Transcript

Q2 2020 Earnings Call

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Corporate Participants:

Keith Creel – President & Chief Executive Officer
John Brooks – EVP & Chief Marketing Officer
Nadeem Velani – EVP & Chief Financial Officer
Maeghan Albiston – AVP, Investor Relations

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. My name is Jason and I will be your conference operator today. At this time, I would like to welcome everyone to Canadian Pacific's Second Quarter 2020 Conference Call. The slides accompanying today's call are available at www.cpr.ca. All lines have been placed on mute to prevent any background noise.
After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I would now like to introduce Maeghan Albiston, AVP-Investor Relations and Pensions, to begin the conference.

Maeghan Albiston

Thank you, Jason. Good morning, everyone, and thank you for joining us today. Before we begin, I want to remind you that today's presentation contains forward-looking information and that actual results may differ materially. The risks, uncertainties, and other factors that could influence actual results are described on slide 2, in our press release, and in the MD&A filed with Canadian and US regulators. This presentation also contains non-GAAP measures, which are outlined on slide 3. With me here today is Keith Creel, our President and CEO; Nadeem Velani, Executive Vice President and Chief Financial Officer; and John Brooks, Executive Vice President and Chief Marketing Officer. The formal remarks will be followed by Q&A, and in the interest of time, we'd appreciate if you could limit your questions to one and the Investor Relations department would be happy to follow up with you afterwards for any follow-up questions.

It's now my pleasure to introduce Mr. Keith Creel.

Keith Creel

Thanks, Maeghan. Good morning, beautiful day in Calgary. Let me start first and foremost, I'll be remiss not to begin my comments by applauding and continuing to thank our CP family, 12,000 strong. They continue to serve communities throughout Canada and the US with a tremendous amount of pride and it's that pride and it's our culture of accountability and performance that continue to fuel this unique performance that we produced at CP for our customers and for our shareholders. I can tell you as a leader, it's my honor to be able to serve with each of these men and women that make up our CP family every day. These employees are the true heroes that have been supplying and ensuring supplies that people are depending upon are delivered. Rest assured, that's a reasonability that none of us take lightly and I'm grateful to these employees and their union leaders for their continued strength and commitment to delivering for the North American economy, especially during this extraordinary time of need. So, on to the guidance and the results. I can tell you we consistently said that PSR is an operating model that works both on the upside and on the downside, and I'm sure that you would agree that today's results are a strong testament to that. In spite of the rapid change in volumes, Mark, and the operating team rose to the challenge throughout the quarter. They remained nimble. They adjusted resources in lockstep with our demand from the beginning to the end. This is what has enabled our strong operating performance across the board. Train weights and lengths, all-time record levels up 7% and 8% respectively. Locomotive productivity again an all-time best level up 2% versus last year. Fuel efficiency, a Q2 record and the second best quarter record for the company at 0.92 gallons per thousand GTMs, all of which enabled our record Q2 operating ratio of 57%. And as John will tell you as he provides color into the markets, this performance enabled us to set a number of new records for our grain and our potash customers that we're extremely proud of. We also note in our press release today that we provided updated guidance due to the strong performance to date. We've guided to positive earnings growth for

the year. We're following through on our commitment also that we made on our last earnings call restarting our buyback and increasing our dividend. And as I said on our last call, we assured you that CP would emerge this pandemic a stronger company than we went in and that's exactly what's happening. And it's not just the operating team that's moving the trains day in and day out. It's the folks that are working at home as well, the full team. This is the full team event. The men and women working from their homes have not being resting on their laurels rest assured. They've been keeping constructive tension throughout the entire organization. We challenged all of our people, especially those that are working at home, to find new and more innovative ways to work, focused on people. We focused on leadership development and market development. I challenged John and the marketing team, sales team to get closer to the customer, to mine for opportunities, to drive additional volumes to the railroad, to be a problem solver, transportation solution enabler for our customers in these tough times. We challenged the executive leadership team, get out of the office, get on the network, get on the ground. There's never been a better time to spend time with our people, the men and women, the heroes that are moving this traffic day in and day, not only learn about the business but let them know how much we appreciate what they're doing day in and day out when they come to work to protect the livelihood of others. Collectively also, we doubled down our leadership development. That's a legacy that I certainly intend to leave with this company. In order for this company to continue to improve, our leaders have to improve. And as the leaders improve, the company gets stronger and that's the key to sustainability. That's the key to continuing and sustaining this very unique and special culture of accountability, this culture performance that fuels these results and that delivers our freight to our customers day in and day out. It's the key to it and we'll continue to develop those leaders through the training, the investment in each individual so they can realize their best potential and CP can realize its best potential. So, the team is getting stronger. We're getting close to our customer. We're developing stronger leaders and we're becoming better railroaders. It's fair to say we've been on the offense, not on the defense, through these challenging and turbulent times.

So, with that said, now, I'm going to turn it over to John to provide a bit more color on the markets.

John Brooks

All right. Thank you, Keith, and good morning, everyone. So total revenues were down 9% this quarter to CAD $1.8 billion. RTMs were down 10%. FX was up 2%, while fuel was down 3%. I'll briefly highlight our second quarter performance and provide you guys some color on our major lines of business. I'll speak to the results on a currency adjusted basis. So, starting with grain, volumes were up 8% on the quarter, revenues up 3%. I want to start by echoing Keith's comments and once again congratulating the CP team and our grain customers for delivering another tonnage record for Canadian grain at 8.4 million metric tons. This beat our previous all-time record in Q4 2019 by 500,000 tons and marked the third consecutive record quarter for Canadian grain. The results are a testament to the benefit of our covered hopper investment and the partnerships with our customers who are also investing hundreds of millions of dollars on the CP grain franchise through expansions and new developments to enable our unique 8,500-foot high-efficiency train product. The proof is in the incremental 2.5 million metric tons of grain we have moved this crop year, all while leveraging existing crews, train starts and network capacity. We are excited about recent announcements: Viterra's work on the South Shore at the Port of Vancouver to enhance their terminals, along with the recent announcement of a new greenfield high-throughput elevator exclusive on CP in Rosser, Manitoba, both of which will be capable of handling our 8,500-foot trains. I'm also extremely pleased with the performance at Alliance Grain Terminals and their decision to move to a 24x7 operation on the Vancouver South Shore exclusively served by CP. And to service this export terminal, Paterson Grain, a pioneer of our 8,500-foot model, will be undergoing three more expansions at its elevators to support this new terminal throughput capacity. Now, looking ahead, we expect grain to be

