limited now as precision railroading is being applied in the U.S. That being said, I think, if you think of what's happening in terms of demographic changes and increasing population and some of the challenges on highways and congestion in highways, we believe and we still firmly believe that consolidation can improve increased capacity with limited investment. You can improve your overall service by running the network as one, and that, one day it will be the right thing to do from a North American transportation system point of view. Whether that day is 2 years from now, 5 years from now or 10 years from now, remains to be seen. But, usually, consolidation comes out of a situation of weakness, of challenges, and so forth, I think right now it's probably not that time. I think the railroads are running well. I don't think capacity is an issue. We saw one railroad had challenges with capacity last couple years. But outside of that, I think the industry is in good shape. But again, as highways have more congestion, that premise could change over time.

<Q – Seldon Clarke>: All right. That's helpful. I think we'll wrap up there. Really appreciate it.

<A – Nadeem Velani>: Thank you.