Transcript

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Webcast

Corporate Participants:
Nadeem Velani – Executive Vice-President & Chief Financial Officer, Canadian Pacific Kansas City

Other Participants:
Konark Gupta – Analyst, Scotiabank

PRESENTATION

Konark Gupta
Analyst, Scotiabank

We've got next up is CPKC, or Canadian Pacific. I'm pleased to have EVP and CFO, Nadeem Velani, with us today. Nadeem, welcome and I would probably say over to you for any opening remarks and we do Q&A

Nadeem Velani
EVP and CFO, Canadian Pacific Kansas City

Great. Thanks, Konark. It's great to be back in Toronto. I do have to say, last time I was in Toronto, I had a little bit of PTSD. I was in town for the weekend for games 6 and 7 and, while they were great games, it was a bit of a tough ending as we can all agree, but it is good to be back in Toronto nevertheless.

Turning to CPKC, excited to end this year very strong. It's been 2.5 years now since we became CPKC and we took control of the Kansas City Southern part of the organization after we acquired it in 2021 and the merger was always about growth and really proud of the team, the way they delivered. We've been able to lead the industry in volumes the last few years.

This year, we're up 5% on an RTM basis. We've been able to convert that growth to the bottom line. Last year we were double-digit EPS growth. This year we're going to end the year double-digit EPS growth. We've been the industry leader in safety yet again in the combined entity. We've been able to continue to reduce our train accident frequency ratio, improve on our personal injury rate.

We're investing back in the business for future capacity that's going to be needed to take on additional growth, investing in safety and efficiency while at the same time we've been able to capitalize on our shareholder return approach of increasing our dividend for the first time since our acquisition this year. Earlier this year, we increased our dividend 20%. We've been repurchasing shares.

We just finished our share repurchase program a few weeks back now. We bought back 4% of our outstanding float, so returning cash to shareholders. I think across the board when we look at what we can deliver at CPKC, it's outsized growth, bringing it to the bottom line and being efficient and disciplined in our capital return philosophy. You can expect more of the same going forward.

With that, Konark, happy to take your question.

QUESTION AND ANSWER SECTION

<Q – Konark Gupta>: For sure. Thanks, Nadeem. I think that's a good overview and I think we can unwrap a lot of things there. Maybe we can kick off with a near-term fundamentals. I think it seems like you guys are pretty confident in the guidance I think you had for the full year. Q3 and the previous quarters have been actually pretty much up to the mark. For Q4, do you think the traffic numbers are not there yet. I mean, they can accelerate further from here because I mean, they're not up to the mark.

<A – Nadeem Velani>: Yes. Certainly, October, from an RTM basis, started off a little slower. That being said, October was a was a tremendous month for us across the board. Operationally, we had a strong month to start the quarter. I think on the grain side, Canadian grain, we had our second biggest volume month ever as a company. And so the new grain crop looks to be exceptionally strong, could be potentially a record crop, which bodes well for the rest of the year and into 2026.

So I think our volumes this month, so far to date on -- in November, up about 7%. So for the year, we're still at that 5% level, I'm confident we're going to finish the year strong. From a volume perspective, as well as our mix is starting to move more positive, our cents per RTM is inflected positive. So, despite the RTMs being slightly lower than maybe we should be, we'll finish strong and we'll have the cents per RTM to improve the top line.

And then from an operating ratio perspective, from a cost perspective, where you can expect us to continue to improve the operating ratio sequentially and year-over-year. So that's what gives me confidence we'll achieve our guidance for the year.

<Q – Konark Gupta>: Okay. That's great and comforting. For '26. I know you guys have given us a flavor as to what you potentially could be looking at next year, like when I'm talking to most of the kind of management and CEOs, I think they're not sounding as confident about the economy. What sort of underlying assumptions do you have for maybe the low double to mid teen EPS growth you might potentially get next year? I mean, how should we build those blocks to get to those levels? I know you have buybacks, which are getting a little bit accretive now. Besides that, anything else you can tell?

<A – Nadeem Velani>: Yes. I think giving guidance in October, November is always challenging. And I would say that what gives us long term view of on our long-term guidance that we still feel confident in is what's gotten us through the last couple years, right?