busy the remainder of the year. Carryout from this crop is expected to be close to average, and the 2021 crop is maturing well and our customers are expecting it to be greater than 70 million metric tons. On the potash front, volumes and revenues were up 5%. The strength we expected in potash materialized in the quarter. On the export side, continued strong collaboration and execution with the Canpotex team, including increasing train lengths to 188 cars to their Portland terminal, supported a record performance in Q2. On the domestic side, after consecutive poor application seasons due to weather, we had excellent conditions this spring and delivered strong service for our shippers. The outlook for potash remains positive and I expect double-digit growth as demand remains high and back half comps are favorable. We continue to see strong resiliency of the commodities across our agricultural franchise that make up greater than 30% of our book. I expect momentum to continue that we've seen year-to-date to continue into the back half of the year. Moving on to coal, revenues were down 24%, while volumes are down 21% on the quarter. Canadian coal volumes declined as a result of softer demand related to COVID, production challenges at the mines, and limited port capacity due to the ongoing expansion at the Neptune terminal. We expect 2020 tonnage to be lower than 2019 and Neptune is expected to be shut down through the end of September.

The energy chemicals plastics portfolio saw a revenue decline of 3%, while volumes declined 35%. The significant difference between revenue and volume is driven by crude liquidated damages. These contracts did exactly what we told you and designed them to do. They protected CP from the inherent volatility in crude by rail volumes. Crude volumes fell through Q2 to approximately 8,000 carloads, down about 70% year-over-year. Our guidance assumes minimal crude volumes through the back half of the year. The continued volatility in the crude market only strengthens our conviction in the stability offered by the diluent recovery unit located exclusively on CP in Hardisty, Alberta. Construction is well underway and we expect completion by midyear 2021. Now turning to MMC, revenues declined 37% and volumes are down 35%. This is all driven by frac sand as it was a big decliner in the quarter as a result of crude market declines and resulting shut-in production. Steel, aggregates, other construction inputs, which were all certainly challenged by the pandemic, are expected to gradually recover through Q3 as industrial and construction sectors reopen. Automotive revenues were down 68%, while volumes were down 70% on the quarter due to the North American manufacturing shutdown. Since the restart, restocking efforts and vehicle sales have outpaced our partners' expectations. We have a lot of positive momentum right now in our auto space as we move into Q3 as we welcome two new customers aboard. We welcome FCA at our Calgary and Vancouver auto compounds beginning July 1 and Glovis comes on board beginning September 1. We continue to utilize our unique landholding to provide strategic purpose-built compounds for our partners. Through the execution of our automotive playbook, we have launched four new compounds across our network giving CP customers more optionality and unmatched local market access. Finally, moving on to intermodal. Quarterly volumes were down 7% as a result of overall softer consumer demand across North America. On the domestic intermodal front, we've performed well in the quarter in our movement of essential goods and our refrigerator demand has since returned to pre-pandemic levels. From our trough point to the last week in June, we've seen a 43% increase in RTMs from our temperature controlled TempPro product. On the retail side of our business, we've had strong performances from our leading retail partners as we move through the quarter with a nearly 50% surge in RTMs since our trough. On the international franchise, it remained resilient. We did not see the expected volume of blank sailings which helped us stay close to flat year-over-year. Now looking forward, I am extremely excited about our new access through the CMQ to the Port of Saint John. This port has the potential to be the crown jewel of Eastern Atlantic ports through our strong partnerships with DP World, New Brunswick, and the business

partners throughout that region. The Port of Saint John offers a low-cost existing capacity that is undergoing over a CAD $200 million modernization project. This project combined with CP's shortest route and fastest service to the west offers our customers a new compelling competitive Eastern Canadian option. So, let me close by saying, as Keith said, the sales and marketing team in this company is not resting on our laurels. We've had the team out cold calling, sales blitzing territories on our network, building new relationships, and finding outlets for our customers. That's the PSR culture that we have in the sales and marketing team. I'm pleased with how the team has adapted and we have a strong pipeline of broad-based opportunities for years to come. So, look, the next several weeks will present challenges as it relates to comps given our strong industry leading performance last year, but the volume environment continues to improve. As we look forward, we'll continue with our disciplined approach to picking our partners, executing our playbooks, enabling us to outperform the industry.

With that, I'll pass it over to Nadeem.

Nadeem Velani

Great. Thanks, John, and good morning. As Keith and John mentioned, this has been a challenging quarter, but this team of railroaders once again rose to the challenge as demonstrated by our industry leading operating results. As with Q1, I surprise people with the commitment to a sub-60 OR, but our exceptional team went out and managed to exceed my high expectations once again. Overall, the operating ratio decreased 140 basis point to 57% which is a new CP second quarter record. I've been in this industry for 22 years and this quarter is a significant milestone. When you can report us 57% operating ratio in a quarter with volumes down this significantly, gives me a high-level confidence to eventually achieving mid-50s OR on an annual basis and continue to widen the gap with our Canadian peer. Moving on to a few more notable items on the expense side. I'll be speaking to the operating results on an FX adjusted basis. Comp and benefits expense was down 11% or CAD $41 million versus last year. The primary drivers of the decrease were 10% lower head count as we furloughed employees and significant efficiency gains from lower crew starts and increased train weights. The cost control you're seeing is truly structural. Stock-based comp wasn't a material headwind on an annual basis but at approximately CAD $40 million definitely weighed on expense. We continue to deal with the pension headwind of CAD $8 million a quarter as well as continue to accrue incentive compensation based on our strong results year-to-date.

