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Transcript

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Webcast

Corporate Participants:

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

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Other Participants:

Brian Ossenbeck – Analyst, J.P. Morgan

QUESTION AND ANSWER SECTION

Operator

Hello and thank you for standing by and welcome to the J.P. Morgan Industrials Conference with presentation by Canadian Pacific. At this time, all participants' lines are in a listen-only mode. [Operator Instructions] I would now like to hand the conference over to the speaker today, Brian Ossenbeck from J.P. Morgan. Please go ahead sir.

Brian Ossenbeck

Analyst, JPM

All right. Thank you very much, and good morning, everyone. Thank you for joining the virtual version of the J.P. Morgan Industrials Conference. I'm Brian Ossenbeck, I cover the transports and logistics sector for the firm. I'm very happy to kick off our chat today with Canadian Pacific. So joining us today from the company is the CFO, Nadeem Velani. So he'll be making some opening remarks and then we'll go into Q&A. So Nadeem, I'll kick it over to you and again thank you very much for joining us today.

Nadeem Velani

EVP and CFO, Canadian Pacific

Thanks, Brian, appreciate you managing the schedule and getting us on today. Although we're doing it virtually, it's a real pleasure to be a part of the conference with J.P. Morgan. So where do we start today? So yesterday, it definitely did feel like the world was ending, but let's take a step back and look at how, near-term, how the quarter has unfolded. Overall, I'd say that the railroad continues to run extremely well. It's running as well as I've ever seen it. Volumes have been extremely strong, to start the year, we were up 10% quarter-to-date on a RTM basis, which is ahead of our expectations. From a cost point of view, winter has been definitely much better than anticipated. I think we only had one challenging week, which is very – not very common for a Canadian winter or Calgary winter certainly. So it's been a very good winter despite some of the noise around blockades and so forth. We've been able to overcome some of those challenges and quite frankly, we've built a very strong cushion three months into the year so far. So, there's from a market point of view, there's certainly a lot of volatility and more recently, a lot of headlines pertaining to crude. So, just a reminder, this year or recently the last few years, we've taken a very different approach to crude this time around compared to where we were in 2014-2015. Every single one of our crude contracts is a multi-year deal that has minimum volume commitments. And also remind you that crude by rail amounts to about 6% of our revenue base. But we're not going to be – crude isn't going to move the needle for us one way or another. To put that into context, given our strong performance year-to-date, if we didn't move another carload of crude post-Q1, it wouldn't make us change our low end of our guidance. So crude by rail isn't going to make or break our franchise. Like everyone else, we do continue to monitor the macro economy and what impact this may have. How this all plays out remains to be seen. But one thing is for certain, we've demonstrated our ability to adapt our resources and control costs and we'll continue to do so. Regardless of the macro backdrop, CP remains in a position of strength. So, despite the market volatility, just this week, we executed both Canadian and US debt issuances with record-low coupons. From a balance sheet and liquidity standpoint, we remain well-positioned and with a lot of flexibility. We're going to be very aggressive on our buyback and certainly with the stock at extremely attractive levels and we'll also revisit the dividend later in Q2. But you can expect another material increase would be in the industry-leading dividend increase since the past five years, averaging around 21%. I might have

surprised some people with the 60% OR comments we made I made at our January earnings call and with guidance on a 60% OR for Q1. But sitting here with the third – first quarter almost complete, I certainly have even more conviction on that number and probably a bit of upside. So things are going extremely well, Brian, and we're excited about what 2020 has in-store despite volatility. I mean our PSR model is one that performs in all economic cycles. We have a team that has demonstrated our ability to be nimble, adapt quickly and CP's disciplined approach to precision scheduled railroad is what drives my conviction in our ability to continue to perform regardless of the macro backdrop. So, with that, Brian, I'll hand things over to you to – for Q&A if that works.

<Q – Brian Ossenbeck>: Yeah, it works. Thank you, Nadeem. So you did mention that the 60% OR did catch a few of us by surprise and then you also followed up just now with saying that you might have a little bit of upside to that. So, if you can just maybe expand a little bit on that. Clearly, RTMs are going pretty well, leading the peer group again, cost control sound like they're in line, so are we to read that into 60% with a potential to have one of your five handles on it or should we not get that too far ahead of ourselves in the near term?