So we've been stuck in this freight recession for three, four years now, it seems to be an unending freight recession. But what we've been able to do and why we've been able to outpace the industry and growth and still grow the top line is the self help initiatives, what we call. So taking market share gains off of some of our rail competitors, taking trucks off the road. Obviously, with our transaction, we had significant synergies that have helped us overcome some of the call it malaise in the economy.

So, for '26, I certainly don't expect a robust macro, it'd be nice, but it'd be probably wishful thinking at this stage. We're still feeling the effects of tariffs and we still don't have a trade deal

with the U.S. or USMCA hasn't been renegotiated or whatever form that will take. So we're not overly optimistic from a macro at this stage, but I'll go back to some of my earlier comments just on Canadian grain, on bulk, some of those boring commodities that have been able to overcome the macro environment. And we're still moving significant amounts of metallurgical coal for EVR, potash is going to be strong and continues to support our volumes, and then Canadian grain.

When you look at U.S. grain, even the trade deal that's been negotiated between China and the U.S., while the volumes haven't fully moved yet, started to move yet, it's positive for our U.S. grain franchise as well. So when we add it all up and look at what we can do on a self-help and with synergies and with some of our underlying base bulk business, I think it gives us confidence that we'll still be able to grow our volumes, bring it to the bottom line.

Pricing is still strong, our service is valuable in the marketplace, and our customers are willing to pay for that service, and so our overall revenue outlook is still favorable from a self-help point of view.

<Q – Konark Gupta>: And I want to address that self-help and KCS thing. I mean, last six quarters straight, I think you guys have done mid-single RTM growth, right? Nobody in the industry I can see that's doing that kind of traffic growth, obviously, right? Is it easy for you to identify how much is coming as a result of the KCS transaction or synergies, and how much is like self-help pure for CP legacy? Like I mean, it's very difficult to parse out the underlying, looking at your traffic numbers, because they are so completely out of the books, right?

<A – Nadeem Velani>: Right. Yes, no, it is difficult sometimes even to what's truly a synergy versus you are putting a transload, for example, in place that can help take trucks off the road and a new facility. Take, for example, Americold that we've announced in a few locations.

We just opened up a new facility in Kansas City at our intermodal terminal cold storage facility that's going to start moving volumes. It opened in August, and that's on Chicago into Mexico City, back up into -- Chicago to Mexico and back up into the U.S. That route, our 180/181 service on the intermodal side. And so you put in a facility like that is that self-help? Is it synergies? At some point, you stop calling it synergies because it becomes just growth on the base network after 2.5 years, right?

So, that being said, these call it self-help real estate plays that we've done where we co-locate customers onto our site. It creates a service that doesn't exist today in the marketplace. It creates stickiness with that customer. We both put skin in the game as far as capital. It builds a long-lasting relationship that you can continue to grow and it's worked well for us. So those have been certainly a big driver of our success. We've got thousands of acres across North America, across our network.

Here in just outside Toronto, we've got hundreds of acres that we're looking at, potentially with Americold, potentially in the LPG space. Across the network, it's been a great driver of growth. So that's what's given us a bit of an advantage versus our peers that we've been able to use that, call it entrepreneurial approach to 140-year-old company and bring on additional growth that maybe is different than our peers.

<Q – Konark Gupta>: Okay. And so, staying on the synergy side of things, you guys, when you had the Investor Day, you had laid out some targets for KCS synergies on the revenue side and the cost side. And I think, I mean, we have been talking about the revenue synergy quite a lot, but I think recently you guys started to talk about cost synergies and how they're progressing kind of fast now. Can you tell us about what innings are we in right now on the synergy front, based on the obviously, the targets you had back in those days? And what's the incremental going to be driven by in the next two or three years that you see?

<A – Nadeem Velani>: Sure. Yes. So, I think this year we'll probably end our revenue synergies of about $1.1 billion. And next year, I'd see probably a quarter of that as an opportunity.

<Q – Konark Gupta>: So, that's a U.S. number or a Canadian?