Fuel expense decreased CAD $112 million as a result of a 38% decrease in the price paid year-over-year. Lower volume and the benefit from a CAD $13 million lag in our fuel surcharge program in Q2 which we do not expect to replicate in Q3. Our record Q2 fuel efficiency also played a big role. This also marked our second best ever quarterly fuel efficiency. Our investment in modernizing locomotives, fuel trip optimizer, and the 8,500-foot grain model continue to drive our fuel efficiency, 14% better than the Class I average. Since 1990, CP has reduced its locomotive greenhouse gas intensity by 42%, avoiding over 31 million metric tons of carbon. Depreciation expense was CAD $195 million, an increase of 6% as a result of higher asset base. Purchased services was CAD $266 million, relatively flat on the quarter despite lapping a CAD $17 million headwind from a land sale in 2019 and approximately CAD $10 million in higher casualty cost year-over-year. The team effectively controlled spend and adapted to the current volume environment. This is a testament to what a true PSR railroad is. Mark Redd and the operating team worked closely with John's team, Mike Foran and the asset management team, and my finance team to achieve these results. This does not happen by accident. Moving below the line. Other components of net periodic benefit recovery

were negatively impacted CAD $12 million or 12% primarily due to a lower discount rate. Interest expense was up 5% as a result of foreign exchange on US dollar debt. Income tax expense increased CAD $65 million or 52% primarily driven by a recovery in Q2 2019 related to changes in the Alberta corporate tax rate. We now expect an effective tax rate of approximately 24.8% for the year. Rounding out the income statement, adjusted diluted EPS declined 5% in the quarter. Moving on to the free cash statement. Cash from operations increased 17% on the quarter. We are continuing to adapt in real-time as volumes change and the economy moves forward. We are stretching our capital dollars through greater efficiency. In fact, we experienced all-time highs for engineering efficiency as measured by block time availability. This quarter, our engineering crews had only six zero block days which are days where they could not access the track as compared to 30 zero block days in Q2 2019. This shows our engineering teams were efficiently able to complete their work and trains were able to run on schedule. Year-to-date, our capital efficiency has improved 19%, so it's a huge credit to the operating teams and the engineering teams who are working collaboratively to enable us to achieve significant capital efficiencies. We remain committed to our CAD $1.6 billion of capital spend for the year and are managing the capital envelope for the long-term benefit of the company. Rest assured, we continue to maintain discipline on capital deployment as evidenced by our adjusted return on invested capital of 17.1%. As a final note, we continue to be in a position of strength from a liquidity perspective. As of June 30th, our USD $1.3 billion revolver was undrawn and we had no commercial paper outstanding. We are proactively managing liquidity and feel confident in our decision to increase the dividend by approximately 15% which we announced yesterday on our path to an adjusted payout ratio of 25% to 30%. Since 2015, we have led the industry in dividend growth with a compound annual growth rate of 17%. We will continue to balance our shareholder returns and have restarted the buyback program which is about 40% complete. We'll remain opportunistic and disciplined on the buyback as Keith spoke to a strong performance year- to-date and our increased clarity on the back half of the year have given us the confidence to increase our guidance to EPS growth for the year. The PSR model is one that truly works in any environment. And I can't think of any better proof point than our performance this quarter. I'm confident that in 2020 will be our fourth consecutive year leading the industry in train accident ratio, EPS growth, and return on invested capital.

With that, I turn it back over to Keith to wrap things up.

Keith Creel

Okay. Thank you, Nadeem and John, for the color and I think will save the balance of our time, go and turn it over to the operator to open up for questions and the discussion.

Question & Answer

Operator

Thank you. [Operator Instructions] Your first question comes from the line of Jon Chappell from Evercore ISI. Your line is open.

<Q – Jon Chappell >: Thank you. Good morning, everyone

<A – Keith Creel>: Good morning

<Q – Jon Chappell >: John, I want to ask you about some of the commentary you made on the intermodal and the auto side. Clearly, inventories in North America are very low, the blank sailings are much lower if not reversing and the auto plants are kind of cranking. When you speak to your customers, how much of the restocking seems to be a 3Q event only, and how do they feel about the duration of potentially the entire second half of the year on both of those business segments?

<A – John Brooks>: Yeah, so maybe a couple of comments on that, Jon. Look, just like else everybody else, we're continuing to navigate this uncertainty. So, the auto manufacturers, the retailers, if you know the answer what this pandemic looks like over the next six months, we're all sort of estimating and guessing based on that. Now, that being said, we have definitely seen those areas ramp up and I think our expectation is we're going to continue to see that stabilize, probably through Q3 and then maintain that sort of pace or that gentle recovery as we move into Q4. Certainly, in the auto space right now, we're seeing an initial surge. And that probably doesn't continue. But don't forget, we are going to see a nice bump the back half of this quarter as we see Glovis join our auto franchise which is going to be a significant tailwind for us.

<Q – Jon Chappell >: That's great. Thank you for the feedback

<Operator >: Your next question comes from the line of Tom Wadewitz from UBS Securities. Your line is open.

<Q – Tom Wadewitz >: Yeah, good morning and congratulations on the really strong performance in the quarter. I wanted to see if you could offer some thoughts perhaps, Keith, on just the scheduled changes that you made in order to achieve the 8% increase in train length. And how you would think about operating leverage given that you've already expanded train length, do you expect that number to keep going up as volumes come back, any thoughts about kind of volumes coming back unit train versus carload, how do we think about that operating leverage given that you did so well in the quarter with expanding train lengths?

