Transcript

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Webcast

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Other Participants:
Ravi Shanker – Executive Director/Analyst: Transportation, Morgan Stanley

QUESTION AND ANSWER SECTION

Ravi Shanker
Executive Director/Analyst: Transportation, Morgan Stanley

Let's kick off day two of Laguna Conference. Thanks so much for joining us early.

And I promise you we got you out of bed early for a good reason, because we have with us Keith Creel, CEO of Canadian Pacific, arguably the best idiosyncratic growth story within all of freight transportation.

Keith, thanks so much for joining us.

Keith Creel
President and CEO, Canadian Pacific Kansas City
My pleasure to be here and welcome back to the file. I saw you started covering again last week, congratulations.

<Q – Ravi Shanker>: It's been a painful couple of years forcibly on the sidelines, but yes, I'm glad to be back in the mix. Before we kick off, please note that for important disclosures on Morgan Stanley's relationships, please see Morgan Stanley's research disclosure website at morganstanley.com/researchdisclosures, or please read our research.

Keith, I'm going to spend a bunch of time -- most of my time actually, talking about the long-term growth opportunity at CPKC.

But maybe let's just kick off with a little bit more of a short-term view, kind of, how is 3Q tracking relative to expectations? Obviously, some noise with the strikes and the fires, et cetera, as well as a soft macro, how is it tracking versus expectations?

<A – Keith Creel>: Let me start at a high level, Ravi, number one, overall, I think today, I looked at the calendar, is, I always say this every time I speak, it's day 152 of a forever story. This quarter, and I'm learning through the quarter with a network this large, there's always going to be some choppiness. There's always going to be an opportunity or a challenge. And this quarter obviously had some: the strike, we did not anticipate in Vancouver. We had to navigate that, created a bit of backlog in traffic. A little headwind, I think we quantified maybe $80 million of headwind from a revenue standpoint. We wouldn't claw it all back but we've clawed most. We're pretty much -- we're caught up in Vancouver in both intermodal terminals, still a little work left to do at Centerm but Vanterm, Delta Port we're square there.

We had some fires, obviously. Fortunately, from a material way, we have not been impacted as much as perhaps maybe our competitor did or obviously, as the environment has, it's been substantial this year. But all in all, messes your rhythm up a little bit, it creates a little bit of extra operating costs that otherwise you wouldn't experience. But again, it doesn't become excuse. It's just a challenge and an opportunity for us to overcome. And I'm pleased with the way the team has performed.

The other area of the territory, we talked about this a little bit towards the end of the last quarter. Mexico started off strong when we started to integrate and we saw a little bit of slippage. So we put a task force together. They've been deployed now for about, I'd say about eight weeks, and they're

making a material difference. John Orr is leading the team, leading the charge in Mexico. Had a lot of experience, obviously, from his previous experience as the COO of KCS and KCS de Mexico. So that's working well. We're seeing progress across all the operating metrics: train speed, terminal dwell, car miles per car day, locomotive productivity, service experience for the customer. So that will continue to gain momentum and to improve. So very encouraged there.

Other than that, from a demand standpoint, a little bit softer than we had anticipated. I think we're 4% down quarter-to-date, but that's getting stronger. The grain harvest is starting to come on. This week -- last week I think we had 5,100 orders, this week 5,700. It's going to be incrementally higher next week, and we expect that to be a strength as we go through the balance of the quarter.

We'll close strong this quarter. We'll go into fourth quarter with a lot of momentum. I'd remind, from a comp standpoint, fourth quarter last year, we had an outage with Elkview on the coal side. I think that happened in third week of September. So from a compare standpoint, we're going to move a lot of coal. We're going to move a lot of grain and potash. So we're in a very good place to finish strong this quarter, carry that momentum into next, close the year as we suggested, and we still see line of sight to that single-digit, mid-single-digit EPS growth that we signaled to the market.

<Q – Ravi Shanker>: Got it. So you're already starting to see some of that backlog from the strike kind of if you're working through that, that should be a nice sequential tailwind into 4Q as well, kind of specifically in potash and intermodal or kind of which end markets do you think we'll see that?