<A – Nadeem Velani>: No, I think that that's a – I think that's a reasonable expectation. We certainly volume – from a volume point of view, we're ahead of the game, double-digit RTM growth in this environment is extremely strong start to the year. We've got currency working in our favor from a yield point of view. You've got fuel lag that's probably going to be supportive. You've got stock-based comp unfortunately being a bit of a cushion as well. So a number of like, call it, economic factors or macroeconomic factors, but at the same time, more importantly, the network is running exceptionally well. Our safety record has been extremely strong, so our casualty cost, which is a big headwind a year ago, turning to a massive tailwind. You're also seeing just overall network performance and the ability of our operating team to work closely with our market strategy and asset management team and working closely with the finance team. You're going to see our cost structure be at a historically low levels. So really excited about how we're starting the year.

<Q – Brian Ossenbeck>: Okay. Great. So you did mention on the crude side, obviously got a ton of attention yesterday and probably will for some time, but there are some protections in the contracts as you mentioned. So can you just go over how those liquidated damages work we've seen them pop up on a third quarter before. Are these monthly, are they annually, what type of mechanics are behind these sorts of contracts realizing there's a whole bunch of them in the mix. What's sort of the net result?

<A – Nadeem Velani>: Sure. Yes. As you mentioned, there are a variety of mechanisms behind the deals. So every contract is different, but most do settle quarterly or semi-annually. And I think just the lessons learned from the last go-around from an energy point of view, having very thoughtful and intentional contracts that protect the investment we make in terms of capital, the investment we make in terms of people and locomotives to move the traffic and the capacity that we protect on the network. It does generate – allow us to, with confidence, invest capital or hire and train and set aside network capacity. So, we are fully protected when it comes to crude by rail on the downside.

<Q – Brian Ossenbeck>: Got it. And then for the longer term DRUs, the diluent recovery units were a focal point on the last earnings call. They've been talked about for a while now, but they're starting to be built. How do those factor into the long-term outlook for crude by rail?

<A – Nadeem Velani>: Sure. So, we're the only rail that has access to a diluent recovery unit that's being built in Hardisty, Alberta. It's something that we are very excited about because it takes away the volatility around crude. It creates a mechanism to have kind of ratable traffic over the long term, long-term being we have a 10-year deal with ConocoPhillips. So, this isn't an upside in terms of incremental revenues or volumes, but what it does is protect a base level of business, that base level business being about – the nameplate capacity is about 100,000 barrels per day and half of that has been contracted. So it works out to about CAD $100 million of revenue per year, which provides us basically a floor on our crude by rail revenue. And I think even more importantly, it takes the technology behind what a DRU is takes a hazardous commodity and makes it a non-hazardous movement of goods, of traffic, which makes it a much more safer and environmentally sound product for us to be moving. And so we're excited about what that has in store for 2021 timeframe. And I should also point out that it is scalable. It is something that can grow with additional investment, it could grow to become something bigger than that CAD $100 million, but we feel good about that base level.

<Q – Brian Ossenbeck>: Okay. So, the other news item obviously that we'll be talking about certainly for a while just the impact of the coronavirus. What's the latest update from your perspective based on the activity in China, the decline in demand that you see over there? What are you hearing on the grounds and are you hearing anything from your supply chain partners in terms of when to expect a recovery?

<A – Nadeem Velani>: Sure. So we've been certainly, international intermodal is an area that we expect the largest impact near-term. We've had – we do have a view into a certain level of blank sailings that we'll probably start seeing landing in the next week to 10 days in terms of the impact to that business. So I think the back half of March and into early April, you'll see a bit of a slowdown in terms of international intermodal, but at the same time, we see a very quick recovery to those volumes, as restocking for retailers has to take shape and manufacturers as well. So we don't see this necessarily as lost volumes as opposed to some level of timing. And so, what we're hearing is, it doesn't scare us in terms of the impact on international intermodal business near term and certainly, it's something that we think we can make up.

<Q – Brian Ossenbeck>: Got it. How has pricing been trending amidst all this? And are there any noticeable difference that you would sort of call out between the US and the Canadian markets?