<A – Keith Creel>: So, listen, let me start with a probably pretty known fact at least in my company, our company. I'm a pretty demanding person and I've got pretty high expectations and got a lot of confidence in Mark and the team. They were challenged with take our plan which obviously was built for a different demand level and adjust and tweak it. And as you do that, you consolidate, you get an opportunity to realize some of these synergies. So that did help with training weights; that did help with training lengths. So, as the business comes back, you'll adjust some of those things, but you won't see a monumental change. I mean you might see 1% or 2%, but the expectations aren't going to change. We become smarter as we go through these processes and we go through these challenges. Some of the things that will offset even may be that degradation is getting a full impact with some of the operational changes we made prior to the pandemic and I'll speak specifically to potash. This time last year or in 2019, we moved a lot of potash for Canpotex. And when I say lot, the tonnage that we moved, we moved it differently. We were running 172 car trains to Vancouver. We were running 130 car trains to Portland. Well, we've flipped that model upside down. We've taken the next step. We're running 200 car trains to Vancouver today. And in partnership with DP, we're running 180 car trains to Portland. So, those incremental gains from productivity gives me the confidence that you might see a little tweaking, but you're not going to see much degradation, Tom, because of the fundamental changes we've made in the network. And that's just one story. I could get into lot more detail. But just rest assured, you look at our track record, we challenge ourselves to get smarter every year. This is a process of continual improvement. We're eight years into PSR. This isn't new to us. We understand what we're doing. It's woven into our DNA. We know where our pinch points are. And as we attack those issues and we become better leaders and better railroaders, we sustain, maintain and continue to improve.

<Operator >: Your next question comes from the line of Steve Hansen from Raymond James. Your line is open.

<Q – Steve Hansen>: Yeah. Good morning, guys. Just a quick question for you maybe, John, on the potash outlook. I think you described double digits through the back half year. Some of the larger exporters have signed contracts through October. I'm just curious if you have any visibility right through the end of the year when the comps really do start getting easier. Just any context around sort of that cadence as to how that will continue to flow would be great. Thanks.

<A – John Brooks>: Yeah, Steve, so if you think back to last year, we saw a little bit of a decline start to take place in August, and then September, you saw a pretty dramatic fall off. So, I'm confident we're going to see a pretty big spike as we hit September and certainly October. Now, discussions with Canpotex, I think they remain very bullish on the marketplace. You're right. There are some contract extensions they have to work through that will cover off the very back half of the year. But like anything, I think they've been resilient as they've worked through those negotiations with China. They've opened up new markets and strengthened relationships into other areas such as India. And so, I think they remain quite optimistic that this thing is going to remain strong right through the end of the year, Steve.

<Q – Steve Hansen>: Appreciate it, guys. Great quarter. Thanks.

<Operator >: Your next question comes from the line of Ravi Shanker from Morgan Stanley. Your line is open.

<Q – Ravi Shanker >: Thanks. Good morning, everyone. Keith, Nadeem, a quarter ago, if I had offered you earnings down 5% this quarter, I suspect you'd have taken that with both hands. So, if we can just take a step back here and kind of look at this performance in the context of what is to come, I mean do we think of this as you guys just performing remarkably well to limit the downside in an extremely challenging quarter or do we say, now, hey, they did a 57% OR in a quarter like this, which means if the cadence of the volume recovery that we saw in the second half of June continues through 3Q, 4Q and 2021, that mid-50s OR is something that can be achievable as early as next year?

<A – Nadeem Velani>: While I think it was a phenomenal quarter. I think it's – there was nothing unique about it. This is – I mean, when Keith built this team and he took over as CEO, I mean, this has been a long time coming. This isn't just an overnight kind of fix. This is building the team, building beyond the people that you know. We all have strong benches behind us with the best team in the industry. And so we'll take what the environment gives and I think we're very proactive and very collaborative and can adjust obviously as you saw this quarter to what the volume environment is. But when we look at what we have ahead of us, I mean, we're probably, as John would say, as bullish around our revenue outlook over the next two years as we've ever been. And from a cost point of view, why I say this is a bit of a milestone quarter is when our operating team and our markets asset management team and our finance team and so forth can put together – adjust the OR and adjust our expenses to overcome this kind of headwind in a downside scenario as we saw to your point on the operating leverage on the upside, it creates kind of a new environment and a new perspective on what you can deliver. Now, do I think we can hit a mid-50s OR next year, I don't want to say that right now in the middle of a pandemic in July of 2020, but I certainly have a lot of confidence that we will continue to improve our OR. We'll have the best OR in the industry this year. We have the potential to continue and improve in 2021 and 2022. And so, I feel good about – I feel great about our revenue story. I feel very good about our cost story. I feel excellent about our free cash conversion story, our return on invested capital. So, I think every bucket and when I look at the performance of what this outlook of this company

can deliver is extremely positive

<Operator >: Your next question comes from the line of Fadi Chamoun from BMO. Your line is open.

<Q – Fadi Chamoun>: Yes, thank you. Good morning, everyone. So, just a question on the comment you made around Saint John and the opportunity there. I mean you're kind of leaning off Saint John, your competitor is leaning on a different port out east. I just wanted to kind of understand from your perspective kind of what does the the supply chain look like for you, coming through Saint John like kind of where is the originating market that would be using Saint John and where would that traffic be going? And where do you think this opportunity kind of materializes from a revenue perspective? Is this a 2021 or a 2022 kind of opportunity that you see it?