<A – Keith Creel>: Yeah, you're going to see a nice tailwind on coal, on potash, grain. Intermodal, I think it's hit the trough in all honesty. Domestic, we're starting to see a little bit more demand. It's still down from last year but sequentially getting better, and we expect that to continue into the fourth quarter. So all in all, the entire book of business, pretty solid. And then the unique piece to it, though, which is unique to our industry, and you mentioned this, it's the self-help, it's the initiatives and the synergies that are being unlocked by this merger that are allowing us to be an offset to that macro headwind that everyone else is facing. That's unique to our rail network.

<Q – Ravi Shanker>: I'm going to get to the CPKC synergies in a second, but just kind of -- you referenced the Mexico service issues. Can you just unpack that a little bit more, kind of what exactly happened, kind of what's the path forward? Like is it a “we know exactly what to do and it just takes time to do it” or, just clearing that up?

<A – Keith Creel>: A lot of it gets down to process and it gets down to a ramp-up of business. I don't think it's a secret, the automotive industry has shifted a tremendous amount of capacity and demand to Mexico. So they're bringing online those investments, more cars to ship, a lot of cars that were produced during the time that we had no chips, that were parked effectively everywhere they could park them. You get chips in, you want to move those cars, you get today’s production, tomorrow's production, you get to a situation where you have a lot of pent-up demand. And if you don't have the exact right processes, then you can get a little bit behind. So that's what we started to see. We responded. And the other part, that clear transparency, I said this in the beginning, we're going to focus initially on making sure that we integrate a stable U.S. and Canadian network. We're not going to try to change dramatically anything in Mexico, and that's what we did.

We integrated well, stable railroad. We didn't destabilize the network through our integration, which was the mandate, and it was time now to shift to Mexico, and that's what we're doing. So in line with that, I'll say this as well. We just announced this yesterday. Thinking about the talent that we have, and I've always said this, we don't have a static operation. PSR is about measuring, executing and constantly striving to improve upon your execution by using your metrics to tell you

where your opportunities are. So with that said, looking at our metrics, what they were saying to us and what it said to me, it's time to modify the organization a little bit. So when we initially rolled out Mark Redd as our COO, I have every bit of confidence in the world in Mark. He's a very talented operating mind, a lot of talent, a lot of bandwidth, but then I had John Orr too. We retained John. John wanted to stay part of the story, he wanted to stay part of the team. I've got a lot of history with John. Equally, John is a very strong operating mind. So I said, "You know what, we're going to divide and conquer.

He led the team to Mexico on a go-forward basis as effective as yesterday. One of John's additional responsibilities is he's going to focus on the Mexican operation, with his support team. Mark Redd is going to focus on the U.S. and the Canadian operation. And so with the 2 of those working hand in hand together, hand in glove, bringing the focus on process, bringing the focus on culture change, on onboarding business. I think that's the exact appropriate leadership setup for this season. It's not going to be forever, but for now in our unique growth story opportunity, I think it's appropriate, and I know the organization is going to respond well to it.

<Q – Ravi Shanker>: Got it. Just kind of on the synergy side of things, obviously, you had the revenue synergies and the cost synergies as well. I'm going to touch on the revenues in a fair bit. But just kind of on some of the cost side, the integration synergies, how are those going? What have you achieved so far? And what's the runway or the timeline to getting to the final goal?

<A – Keith Creel>: I would say they're on track. Obviously, I think we signaled over the multi-year period of a couple of hundred million dollars in cost synergies. We're seeing headcount synergies already. We're starting to see some fuel synergies. Some of the Mexican synergies we've not mined that yet. So I would say we're on track. A little bit of a setback for the Mexico, but I'm not losing any sleep over it all with the momentum that we're continuing and gaining, I think that will become more of a tailwind, not a headwind.

And then on the revenue synergies, that's an area that, in fact, I'm pleasantly surprised, we're a bit ahead of track. So again, over the 5-year plan, we guided to $1.5 billion of revenue synergy. We're at pace now after 8 months. I think we said at our Investor Day $240, $250 is what we saw. We're at a point where we've converted now, we'll close out December at about $350 million. So 8 months into it, I think that's a pretty significant achievement for the company with a lot of momentum and things that were in process now that will come on in 2024, it's just going to be accretive and keep adding to that number.