<A – Nadeem Velani>: U.S. Yes. When you think about some of these new services and facilities that we've laid out, we never wanted to have them all come on at the same time, right? You're going to ruin your service if you try to do all your synergies in year one.

We laid out what we thought we could achieve for a three-year period when we did our STB application, and we laid out that target of $1.2 billion. We had our Investor Day after we had taken over, and we saw the opportunity to be a bit larger and longer lasting than we had initially thought. So our view at that point was about $1.5 billion of revenue synergies.

So here we are end of 2025, we're going to achieve about $1.1 billion. Some of that run rate is going to carry through of recent projects. There's additional contracts that are coming online with customers that are going to open up that will be part of the 2026 synergies. You've got these new sites and new locations that are coming on. You've got investment in some of our locations in Mexico that will be part of our growth story that will call it a synergy as part of the combined network.

When we look at 2026, I would expect in that $200 million, $250 million of additional synergies for 2026. And it doesn't end in 2026. There's an opportunity for some of this stuff to continue. When you look at what happened with some of the trade issues in the past year and the administration change in Mexico, there was a bit of a pause on investment. You can expect some customers that maybe were thinking of doing certain capital investment in certain locations. They needed to wait and see what transpires with some of these trade agreements and trade policies.

And so that has led to a delay in some projects that we laid out during our Investor Day, which I think they're not written off, but rather paused. That gives me comfort that '27, '28, you're going to see some of these projects come to fruition once the terms of a new USMCA or a new trade agreement comes to play. From a revenue point of view, I'd say we're probably still probably in the sixth inning or so, seventh inning. We'll probably see some additional opportunities over the next several years.

The cost side, we talked about $200 million of EBITDA on synergy savings from the combined or from the deal. I'd say we're probably early, mid-innings on that. Some of the benefits on procurement, for example, you can't generate it all at once. Again, you need those contracts to

come up on the procurement side to be able to renegotiate and get the combined company to be able to get benefits from your vendors.

We had our Day-N integration, so our system cutover. We had a lot of employees on the IS side and a lot of contract employees that were put in place to support that. Now that we're past that system integration, we will see some of those employees naturally roll off, as well as other G&A employees that will attrit out over time that we won't need to backfill. So there's still opportunities from a headcount point of view over the coming year or two that we'll see as natural synergies.

<Q – Konark Gupta>: Okay. And I know you touched on that integration on the IT side. I think in May, that's when you guys started that, we saw some disruption on the network side, I guess, and it was well-advertised all across media and stuff. But what was your learning from that whole process? I guess this is probably not the last integration on the IT side. You probably might have more coming along the way. But any learnings from that? And what really caused that issue? I mean, was it totally unexpected on your side?

<A – Nadeem Velani>: I knew I shouldn't have said IS integration that you'd asked me about that. No, I'd say you do a consolidation like this, a merger like this, of this scale, you're always -- nothing's going to be perfect. We're certainly not perfect. And we put a lot of time and resources into that integration. And you're dealing with all kinds of different stakeholders, whether it's other railroads, customers across the geography, you're going to have potentially issues. And we did.

And so, I mean, ultimately, we could talk for an hour about this, but no one will want to talk for an hour about this or hear me for an hour. But I would just say that it comes down to sometimes change management. You can train, you can educate, you can test as much as you want. But at some point getting in the seat of a customer that may have been doing things a certain way for decades down in, this mainly was impacted in Texas and Louisiana and down the southern part of the network.

And there's processes that they'd been doing for years and utilizing a system that had more flexibility than the newest system we've implemented. So putting in data, if it wasn't completely accurate, there would be ways that the system, the previous system would accept it and it would work. When we put in our new system and integrated the combined entities, you ended up having kind of rejection if the data wasn't a certain way or if there were other ways to pass on information from the customer of a third party wouldn't fit in the fields in a certain manner, it would just not accept it. But it steamrolled into an issue that became losing visibility into inventory and so forth.