<A – Nadeem Velani>: Pricing as a whole has held up. I mean, certainly, 2019 was a very strong pricing year given the macro environment, given the overall freight environment and more importantly to CP, the service that we sell in the marketplace has been extremely well received and we were able to leverage that service to – into better pricing. I'd say our more recent view is the last, call it, three, six months, haven't changed much from that point of view. So we haven't seen pricing being impacted negatively. Certainly, we'll see what happens with some of the interest rate cuts and what that means for inflation and so forth. But right now, pricing has been above inflation in that, call it, 3.5% same-store range which is attributable to the service we provide.

<Q – Brian Ossenbeck>: And a lot has been made of rail competition in Canada. We've seen a few contracts changing hands this year in particular. How does the competitive environment feel? Are there any other – any specific commodities, rather, you feel like that are more or less competitive with CN?

<A – Nadeem Velani>: I mean, we compete head-to-head in a number of places with CN. We compete head-to-head with some of the other US railroads. But more importantly, we probably compete mostly

with the trucking environment. I think that we've seen the overall competitive environment be very rational. I think you should see contracts change hands every now and then. I think that that's healthy in the environment. And as our strategy evolves and others evolve their strategy, that's also going to play a role in terms of how contracts shape up. For CP, we spend a lot of time, a lot of focus around expanding our product offering. So, through tansloads to some of our real estate initiatives, which are creating, call it, a bigger pie for us and that's creating opportunities for us to grow with new customers that we've haven't shipped freight with or we've only shipped a very small amount of freight with. And certainly as we continue to improve our service, continue to be recognized by our customers as having been the industry-leading provider of transportation service, you're going to continue to see us increase our market share in a number of commodities and that's what we've seen. I think we've been the industry leader in terms of volumes two straight years and fully expect 2020 to be the third straight year and it's tied to our service proposition, certainly not rates.

<Q – Brian Ossenbeck>: So before we get into the end markets a little bit, can you just talk at a high level about the constructive tension that you guys are kind of known for and like to talk about, is there – are you able to still pull the levers to control costs without impacting what you would see from a current or future volume growth? If things do slow a little bit more from here, how do you feel about being able to manage both the cost side and the growth side at the same time?

<A – Nadeem Velani>: Sure. It's a great question. I mean, our culture of accountability and our culture of constructive tension that we operate day in, day out is something that's built into our DNA. I think it's what separates CP from many companies. We – my team, our operating team, our sales and marketing team, our market strategy asset management team led by Mike Foran, we work hand-in-hand with one another. We believe our operating leaders have a Monday morning call to go through number of initiatives and collectively, our CEO Keith is that a team that gels together, that pushes one another to get the most out of one another, we don't have a culture of harmony, but we do have that constructive tension or we push each other again in a respectful way to get the most out of one another and I think that's what separates us from the rest. And so when we look at changes in demand, look at opportunities before we even go down the road of chasing opportunities, we understand what the capacity is, we understand what it means in terms of resources from a car side – from a car perspective, from a locomotive perspective, from a people perspective. And we won't look at an opportunity before we understand what it's going to mean for the network, for our service and also in situations where volumes are declining or the picture gets more negative, we do the same thing. We are quick to start turning off the taps on hiring. We are quick to start storing cars, storing locomotives and taking costs out ahead of the curve. And I think that that's what you saw even in 2019 in the back half of the year where we led the industry in margins, we had call it mid-50's level of operating ratios despite a pullback in volumes, it was the output of the conversations and the discussions that I just described, that constructive tension. Without it, we wouldn't have been able to perform at that level and it's something that we're paid to do and it's something that is just in our DNA and it's what separates us, as I said.

<Q – Brian Ossenbeck>: So one of the end markets that was really strong last year despite some challenging operations in market conditions, that was in grain. So, do you think there's room to beat that mark that you set in 2020 especially with the new grain hopper investments continuing to ramp up?

<A – Nadeem Velani>: Yeah. I mean I think we finished the year October, November, December, January, with record volumes. And I think February, we were within eyesight of another tonnage record, but just missed that and certainly were impacted by some of the supply chain challenges that we faced in the West Coast because of weather and disruptions in the ports. So I'm bullish – we're bullish around what the grain crop looks like heading into the rest of the grain crop ending I guess July 31. If you think about where we started last August, September, it was a very wet harvest, it was a delayed harvest. So that creates an opportunity for inventories to remain at a high level through the end of the crop year and so yes, I do think on the Canadian side, we're going to continue to see optimistic volume kind of outlooks and I think even on the US grain side, we've had bad comps, easy comps for I think for three or four years now. But as we get some level of better cooperation from a trade point of view between US and China, that does create opportunities for us, particularly on the bean side. So excited about what grain, which is 25% of our franchise, what grain volumes the outlook is for the rest of the crop year.