<Q – Ravi Shanker>: Obviously, the value proposition of the kind of MME service is kind of undeniable just given the speed and the service and kind of obviously very truck-competitive, if not actually quicker than truck, right? What has the customer reception to that service been so far? Has there been skepticism? Has there been just universal excitement? What's the reaction been? How quickly do you think is it going to take to actually deliver that or convert customers to actually move -- putting stuff on a train?

<A – Keith Creel>: I would say there's optimism -- skepticism, maybe from our competitors perhaps, but from customers, the reality is the facts are the facts. Again, I'll talk about our Mexico and Midwest Express train or MMX 180 and 181. We put that train online about a month into it. We said that we're going to do 4 days from Chicago to SLP, which is just north of Mexico City. You're talking about a 2,100 -- 2,150 mile length of haul. If you go to the Monterrey terminal at Salinas Victoria, that's about 1,800 miles from Chicago. We're doing it at a truck-like speed. We're beating what we advertised. And that train is 95%-96% on time. I look at it every day, every morning. If it gets late, I

know about it. It is really symbolizing the power of this extended length of haul network, and it's attracting business.

I can tell you, next week, we just have finalized 4 contracts with new business with 4 different reefer shippers. Next week, we're going to add -- I think run rate is going to be about 250 loads a week between Chicago and Laredo moving cold goods using those refrigerated containers that we purchased 1,000 of in anticipation of this. So things like that. There's another move that's about to occur as well that should start today, actually moving automobiles, finished automobiles out of Mexico to U.S. markets and Canadian markets in intermodal containers. That's going to be moving on that train service. So again, it's a best-in-class, truck-like, competitive, extremely reliable. It is symbolic of the foundation of the service that we're building. So it's building tremendous market credibility.

The other thing I'd say is when -- I've said this from the beginning, this automotive area is an area ripe for opportunity given that the industry uses one reload pool. So the TTX reload pool, we share the assets. So if you're doing a multi, a 2 railroad move, you're only as good as your partner. So you can originate it, but if you don't terminate it, you don't control the end product, the cycle time. So I always have wanted from the days back when I worked in Michigan, this is 2 decades ago, an ability to control my own destiny. And I can tell you, we had those conversations before, leading up to. We said at our Investor Day that that's probably more toward the tail end of the story in our synergies. I can tell you with what's happened in this marketplace since we've taken control of the discussions that we've had, we're in final negotiations now with more than 1 OEM to make that model possible, to look at and to actually buy railcars to put in a closed loop, to create our own self-help, to create a cradle to grave, taking a facility plant that might be in Canada, the facility plants that might be in Mexico and running load-load -- so loads out of Canada going to maybe Texas markets or Kansas City markets, making empties for Mexican loads, coming back up into be it a Texas market, be it a Minneapolis market, be it a Canadian market. So that's something that I've wanted to do for 2 decades. It's coming to fruition. We'll be able to talk more about it, I believe, on our analyst call that's coming up very soon, and we expect those movements to begin first part of January of 2024. So that, again, just another proof point of what this model can do.

And the other part, we talked about Shell on our call last time. We're ramping that up. That's a hugely material change to our book of business with Shell. It's ramping up now. It's gaining momentum. But again, it's all about the story of the value that this extended network can bring to someone, like a Shell, that owns their own cars. So what OD pairs -- what origins, what destinations -- what does that additional reach give us an ability to better serve them and also create competitive leverage for them. They're not hostage to any other particular railroad because now we reach and kind of de-risk the ability for the other railroad to perhaps not give them great service or punish them in another lane. So at the end of the day, that is proving extremely well. The customers that we're meeting with, there's not one, there's several that say, okay, listen, now with this extended reach, when you were just CP or just KCS, this is what made sense. We couldn't go to these other markets. Now that you can, for instance, there's one, I'm not going to name it, it's a $40 million book of business.

We're on the verge of, the discussions we're having, here's another $40 million of lanes. How can you add value and if you can add value, that $40 million is in play. So you put those 2 together, you start -- they're not billion-dollar moves, but $40 or $50 -- you do a couple of those. You start adding them up those -- I don't call those singles, those are more doubles and triples, you start taking a large bite out of that $1.5 billion synergy apple.

<Q – Ravi Shanker>: You reference your competitors, so I have to ask you this: obviously -- so a few of your competitors kind of got together to launch a rival service, if you will. It's not as quick as yours is. But they did take 1 day out of that move, they announced yesterday. So do you think that is close enough for this to be like a true competition service? Does that -- I think the 1 or 2-day gap that remains kind of, is that enough to tip it in your favor? And also because you have this superior service, does that result in better pricing for you as well?