<A – Keith Creel>: Let me say a couple of things, Fadi, at a high level, then I'll turn it over to John to provide some color. But if I'm going to lean on a port to tidewater, I'm going to lean on the one that's closest to market. There's a 200-mile route advantage. You take a railroad that gets you there line of sight as a crow flies faster on our best day, the service is unparalleled, and we'll create the market with the service. So, it's going to come from all commodities. If I look forward over 2021 and 2022, I feel confident saying based on what we know now and the opportunities that are in development, these aren't conceptual ideas. These are sustained steps that are being taken, business that's been won, business that's being planned, infrastructure that's being invested. Collaborating with the Port of Saint John and collaborating with the province of New Brunswick, collaborating with our customers. We've got a space out there that had one, I guess two competitive options. You had our competitor or you had the truck. And I can tell you there's a lot of trucks on the road. And when you get to something that's truck-like competitive from a service standpoint in time and you have the track record of reliability that this team has established, customers will step into those solutions with you. So, it's across the board. This time next year or by the end of 2021, I'm convicted and I'd be extremely disappointed if we wouldn't be celebrating a steamship line that's got a flag flying in the Port of Saint John. I'll tell you I'd be disappointed given the things that are developing if we don't have automobiles that are moving from a domestic destination in the Port of Saint John. I would tell you I would be disappointed if we're not moving a whole lot more forest products, and LPG, and fuels, it's just across the board opportunity. You're interjecting a best-in-class railway competition and great transportation solutions that get our customers' products to the market faster and allow them to compete to win more market share and that's a powerful recipe for success. So, I hope you – sense my conviction, when we say we're going do something, we're going to do it at this company. And I'm not saying it because we think it can happen, I say it because we believe it and we're working toward it and we'll execute. And by the end of 2022, that little CAD $40 million railroad that we bought is going to be well north of $100 million in annual revenue in US dollars, in CP margins. John?

<A – John Brooks>: You know what, Fadi, Keith said it well. I might add that we're excited about the prospects of seeing manufacturing and of consumer goods shift more and more to places like Southeast Asia and India and South America and potentially even near-shoring opportunities. Port of Saint John sets us up well for I think all those categories. And let's not forget that CMQ also gives us access into Searsport, Maine, a second port over there that I frankly believe we haven't scratched the surface in terms of what those opportunities will look like. And as you know and I've talked about in the past, we've built a lot of, hit a lot of singles and doubles over these last two, three years with our short line partners. And that part of the US opens up whole new category of opportunities in that bucket that the merchandise team, Coby Bullard and his team are attacking vigorously. So, beyond all the things Keith spoke about, to say that we're bullish on that opportunity is an understatement

<Operator >: Your next question comes from the line of Konark Gupta from Scotia Bank. Your line is open.

<Q – Konark Gupta >: Good morning, everyone, and thanks for taking my question. Just wanted to understand some key assumptions behind your revised guidance for EPS growth for the full year especially for operating ratio. I guess you have some relatively tougher comps in the back half here and then the volumes are obviously slow kind of down versus last year, what kind of volume environment do you expect in the second half especially for crude by rail and frac sand assumption? Thanks.

<A – Nadeem Velani>: So, I think as John mentioned, there is not a lot of outlook on crude by rail that we baked into our guidance. So, it's very minimal volumes. We've kept our guidance on RTMs down 5%. Certainly, we have very difficult comps in the first half of Q3 which you're seeing we're down about 10%, 11% which is as expected as actually we're performing a bit stronger so far in Q3 than we originally thought. So, it's really around a cost side. I mean we're performing exceptionally well on our – on the operating performance led by Mark and his team and the cost takeout opportunities are very strong and that's what's driving the upside on EPS.

<Operator >: Your next question comes from the line of Chris Wetherbee from Citi. Please go ahead.

<Q – Chris Wetherbee >: Yeah, hey, great. Thanks. Good morning. John, maybe you could hit on peak season intermodal. Obviously, we've seen some of those numbers look a little bit better, but I guess it's a little difficult to tell sort of where inventories are and sort of what the confidence level is in consumer demand as we go through the rest of the year. So, any kind of color you can kind of give or dig a little bit deeper in terms what you're hearing from the customers, how they might be setting up for later this year on intermodal.

<A – John Brooks>: On the domestic side, Chris?

<Q – Chris Wetherbee >: International.

<A – John Brooks>: International, okay. Yeah, so I think right now, we are seeing the blank sailings that have been laid out for July, August, and a little bit into September. We're seeing ours steamship lines sort of methodically pull those back. I was looking at coming weeks and next two weeks schedule what's on the water and I say overall volumes look strong and encouraging. Look, I still think there's a lot of uncertainty in this space, sort of depending to your point exactly what the consumer does and how this pandemic, either we continue to push forward with the opening of the retails and all the sectors across North America. But I think our forecast right now is we continue to see, I would say, a little bit of a surge here continue in Q3 and then maybe a little bit of normalization as you move back into Q4 but that's going to all be dependent on what we see happen with this pandemic

<Operator >: Your next question comes from the line of Walter Spracklin from RBC Capital Markets. Please go ahead.

<Q – Walter Spracklin >: Yeah, thanks very much. Good morning, everyone. So, I guess my question is for John here on yields going into next year. Obviously, you have a lot of moving parts here with some of your line items. So, I just wanted to make sure I'm getting the yield right, and perhaps, if I could frame the question relative to your core price, do you expect yield to be above or below core – or additive or negative on core price? I'm referring here, you've got the grain minimum revenue cap that's coming down for you, you've got your Teck volumes switching over, you've got liquidated damages that might come off next year, maybe the year later. So, all those moving parts, just looking to see if you see yield as enhancing or detrimental to your core price for next year?

<A – John Brooks>: I mean our core strategy has been sort of picking our partners and maximizing those, the leverage of whether Keith spoke the train length, our capacity on existing trains. So, I think, Walter, initial response

is we continue to see that margin opportunity out there. I can tell you on the pricing front, I've been very pleased with how we've performed the first half for this year despite all the uncertainty. And trust me, it's been tough discussions in some cases with customers given the challenges they've been facing. But I'll remind you, my sales team is – a large part of their compensation is tied to price discipline and we've been able to deliver. I'll go on to say this. As I look to the back half of the year, I'm actually pushing for price acceleration from where we're at. And I think as trucking capacity continues to maybe tighten in some of these lanes and areas with recovery also, I think we're seeing discipline across the rail sector and certainly maybe some challenges as other roads try to ramp back up the volume, I think leads to an opportunity on that front.

<A – Nadeem Velani>: And Walter, it's Nadeem. I'll just add if you think about next year, we have a very bullish outlook as far as of our automotive volumes which is going to be beneficial to overall yield. As some of the Teck revenues roll off, that's going to be beneficial to yield. So, net-net, I think it's a long way from now, but certainly, I don't see too much detrimental impact on yield to your question.