<Q – Brian Ossenbeck>: And just on that trade deal, I think it's gotten a little lost now in the recent noise. But that was just the general expectation for any sort of movement or improvement now that phase one is done. So, it's a pretty much a wait-and-see or are you a little more constructive on that?

<A – Nadeem Velani>: Yeah. I mean I think it's still a bit of a wait and see. To be honest, I think the focus for most has been on the COVID-19 lately, so the trade deals have kind of…

<Q – Brian Ossenbeck>: Right.

<A – Nadeem Velani>: … been lower on the headlines. But I think where we entered the year and in January, things were pretty constructive. I think that what I've seen and what I've heard from a China point of view is, it's a real look to revamp their economy and get things moving very quickly. And I think trade deals should be supportive for both the US economy and China to accelerate and avoid any sort of macro slowdown. The support of trade deals, I think the atmosphere will continue to be receptive to working together and collaborating and making sure that this headwind in – from a macro point of view, from a coronavirus point of view, doesn't escalate in something bigger. And so I think that that should be bullish for trade cooperation.

<Q – Brian Ossenbeck>: So, the other headline out of China at least we've talked about for a while is potash. What's the status, the latest status on Canpotex contract there?

<A – Nadeem Velani>: Sure. So our view and the intelligence that we've received the last, call it, three, four months have been pointed towards a resolution or an agreement being signed in Q1, tail end of Q1, which is your typical timeline. Now that being said, with some of the challenges tied to the coronavirus, that's probably held that back a little bit. But I'd say that we're still cautiously optimistic that this is something that we think could come to resolution in the next four to six week type of timeframe. So, we don't see this extending beyond, significantly beyond April, May timeframe. And so we think there's upside in terms of what that means to our overall potash volumes.

<Q – Brian Ossenbeck>: Okay. Meaning upside if a deal were to get done on that timeframe?

<A – Nadeem Velani>: Yeah. I'd say that's where we are – the feedback we've received has been very positive as it relates to potash, both globally and domestically. And so I think this is going to be an area of good growth for us. And so I think if a deal was signed in the next four to six weeks, we will – there will certainly be upside.

<Q – Brian Ossenbeck>: Got it. Okay. I think one of the things we've talked a lot about recently was the Teck contract and that moving over to CN obviously has a lot of moving parts in that supply chain. How are you thinking about potentially offsetting some of those lost volumes in 2021 and I guess just more basic level, what type of concerns does CP have with the interchange at Kamloops in terms of what this expansion could do to service levels?

<A – Nadeem Velani>: Sure. So yes, we do have concerns around taking a very important interchange and creating a great deal of work in an interchange that's not set up for it. That being said, we do have time. We do have a year to work through this and we'll work closely with Teck. We'll work closely with our Canadian competitor to make sure that the supply chain, as far as we can control, can handle it. And so we'll work collaboratively as much as possible to get it to optimize it. Not overly optimistic that it'll be the best way to handle the traffic. That being said, we'll do our best. What it means in terms of our coal franchise? I mean look, coal is I think 8% of our volumes. It's – they're an important customer, Teck is and we'll still originate two-thirds of the miles. We – this is a long-term contract that was signed in advance of the management change. When you do long-term deals, typically, you typically don't get full value and you certainly don't get full value for the service that we've provided and the improved service that our customers saw with precision scheduled railroading. And so we'll have a discussion around what that means in terms of value for the service we provide that. That's one aspect in terms of how do you mitigate any sort of lost revenues. I mean at the end of the day, if we don't backfill the volumes and you get – so we maintain two-thirds of the miles and if we don't backfill the revenues associated with the last third of those miles, it's not a huge impact to our earnings. We estimate it to about 1% of earnings in 2021 and that's – if we don't backfill it. Now, we'll work actively to backfill that capacity and it's an area that we have a number of opportunities that we will explore, not something that we're necessarily actively exploring today, but we're confident that we can backfill those volumes in that corridor. So I think we'll see how the supply chain works. This is something that can be impactful to a number of customers as you move more traffic ultimately to the north shore. That's something that we are concerned about because that can impact a lot of your other bulk commodity partners and that could impact overall capacity for the Canadian kind of export supply chain and I think that's the bigger issue that we're concerned about, the knock-on impact to other customers and other industries.