<A – Keith Creel>: I think better service is always, should -- if you extract the value for it, and you provide the value for the customer -- mean better pricing, that's our proposition. That's what we sell. And again, I liken it to -- if you've got a three-railroad move, you can take a day out of it, but you can't take the complexities out of three railroads run by three different operating groups, being guided by three different sets of priorities versus one. So the complexities, historically, I don't care who you are, I'd never argue that a three-railroad move is, can be the same, and achieve the same potential as a one-railroad move. Unless there's a huge, material mileage difference.

And in this case, in that three-lane move, what UP has, and I'll speak to UP's network, they've got a great network between Laredo and Chicago. It's shorter than ours, as the crow flies. But when you get to Mexico, everything they have in U.S., we pick back up in Mexico --and it's our terminals. So at the end of the day, their best day versus our best day, I think there's a place for both. But I do think if we do our jobs, that the premium freight is going to be on our railroad because it's going to be the most reliable, the most consistent and the transit time is going to be the best. And quite frankly, we're going to strive to be the best operators and do what we say to our customers we're going to do. And so far, that's exactly what has gotten us to the table, and that's exactly the recipe that's going to carry us forward. So I wish them well. I think they'll grow. I think they'll do okay. But again, the premium freight, we got to do our job and do it right, it's going to be on CPKC.

<Q – Ravi Shanker>: So again, to that point, you're saying that there's absolutely room for both, as you said, the truck opportunity is so large to drive truck conversion that you think both can grow and kind of it's ultimately truck that it’s coming out of.

<A – Keith Creel>: Again, depends on the lane. A lot of, as I understand it, some of the -- at least the first railroad in that three-road move is coming out of Toronto. We're not targeting Toronto-Chicago. We're targeting Chicago to Mexico. So yes, there's going to be some incremental business there. There's 1.5 billion of trucks that are running on the road that are convertible to rail. I don't think we'll get it all. I think there'll be some left. But at the end of the day, my objective is: partner with the customer, provide great value, get paid for that, and create stickiness.

So there's a lot of moving parts to this. It's not just taking trucks off rail, it's building Americold facilities. It's creating cold storage. It's those reefers that we've put into play that, quite frankly, that model doesn't exist in the U.S. So we're creating an ecosystem of supply chains that the stickiness and the replication model is never going to be apples to apples. It is going to be the premium supply chain, connecting Chicago to Mexico or Mexico to Chicago.

<Q – Ravi Shanker>: Just shifting gears a little bit. Obviously, nearshoring has been a big theme of this conference so far. Arguably, you're the executive that's closer to it than anybody else because you're doing nearshoring for so many different industries. How would you address the topic at a high level? Kind of is it happening now? Is it happening at a pace that you expected faster, slower? How does it ramp over the next 5 years? Where does it go in terms of -- is it going to be a few industries that do it and then it stops or is it going to be broad-based? What do you think of near-shoring versus on-shoring? Just kind of any broad thoughts you have on the topic.

<A – Keith Creel>: Let me start with -- I'm not going to suggest or maybe guess what it might be beyond 5 years. But what I see over the next 5 years, for sure, is not less demand, more demand. You've got Tesla that's building a new facility, you've got BMW that's expanding. You've got Constellation that's building their facility at Veracruz. You've got our steel producers that are expanding their networks. You've got steel producers from the U.S. that are building new locations in Mexico. You've got Bosch. There's a long list, Mattel. I mean the reality is de-risking supply chains, getting your product to market to the shelves.

I think we've all learned the risk of depending upon things that are produced overseas to get to our shelves and all the tsunami of challenges that we had, the cost inflation, all those things. So it's just a solution that works. So as long as we have trilateral cooperation between the governments, which we are advocates for, we're going to continue to advocate for that. And it just makes great sense and especially the government between the U.S. and Mexico that see the value of it. I don't know if it stops at five or 10, but I don't see it slowing down.