<Operator >: Your next question comes from the line of Ken Hoexter from Bank of America. Please go ahead.

<Q – Ken Hoexter >: Great. Good morning and congrats on the great operating performance, really great to see, impressive. Just maybe talk about the structural change out of your downturn. Your peer talked about closing some yards or facilities through this downturn. Just want to see if you've done anything like that. And really thinking of this is a CapEx question, I guess is there room to increase free cash flow further given the improvement in train lengths and weights? Are you still moving to upgrade sidings, is the CapEx still, any thoughts on that given the near 20% of revenues?

<A – Keith Creel>: Ken, let me – I'll say at a very high-level, part of what we do pandemic on non-pandemic and have been doing at this company is always rationalizing and driving for productivity improvements. So, as far as any quantum changing, change is shedding structural yards down, we've gone through that several years ago. But what we do today and what Mark and team have done, when you respond like we've responded as you consolidate traffic, you bring in the terminals where it's best served at your lowest cost, your most productive facility, so case in point here in Calgary, we've spent a lot of money over the last – I guess it just came online in 2019 actually redoing our yards. So, that was a hump yard that was closed down back when we first started our PSR journey in 2012. We made do with what we had because we had other larger priorities, optimizes the network. We came back to Calgary, said listen, Calgary is the place to switch cars. It's not do all this extensive switching and outside satellite locations. Let's consolidate, let's invest, let's create a very productive facility which is what we've done and which is what Mark has been optimizing in 2020 through this pandemic. So, that's been a blessing for us. Structurally, that's a change that we'll retain, and again, we're becoming better as we evolve and we increase train lengths. Even to the question I was asked earlier, think about our grain program, that's structural for this company. We led that innovation in this industry in the Canadian space driving to an 8,500-foot operating model. G-3, the terminal that was built, was built to facilitate that on the North Shore. We've got 15% of our elevators now that can launch 8,500-foot grain trains. We've got a fleet that's being modernized. We're up, by the end of this year, we'll be in excess of 3,000 of those best-in-class cars that are coming out of Hamilton, Ontario that allow us to haul more grain per car, shorter length of cars that drive productivity. So, the structural changes that you see in our performance will continue and be baked in and we'll realize full year and get more of a mix as we go forward on this 8,500-foot grain program. We'll be 30% of our elevators by the end of this year and the work continues, the productivity and the increases in capacity on the South Shore to match that as well as G-3 on the North Shore, I'm just very bullish about our opportunities to make these margins to make these efficiencies stick. So again, high expectations, strong conviction based on our fundamentals that we're not perfect, but we're darn sure, pretty educated and pretty efficient in what we do and we'll continue to do that and do it well.

<A – Nadeem Velani>: Yeah, and Ken, I'm just saying on the CapEx side, we're extremely pleased with what we've been able to deliver on, take advantage of some track time to be much more efficient as I mentioned in my commentary, and so we're taking this unique opportunity of volumes down that we haven't seen volumes down like this in many years that we can look to build a network that is very resilient, look to build a network that can support some of the initiatives that Keith spoke to around our 8,500-foot model and so forth, initiatives that will increase the capacity and the safety of our network. And so this is something that's going to, I'll say, it's going to pull forward some of those expense or capital dollars from future years and it's going to set us up extremely well for the rebound in the economy over the next, call it, 12 to 18 months and we can take advantage of these significant revenue opportunities that Keith and John have talked about. So, it's a bit of a different model, but we tend to be a bit different.

<Q – Ken Hoexter >: Thanks Keith.

<A – Keith Creel>: Thank you, Ken.

<Operator >: Your next question comes from the line of Benoit Poirier, Desjardins Capital Markets. Your line is open.

<Q – Benoit Poirier >: Yes, thank you very much and congratulations for the very strong performance. Could you talk a little bit about the potential for further M&A on top of CMQ and maybe very quick question for Nadeem if you could quantify the fuel lag in Q2, that would be great. Thank you very much.

<A – Nadeem Velani>: Quantify what?

<Q – Benoit Poirier >: Fuel lag.

<A – Nadeem Velani>: Fuel lag, fuel lag, I believe. Yeah, I think fuel lag was about CAD $13 million in the quarter. You won't see a benefit of in Q3.

<A – Keith Creel>: Yeah, and as far as, Benoit, M&A, listen, right now, we're focused on optimizing the CMQ. That's going to keep us busy for a little while. Certainly, I don't want to dilute our efforts there, but we always have a keen eye. If there's something that complements our network, we stick to our core fundamental strength which is running railroads. I don't see anything immediate that's out there, but rest assured, we're going to maintain a strong balance sheet. We're going to maintain a best-in-class operating team to be able to realize the potential of our network and any other network that we might couple on to this thing. But right now, there's nothing immediate. But our eyes are always open and if it makes sense, we'll not hesitate to move.

<Operator >: Your next question comes from the line of Scott Group from Wolfe Research. Please go ahead.

<Q – Scott Group >: Hey, thanks. Morning, guys.

<A – Keith Creel>: Morning, Scott.

<Q – Scott Group >: So, Nadeem, any chance you can just give us some just directional color on the magnitude of earnings growth you're expecting? I think first half is up 20%. Second quarter, the worst of it, only down 5%. So maybe just some thoughts there. And then, any thoughts on the ability to improve margins again in the third quarter would be great. Thank you.

<A – Nadeem Velani>: I don't want to get into quarterly guidance necessarily. We do have – as I mentioned, the first half of Q3, there's a bit of tougher comps, but then it eases pretty significantly with grain coming on, assuming a decent grain crop, which we do assume. And given it was a very wet crop last year, grain didn't start moving for some time. We have very easy comps for potash as well in Q4 versus where we were a year ago. And so, I think you're going to see Q4 being stronger than Q3 just assuming what we know now with how the pandemic's been reacting and how the economies have been coming back. So, beyond that as far as given operating ratio, kind of OR guidance, I'd say I'd point to the same things I just mentioned, right. So, you're going to see a better OR in Q4 than in Q3 for those exact reasons. I think we'll have better volume performance in Q4 than Q3. And so I pushed the team as far as they can deliver and they continue to surprise me. So, is there potential to continue to improve the OR? Yes, I'm not going to deny that and I'll just leave it at that, Scott.