<Q – Brian Ossenbeck>: Okay. So more in the destination, not necessarily at the origination aspect in terms of how this is going to reorganize the supply chain?

<A – Nadeem Velani>: Yeah, I mean, it's both. We can – we'll work to control what we can, which is partly the interchange. There's not a lot we can do on the north shore ultimately. It's not an area that we can control. So we're raising that dialogue and raising that the discussion around it. So other partners in the supply chain can do their bit to help mitigate any sort of potential impacts.

<Q – Brian Ossenbeck>: Got it. And so the CMQ acquisition, what's been the initial feedback on that? I know – I don't think it's completely closed on the US side. But what was the feedback from operating the marketing team, what sort of contribution you think this is going to make here in the near term and I guess next year as well when it starts to ramp up? It does sound like you need to make some investments to get it up to your level of service and safety, so maybe if you can elaborate on that and a little bit more color around something that I don't think people have paid quite enough attention to yet?

<A – Nadeem Velani>: Sure. So this is – to us it's a very strategic investment, it gets us access to the East Coast, which is something that we haven't had the opportunity for some years. This was the line that CP

previously owned and so repatriating that line was important to us at the right price. I think it's been very well-received from an employee point of view, both, CP employees and the new CMQ employees that will be joining the bigger CP family, I think it's been very well-received from a community point of view, from a – from the regulatory side. I think it's something that made a lot of sense if you look at the network fit. We will invest – we are investing, as we speak, capital towards getting that line up to, as you mentioned, our standards, it's important for us to do that. We weren't going to acquire this line unless we had full conviction and full confidence that we could invest and still get a return and that's what we're doing. It's the right thing to do as well. So, CAD $20 million, CAD $25 million type of capital numbers is what you should expect in terms of network upgrades. We do expect kind of mid-year, this year getting STB approval. So that is something that's still, we're working towards. We spent from day one time with employees speaking around our safety culture, our expectations in terms of from a safety point of view, how we interact with one another, that culture of accountability, as I mentioned, and just making sure that they know they're part of a bigger team that is going to put money back into the railroad. From a market point of view, I think once we've dug into this a little deeper, we are uncovering a lot more opportunities than we imagined. We took a bit of a conservative approach when we looked at it. Some might say, well, you did pay a pretty high multiple. Well, we did because we felt that there was value to be had and that we're seeing opportunities that are significantly much more – significantly greater potential than we could ever imagine. And so, we're excited about getting that franchise. As you mentioned, it's going to take a year or two to realize some of those opportunities. But they're real and they're going to occur, whether that's on the intermodal side. Whether that's on the merchandise side, we're going to see some increased volumes.

<Q – Brian Ossenbeck>: Great. So, I think we have about 5 minutes left here to keep everybody on the virtual schedule. So, I did want to ask about, you mentioned being in the market the financial stability of the balance sheet. You did a couple of issuances last week on the US and Canadian side. I think back in 2018, you saved about CAD $20 million in refinancing. Clearly, rates are all over the place, but they're still pretty low. What else do you think you can accomplish here and is there another material uplift when you think about the interest cost and just the weighted cost of debt for CP?

<A – Nadeem Velani>: Sure. So yeah, we were – I think very well timed and well planned by our Treasury team to get these deals done in a very volatile environment. We did a USD $500 million US 10-year 2.05% coupon, which is the lowest of – lowest by any BBB plus company in history and I think it was the second lowest ever other than what IBM did back in 2012. So very opportunistic deal and our deal in Canada, a 30-year 3.05% coupon was the lowest by a BBB plus company in the history of Canadian 30-year offerings. So it was very well timed as well by our Treasury team. So as far as your question, it's not necessarily going to be a – or as it's on a refinancing, you won't see the same opportunity. But what it does is it avoids having a lazy balance sheet, it allows us to add leverage in a – to a company that's growing its EBITDA. So this is part of our approach of having a leverage in that 2 to 2.5 times range. We would have – these offerings to be in – our leverage come down closer to 2 and so we will see interest savings relative to what we had expected in terms of the coupon. And so I'd estimate that about CAD $3 million to CAD $5 million versus what we would – annually versus what we've expected to issue at. And so we don't see a lot of opportunities necessarily in terms of adding additional debt through the course of the year, maybe at the end of the year and then we do have some other refinancing opportunities as we get closer to the end of 2021. So a year from now, we'll probably look at that.