Our challenge is to make sure we onboard it the right way, and much in line with what we've talked about with building our network out. We can't let our eyes and our hunger for revenue for the lack of a better term, ever deter us from it has to be quality revenue, it has to be sustainable, and we don't have value if we don't do for our customers what we tell them we're going to do. So you cannot oversubscribe your network. So that's a philosophy that if I wanted to bring it all on tomorrow, there's a lot more in Mexico to come north. That's part of John Orr's mandate too. We're not going to oversubscribe the network. We've got to connect all the dots. We got to sequence things right. We've got to make sure that when we tell a customer, we're going to do this, because we're selling value on cycle times. You get one shot at this. These customers that are opening their books of business for you to effectively, some of that is rail to rail share. Some of it is road to rail share. They're not going to give you two kicks at the can. We got to get this right from the start. That's exactly what we're going to do. So we're going to be very intentional about doing it. But from an opportunity standpoint, there's certainly nothing that's slowing down from our viewpoint.

<Q – Ravi Shanker>: You touched a lot on raising my next question, but just to follow up on that: I think for better or worse, growth is almost a dirty word in the rail space, and investors get scared of that, just given some of the issues with it in the past. How do you internally kind of make sure you don't oversell the network? Like is there an OR threshold that you aim for? Is it a planning -- a route planning system, kind of, how do you balance that growth-versus-OR-versus-network optimization dynamic?

<A – Keith Creel>: You know what Ravi, we're going to do it the same way we've done in the last decade. You run an efficient railroad, you understand your capacity, you understand what your weak points are, you invest strategically with your capital to create capacity so that you can grow trains. You can't just run long trains if you don't have a network built to run long trains. You can't build 10,000 foot trains in sidings or in terminals, if you don't have tracks that are built to do that. So again, that methodical, operational focus first to understand what your capacity is and what you can do, and then you sell that to the market.

That's the same approach that's gotten us to the table. That's what allows you to get a valuable rate for your service. You give value to the customer, they give value back. That recipe just works. And if you stick to the disciplines of doing that, the way we have, it's a recipe for success. The same way we've done it in the past at a larger scale is the same way we're going to do -- at a smaller scale is the same way we're going to do it at a larger scale.

<Q – Ravi Shanker>: You gave us a pie chart of like $5 billion of revenue pipeline kind of divided into multiple buckets. It was nearshoring, there was truck conversion, there was sharing it with other rail. One of the segments there was self-help. I'd say that's probably the segment that I think investors, not have most questions on, but it's not as -- kind of -- obvious as what the other 4 are. So what exactly is self-help? How much control -- like how much "self" is that help versus what your customers decide for you? And again, what's the visibility into that over the next 5 years compared to the other segments?

<A – Keith Creel>: Self-help is -- the way we think of self-help is what can we create from a supply chain perspective, what customer solution can we create that doesn't exist today that allows us to create new revenue streams. So it's not stuff that's out there moving today. It's stuff that's never been thought of, never been possible without this network. So one key piece of self-help, which I think is going to come online in next year is opening up the Port of Lazaro Cardenas as a gateway to America as opposed to just a domestic terminal. That's been a domestic terminal since its inception. It should be domestic and it should be international. You can do 4 million TEUs there and they're not even doing half that.

How do we get that done? So we are creating now, using AI to help us do it, part of -- part of what we've heard from our customers, to bring product in at Lazaro, to bringing it into the U.S. product. It's more complicated through Mexico because of their regulations. So how can you, CPKC, help us make it seamless so it's no more painful, or not that much more painful than importing it, say, L.A. Long Beach. So we have deployed and are using AI to create custom processes that make it more transparent for the customer so they don't see a material difference between importing there than importing in L.A. Long Beach. That's all coming to fruition. We'll see that next year.

The other thing from a self-help standpoint, you think about the land. Think about our strategy at CP. We're rolling out that same strategy, monetizing our land assets. So we announced at the Investor Day that we're building an auto compound in Dallas via Wylie terminal. That's going to be online first quarter of next year. We already have 3 OEMs signed up for it. So it's going to be much like Vancouver. I think before it's even open, we're going to have it close to capacity. But the beauty of there is, we have 500 acres, so we can keep building as the business demands.