And so, yes, it was -- it did disrupt the network. The recovery by the team was exceptional. 30 days later, we were back up to normal. And so there were definitely lessons learned on the whole organizational change and change process and how we can do things differently. So the next step is Mexico, which is that much more complicated, if you can imagine. And so we paused that to make sure we're -- we upgrade some systems first before we do that full integration. So that will probably be about three years timeframe before we tackle that next integration.

<Q – Konark Gupta>: Okay. Moving on to the balance sheet, I think, I mean, talking about the CapEx intensity for the network, what's the right level you see going forward? I think, as you said,

obviously, you're in the later part of the innings on the revenue synergy side of things. So, presumably, a lot of the CapEx might have been spent by now. Any more remaining CapEx to support the synergies? And how do you think about just overall for the base business now going forward?

<A – Nadeem Velani>: Yes. So, this year, we'll have the highest CapEx of the company's history, the combined company's history, about $2.9 billion. And some of that's impacted by currency, the Canadian dollar depreciation certainly has an impact. So we've guided to $2.6 billion to $2.8 billion long term worth of, as far as our capital investment. I'd say that some of the major projects tied to integration are now, for the most part, complete. So we'll have less capital required for that.

From a capacity point of view, we're in excellent shape. Certainly, if the macro returns, that'd be a good problem to have, and we could add additional capacity. But we've got plenty for the foreseeable future. We are investing in locomotives. I think it's the first locomotive we bought since the management change in 2012. So we're investing in 100 locomotives this year, Tier 4s, that are going to help our efficiency, help our fuel productivity. We have another 70 locomotives that we're going to be acquiring next year, and this is part of our phased-in plan over a multi-year plan to upgrade our locomotive fleet. So it's going to be a shift in capital spending from the base network to more rolling stock, I'd say. Less capital required for systems, given what we just discussed.

So, net-net, I think, 2026, we should be closer to $2.8 billion of capital. So you'll see a reduction year-over-year, and on an exchange-adjusted basis, it's very much in line with what we've guided to in that $2.6 billion to $2.8 billion.

<Q – Konark Gupta>: Okay. In terms of your leverage ratio for the balance sheet, I think this is probably, again, maybe a good problem to have or not, but your stock price is obviously kind of range-bound or pulled back a little bit or something, right? So maybe that presents an opportunity. But is the leverage ratio where it is right now, does it give you sort of enough confidence that maybe you should continue to buy back stock at the current level, even if the leverage ratio remains a little bit higher for longer? I mean, doesn't drop down to 2.5x overnight.

<A – Nadeem Velani>: Yes, no, it's quite, the timing's good. I just met with two of the rating agencies this morning. We had excellent conversations. I think they're very supportive of our approach to capital allocation as a whole, but we had that discussion as well with them to an extent and our balance sheet has come a long way from where CP was historically and KCS was historically. And I think we are in a good spot as far as being in that range of 2.75x to high 2s, if you will, something less than 3x is what we feel comfortable with.

And then the capital allocation decisions outside of like capital shareholder return decisions, certainly it's going to be impacted by where we think the stock price is relative to our intrinsic value. It's why we bought back 4% of our shares between February and middle of or early November. We felt there's a strong return opportunity for our shareholders with that.

You can expect us to continue to do both as far as increasing our dividend and returning cash to shareholders by repurchasing shares. So I would expect in that 4% type of buyback a year is a good spot to be in. If the share price, which right now has declined our multiple has basically disappeared over the last couple of years despite double-digit growth the last two years. So we

still see that as a huge opportunity for returning cash to shareholders. I'd say we'll probably put more towards a buyback than a dividend at these levels.

<Q – Konark Gupta>: Okay. And I want to spend like last few minutes, on the whole industry landscape, how it's potentially changing and whatnot. I mean, in your capital allocation framework, do you set aside any capital for potential opportunities that may come out of any concessions that might happen in the U.S.?

<A – Nadeem Velani>: I think under those scenarios, we would have capital available if there was a divestiture of some sort or -- yes, I'd say that we would be able to have the flexibility. That's the good thing about share buybacks is that you have flexibility as opposed to a dividend that if something comes up, you can take advantage of it.

<Q – Konark Gupta>: Okay. And have you sized up any of the opportunities? I mean, I know it's too early in the game, but any placeholders, any eyes on where things could be?