<Q – Brian Ossenbeck>: Okay.

<A – Nadeem Velani>: Yeah.

<Q – Brian Ossenbeck>: Okay. Got it. I think the other line item to kind of track down in all the market volatility is the pension income. It's typically a decent tailwind for the Canadian rails just based on the pension structure. How do you see that moving if we don't really see an equity market snapback? Could there be a little bit of a drag on your expectations relative to what you initially thought starting the year?

<A – Nadeem Velani>: Yeah, so just a reminder that our – all of our pension amounts are locked into 2020 based on where the discount rates and investment returns ended in 2019. So you won't see any change or any impact in 2020. If you're looking forward to 2021, certainly with market performance year to date and where discount rates are trending, there could be some income statement impact into 2021, that there's no recovery. But we certainly don't expect any cash impact. We have done a number of steps to de-risk the pension plan. So in late last year, we implemented changes to our fixed income strategy and that helps to mitigate the impacts of declining interest rates and the plan was also in a very strong solvency position to start the year. So, that's provided us a very strong cushion and just a reminder, we also have CAD $400 million still left in our prepayment account if required to draw on. So, overall the pension plan is in a very strong position and some of the changes that we've made even over the last several years to lower our return on asset assumptions, that's led to our reduction in pension income below the line, which is non-cash. We have been taking down our return on asset assumption and it's something that we'll continue to look at annually and look at going forward and so we're in a very solid footing on the pension plan.

<Q – Brian Ossenbeck>: Okay. Got it. The last one just end a little bit more on the long-term strategic side, when you look at the recent history of PSR, CN provides a pretty good template of the road ahead because it was started first and been at it longer. So in what ways do you think CP will look similar to CN and different to CN in the next five years?

<A – Nadeem Velani>: Well, I think we're going to look very different. We look different today and we'll continue to look different and that's reflective of a very different strategic vision and a very different culture, to be frank. So not to say one is better than the other or they're just different. So although we both are Canadian railroads and we both have similar types of origins in terms of how we've – who was our founding father, if you will, of PSR, we've taken very different paths. So we're – for example, we're looking and we have been acquiring short lines. They've taken a different approach in terms of their acquisitions, how we look at strategically selling capacity. We look at strategic – the assets that we have in terms of strategic land to increase our services and the products we provide are very different. So I'd just say that we will have a different approach. At the end of the day, we are not looking to do one thing very well necessarily. We're looking at it from a very balanced perspective. So not growing for the sake of growing, but growing in a sustainable, disciplined manner with profitable growth, continue to improve margins, continue to reward shareholders with a balanced approach toward capital allocation, looking towards how we can reinvest in the network, but not create spikes in our capital investments, having dividend that continues to grow and outpaces the growth of our competitors and being very strategic in looking at our buyback as being opportunistic. So they're just different approaches and I think our balanced approach to how we generate shareholder value ultimately is what separates us from the rest and part of the reason why we have the strongest return on invested capital in the

industry and that's ultimately what we – how we measure ourselves and everything I just described leads towards increasing that return on invested capital.

<Q – Brian Ossenbeck>: Okay. Well, I think that's a good place to leave it. So thank you very much, Nadeem, for joining us today. I realize it was not the usual, but hopefully we're still efficient, a little bit, less volatile of a day, so I'm glad we've been sort of able to address some of the stuff on everybody's mind from yesterday and still focus a little bit more on the multi-year path ahead. So thank you very much again for joining us everybody on the webcast. This now concludes the presentation. Thanks again, Nadeem.

<A – Nadeem Velani>: Thanks, Brian.

<Q – Brian Ossenbeck>: Take care.