The other place we're looking at is, there's a little terminal that KCS has never gotten a lot of traction to, it's more internal to Dallas. It's called Zacha terminal. We're looking at how can we, again, bring more revenue streams to the railroad by partnering with the right short line to build facilities to bring more steel and lumber, paper into this area for the Dallas markets. That's another area of self-help. So those kind of things, the things we're doing over the MBNR, the Meridian Bigbee railroad. That wasn't even conceived when we started this journey, but we were able to get that deal signed tri-party between Genesee Wyoming, CSX and CPKC. That's going to open up a whole another lane and options for CSX customers at CSX facilities that are in the Southeast markets to serve the Dallas market, to serve the Mexican market. NS provides that service now. We can grow with NS in their markets, but now CSX customers are going to have the same thing. So those kind of things, you start adding those up, you'll get to $1 billion of opportunity over a 5-year plan once you realize those value opportunities pretty quickly.

<Q – Ravi Shanker>: Any questions from the audience?

<Q – Unidentified Participant>: It's pretty clear the demand component of the near-shoring has a lot of visibility to and line of sight. But how do you think about Mexico's capacity to meet that demand? Do you see any bottlenecks or pinch points that need to be worked out for that to really materialize?

<A – Keith Creel>: Short answer is no. I think a fair answer is, there are realities of Mexico that are different than doing business, obviously, in the U.S. and Canada, and I'm learning more and more about those every day. I can tell you that the President in Mexico wants to grow good paying jobs, they want to bring more manufacturing. He's very, very in line with that. I've met with him. I've spoken to him. I shared the vision of the rail network. He sees our network as an opportunity for him to achieve his objectives too, which is very encouraging. So I think the table there is fair. Obviously, you have to manage it, and you've got to maintain relationships, and keep them informed, and work with the government, and we have and we will.

The second part is labor. Labor, again, a unique model in Mexico. There's one labor union for all rail labor in the entire country, not just our railroad, but also the competitors. Again, my approach to that is develop relationships, understand their needs, articulate what ours are. I was in Mexico City three weeks ago and I sat down and I had a private meeting with the rail labor, with Don Victor is the President. He's been the President of that union for 28 years. He certainly understands the nuances, the collective agreements. What we can and can't do, I explained again to him the vision, the opportunity, and I was extremely, extremely impressed and appreciative of his encouraging support, things that he said he would do with us.

Initially, my concept and thought was let's modernize the agreement because we have a very, compared to their agreement, modern agreement. And even at CPKC, ours is very progressive and modern being an hourly agreement versus the standard in the industry. So importing some of those philosophies or thoughts is kind of what good customer service looks like. But the reality is it's such a dramatic change from where they are. There's an opportunity to enhance their existing collective agreements. So he and I agreed let's not focus on modernization. When you're ready and when the railroad is ready, we can talk about that. I do think it's a better model. I do think employees can make more money. I do think that they can have better qualities of life, all those there's a value proposition in it. But in the meantime, there's so many complexities that prevent us from being as good as we could be providing service within the collective agreement. Let's pick two or three things. Let's negotiate, let's get value for the employee, value for the employer, and we'll kind of grow into this. And that's exactly the path that we're on.

So we've had some very positive meetings over the last two/three weeks that quite frankly, talking about things that -- in talking with John and talking with others that have history with KCS de Mexico -- weren’t possible for the last decades. So again, I think we're in a good place. We have to maintain that relationship and provide the respect it's due, that I would expect and that he expects. But I think if we work together, again, there's no bottleneck that we can’t overcome. And from a capacity standpoint, I think we're moving to a much better place. KCS did a great job of investing money in Sanchez Yard. We have a lot of land to continue to grow. That's the yard that's just South of the border. We're online, building that second bridge, that's coming online next year.

So we're going to double the capacity to go across the river into Mexico at the single largest, busiest border point in America between Mexico. So again, we're in a good place. We just double-tracked a bridge down at SLP. That project just finished a couple of weeks ago. So from a track capacity standpoint, we're in a good place. We just need to make sure we maintain the human capacity side, get a little bit of flexibility on the collective agreement that we pay for, continue to work with the government, size this the right way and pace bringing that business on, we shouldn’t get in trouble from any of those areas that keep us from realizing this opportunity.

<Q – Ravi Shanker>: Keith, some tremendous growth opportunities. I think people are very excited to see how it plays out. Thanks so much for joining us, and we'll keep track of the story.

<A – Keith Creel>: Sounds good. It's always a pleasure. Thank you.