<A – Keith Creel>: So, you could probably convict Nadeem of being conservative in nature, which is healthy. We certainly see a line of sight, Scott, end of the year for margin improvement versus last year. We're not doing our job if we don't get there. There's opportunity there.

<A – Nadeem Velani>: Yeah.

<Operator >: Your next question comes from the line of Seldon Clarke from Deutsche Bank. Please go ahead.

<Q – Seldon Clarke >: Hey, good morning. Thanks for the question. Can you just talk about how some of the productivity initiatives that Keith highlighted have maybe trended in July as it relates to train weights and lengths and fuel efficiency? As certain volume categories start to come back like autos, is there a point where maybe mix becomes a little bit more challenging in terms of adding certain cars to mix manifest trains or anything along those lines?

<A – Keith Creel>: Well, I can tell you this, it's a gift that keeps on giving. So, similar metrics in July versus second quarter. I took a quick look at them this morning. RTMs down effectively 10 points versus last year as of this morning. Crew starts down almost 17%, people starts down almost 18%, train miles down almost 18%, train length up another 8%, train weight up 7%. When you run the business this way and you control your assets and lockstep your demand, this is what you should expect. So, as we bring back business on and these autos start to come on, we've already got a plan. We know what the plan looks like. So, there'll be some transition to the plan, but you're never going to expect to see this company running short trains. We're going to look for way to tweak. You constantly – you make a plan, you execute the plan, you tweak the plan. You communicate with your customers. You satisfy. You do what you say what you're going to do. And this is just the outcome of it. You're going to get a little operating margin, you're going to get a high service offering, and when you can produce a greater service at a low cost. That is a compelling competitive advantage in the marketplace that drives earnings growth consistently. And that's what this formula is all about. It's not complicated. The complexity and the necessity comes in having the right culture to execute it. And at this company, we have it. We're not perfect, but we're getting stronger every day. You can expect to see continued operational margin improvement as well as operational performance improvement in all of our metrics. We're not going to sit still. You sit still, you get passed by. That's not going to happen at this company.

<Operator >: Your next question comes from the line of David Vernon from Bernstein. Your line is open.

<Q – David Vernon >: Hey, John or Nadeem, could you give us a sense for how much liquidated damage is actually in the plan here for 2020. And then, as we think about may be crude volume either coming back or not coming back in 2021, one, what is that due to the setup for the contribution from that fee revenue that you're recording this year?

<A – John Brooks>: So, David, I'm not going to give a specific number on the liquidated damages. What I would say is I think what you've seen over the prior quarters, if we're not moving the crude by rail, you're going to continue to see that run rate and that move into 2021. Obviously, in 2021, there'll be some natural comparables given that we're collecting liquidated damages this year now. But also in that equation, David, don't forget, we've got the DRU that we expect to start up mid-year and that's going to be a significant opportunity for us as we look to the future. And in the bottom line is I know my competitor said this and we continue to say this, I'd much rather be moving that freight. So, our energy team is working close with all the crude shippers and looking for that window of opportunity and when it's going to be, so we can work with Mark Redd and his team to resource up, to be able to handle it in the back half in the year in early 2021.

<A – Nadeem Velani>: And David, I would just add, we don't see this as a one-time benefit. If we saw it as a one-time benefit, we wouldn't expect margin improvement year-over-year to continue.

<Operator >: Your next question comes from the line of Brian Ossenbeck from JPMorgan. Please go ahead.

<Q – Brian Ossenbeck >: Hey, good morning. Thanks for taking the question. Just a quick one on crews. Given that outlook for the back half of the year and on the volume on the train size and weight, can you give us some expectation for how you see bringing back crews from furlough? I know you don't do those lightly. So also curious to see what the availability and the call back has been, given that you and the rest of the industry were pretty flexible, making sure folks are taken care of and in exchange, you're able to get some shorter call back times. So, just some thoughts on the crew outlook and the recall rate in the back half of the year. Thank you.

<A – Keith Creel>: Let me – the crew outlook overall, we ended up I think at the peak. We were about system-wide. This is Canada and US. Unfortunately, we had about 1,200 running trains' employees that were furloughed. We've called some of those back obviously. We'll do that in lockstep. It depends where the business is. But if I just sort of bottom-lined it, if we're going to be down mid-single digits, you should expect the same on a head count standpoint at the end of the year. We'll retain some of this productivity. Obviously, we're not going to call any one back we don't need, but we're working to increase and drive business to this railroad so we can get our employees back to work We hired them. They're part of our family. I take no pride and great responsibility in the fact that we need to get those folks back to work. And what we did I think again, unique to CP and appropriate for CP, we decided that the most important thing through this, is to stick by our employees. We have a responsibility to do as much as we possibly can to help mitigate this impact that this crisis has created for those that are laid off. So, I can't get into all the details, but I can tell you with each individual union, we've worked and created incentives whether it be a top up to their unemployment insurance or whether it be a mechanism to maintain their actual medical insurance that they otherwise wouldn't have. And in exchange for that, not only do we get increased commitment because our employees know we care about them, they've also committed to come back earlier than they would otherwise than their collective agreements have required. So, for instance in Canada, running trains employees the collector agreement gives them up to 15 days to come back, the largest percentage of those employees have committed in lockstep with those increased benefits that we've given them to come back in 72 hours. So, listen this is a partnership. We're in this thing together. What I'm most proud of in all honesty, you think about the culture in this company, you think about maybe some of the bridges that were burned and we've talked about this in the past and we didn't get everything right, we drove fast to our change to turn this company around and restore its financial strength through the first four years of our turnaround. But the last three years as much as we've been focused on growth, we've been focused on rebuilding relationships, and I can tell you this crisis has brought our employee base together. We have relationships and established relationships and trust with our union leaders, with our employees