<A – Nadeem Velani>: I'd say let's see the application first and let's see what the UP-NS are filing first and then we'll go from there. There are going to be conditions placed if this deal goes through, there's no doubt, whether it's trackage rights or interchange opportunities or divestitures. But yes, it's a long road ahead still and let's see what the application looks like and let's see what the STB responds with as far as receiving the application.

<Q – Konark Gupta>: Okay. And then sticking to the capital allocation, I guess technology is one area where you guys have spent a lot of capital. I think like six, seven years ago when we went out to see your Calgary campus, we saw a bunch of new tech gadgets there and you might have spent a little bit more on that on an ongoing basis, but AI is something that people talk a lot about these days, right? I mean, is AI something to do with rails as well? It can help you enhance some of those, I don't know, like maybe the network, maybe the planning, maybe, I don't know, routing as you call it or maybe just the maintenance?

<A – Nadeem Velani>: Absolutely, I mean, it's early stages. We've had various third parties come through recently to show us the art of the possible or how they could support us, but our team has also utilized AI internally for some periods. We've built some internal capabilities, whether that's from a safety track maintenance point of view, whether it's recently a team was recognized internally for supporting one of our customers with a clearance system that utilized AI to help with Mexico to U.S. border customs and clearance on goods, and just mind-blowing stuff on what they could do to support a customer and make it easier to do business across Canada and U.S. and Mexico.

But I think what you're referencing, we've got a team that's in Calgary that's built these in-house capabilities of whether it's track monitors, whether it's wheel technology, different utilization of data and AI and optical readers to make us a safer and more efficient railroad.

So that's something that we'll continue to invest in. We do share some of that information with our peers to make the industry safer, but I think that's certainly the way of the future when you think about, we are an antiquated industry as far as still utilizing human eyes to test and to look at and inspect under a rail car. When you can utilize technology to supplement our labor, I think it can be a much more meaningful inspection and make it a safer and more efficient railroad.

<Q – Konark Gupta>: Okay. So, there's definitely some cost aspects to that way of margins, but I know some of the industries you're talking about using AI for optimizing the pricing structure. I mean, is there an opportunity for the rails as well to do something?

<A – Nadeem Velani>: I think there's opportunities as far as when you look at, think about dynamic pricing and so forth. But I think there's still some near-term opportunities that we can do. It's still the early days on that. I think that's something that potentially down the road, when you have a capacity situation or you can utilize, take away, when you're in an environment where capacity is so sparse, which we're currently not in, so I'd say it's early days for that.

<Q – Konark Gupta>: And maybe the last one here, and then perhaps you have any closing remarks. But I think return on capital, or ROIC, was a focus metric historically for CP. And obviously, since KCS, it's been on a pause. Any chance that comes back as you kind of execute on all those synergies and you get back sort of on track where the business is?

<A – Nadeem Velani>: Yes, absolutely. I think at the end of the day, measuring the performance of a company in a capital-intensive industry such as ours, return on invested capital is probably one of the best metrics. To us, it's the health of the business and how we're managing all of the resources and the allocation of capital, as we discussed, and bringing it to the bottom line.

And so ROIC as a long-term investment or long-term incentive plan metric is going to return. We're also in a period where we did a $31 billion U.S. acquisition and we had the depreciation step up. And so, we took our return on invested capital from -- I think we were 17% in 2020 or 2021, we brought it down to, I think, high-single digits, let's say, 7%, 8%.

So, at some point, you do need a metric that, if you're measuring yourself again, has to have a certain level in order to truly measure yourself and put performance against. So saying you're going to raise 7% to 7.5% is too tight a range to really measure and put compensation towards. So, as we get this closer to, I'd say, double digits, which I think in the next few years will be at that point, I think it will return as a key metric. I know it's a focus of our Board and our company.

<Q – Konark Gupta>: Okay. I think, with that, I think we're up on time. Any closing remarks, Nadeem?

<A – Nadeem Velani>: No, thank you.

<Q – Konark Gupta>: All right. Thanks so much. Okay. All the best.