that quite frankly in my 28 years of railroading, I've never, never seen the depth and the respect and the pride and the levels of growth that we came in that space. Now, we're not done, and again, we're not perfect and there's still a lot more we have to do. But rest assured, if you go out now in our property and you talk to our employees the efforts that we have gone to protect their lives as they protect the livelihood for their families and the communities we operate in and through, we've spared no expense, we spared no effort, we're in this with them and they're in it with us. So, we're going to respond. The business comes back, our people are ready to go work, and I'm ready to get them back as quickly as we can. Our customers will see no different. We're going to do what we said we're going to do. We're going to produce for the customer. We're going to produce for the shareholder. And we're going to take care of our employees

<Operator >: Your next question comes from the line of Justin Long from Stephens. Please go ahead.

<Q – Justin Long >: Thanks. Good morning and congrats on the quarter.

<A – Keith Creel>: Thank you.

<Q – Justin Long >: So, I wanted to ask about incremental margins. If we go back to the investor day, you had talked about 75% incremental margins or so, but if we kind of look at the business pro forma for this year, given the cost outs that we've seen, some of which are structural, some of which are temporary, how should we be thinking about incremental margins now in a recovery scenario looking over a multi-year period?

<A – Nadeem Velani>: Sure. No, it's a good question, Justin. And I'd say when – it depends how quick the volumes come back and where the volumes come back and how we react. So, I think we're in a good spot to be able to absorb the volumes on the way up. As Keith mentioned, we've done a lot of unique things on the labor side. We have the assets in place. We've got a number of initiatives that will allow us to take on step function volumes as they come on, certainly, on the bulk side. As I've mentioned in the past, 75% incremental margins ex-depreciation, stock-based comp, and fuel surcharge, and I would stick with that today. And so, all else being equal, I don't see why that would change going forward.

<Operator >: Your next question comes from the line of Allison Landry from Credit Suisse. Please go ahead.

<Q – Allison Landry >: Thanks. Good morning. So, actually, it goes without saying that that the whole energy complex is under pressure but sounds like there is some interesting dynamics going on in the Bakken with the risk of pipeline shutdowns and capacity constraints. So, have you had any conversations with producers or intermediaries and do you think there's a potential opportunity to start moving crude out of the Bakken again to the extent that these dynamics play out? Thank you.

<A – John Brooks>: Yeah, Allison, I think certainly there is. Now as you know, the courts have stayed the shutdown of the DAPL, but the customers I would say are generally pretty active in those discussions. We are moving some volumes out of the Bakken right now that we expect to continue to move through Q3 and into Q4. And then I would just say the dialogues ongoing in terms of our ability to ramp those up any greater. I would also just say, we don't have a lot built into our second half plan at all as it relates to frac sand either. But if there is one area that I have seen a little bit of green shoot in terms of some movements over the last few weeks is our frac sand into the Bakken region. So, they're both watch areas that aren't built in but certainly could present some upside

<Operator >: Your next question comes from the line of David Zazula from Barclays. Please go ahead.

<Q – David Zazula >: Hi, thanks for taking my questions. Nadeem, I know you touched on a little earlier but maybe for John, just talk a little bit about how you contrast the intermodal or consumer versus industrial end markets, and then how that might play into either a gross dollar CapEx change given the strength in the consumer we've seen and/or a change in the composition of how you're thinking about capital moving forward?

<A – John Brooks>: Well, I'll let Nadeem comment on the latter. Look, the consumer markets generally are fairly strong right now as I said with the bounce back of retail and our movement of our refrigerated products, essential goods, the reduction of the blank sailings that we spoke to. I think we remain pretty optimistic on that recovery through Q3 and into Q4. The industrial market, I would say across the board, are certainly a little slower to recovery, to recover. We'll see our steel and well, frankly, the building products actually have been pretty strong driven by the DIY sort of movement that this pandemic has created. But those industrial sides I would say are certainly a little slower and it's going to be a gradual recovery as we move through the year.

<A – Nadeem Velani>: I would say, our capital outlook hasn't changed from what we've talked about before. If anything, we probably pulled forward given capital efficiency some of our 2022, 2020, even some bit of 2021 capital into 2020. And so, if anything we've talked about, once we get through the hopper car investment that's a pretty significant investment for us, CAD $600 million with 5,900 cars, and so as we finish that over the next call it two years, you'll see our CapEx moderate closer to that CAD $1.5 billion to CAD $1.45 billion, so it's a bit heightened as we speak today but for good reason.

<Operator>: We are out of time, and I will turn the call back over to Mr. Keith Creel.

Keith Creel

Okay. Well, listen, thank you for your time today. Listen, if you took anything away from this call other than the outstanding results, should be a conviction about what PSR is to this company. It's woven in our DNA. It's something we live and breathe every day. It's unique. It's a model that works that we're dedicated to. It's producing these results. This is a team that's not afraid to set targets. We work to meet them. We exceed what we say we're going to do. We pivoted to grow three years ago. We said then what we were going to do. We said then how we are going to take our unique network and create innovative solutions for our customers that drive growth, control at a low cost, it's going to drive earnings, and it's going to be sticky to this railroad. We've innovated. We've led the industry in the last several years in growth and we'll do the same this year. And we said line of sight to fully expect and be able to do that in 2021 to 2022. That's what you should expect from this team. It's a unique investment story. It's a unique story within the PSR world and we're proud of it. And we're proud that we're able to reward our shareholders that trust us to do that as we reward our employees and as we reward our customers that partner with us. It's a responsibility we take seriously and you should fully expect that we'll continue to do that. So, thank you for your time. Everyone, stay healthy and we look forward to sharing our third quarter results when the time is appropriate. Take care.

<Operator>: This concludes today's conference call. You may now disconnect.