Transcript

Q1 2022 Earnings Call

April 27, 2022

Canadian Pacific 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 & Pensions

Kansas City Southern Corporate Participants:
Patrick Ottensmeyer – President & Chief Executive Officer
Michael Upchurch – EVP & Chief Financial Officer

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon. My name is Leo, and I'll be your conference operator today. At this time, I would like to welcome everyone to Canadian Pacific's First Quarter 2022 Conference Call. The slides accompanying today's call are available at investor.cpr.ca. [Operator Instructions]

I would now like to introduce Maeghan Albiston, Vice President, Capital Markets, to begin the conference.

Maeghan Albiston

Thank you, Leo. Good afternoon, everyone, and thank you for joining us today. Before we begin, I want to remind you that this presentation contains forward-looking information, and actual results may differ materially. The risks, uncertainties and other factors that could influence actual results are described on Slide 2, in the press release and in our MD&A filed with Canadian and U.S. regulators. This presentation also contains non-GAAP measures, which are outlined on Slide 3.

With me here today is Keith Creel, our President and Chief Executive Officer; Nadeem Velani, Executive Vice President and Chief Financial Officer; and John Brooks, Executive Vice President and Chief Marketing Officer. Also attending our call today on behalf of KCS, are CEO, Pat Ottensmeyer; and CFO, Mike Upchurch, who will be happy to answer any questions regarding KCS.

As CP investors are aware, KCS is now beneficially owned by CP through a voting trust, pending control approval by the STB. During this trust period and prior to the STB approving CP's control of KCS, CP and KCS operate independently and KCS' business is managed by its own officers and is overseen by its own Board of Directors. During this trust period, truly KCS' management is in the best position to answer investor questions regarding their performance and results.

I would highlight that KCS has also posted an information package to their website. And should you have any questions about their performance that aren't addressed on today's call, Ashley and Daniel on KCS' IR team would be pleased to answer your questions. The formal remarks today will be followed by Q&A. And in the interest of time, we'd appreciate if you could limit your questions to one. It's now my pleasure to introduce President and CEO, Mr. Keith Creel.

Keith Creel

Thanks, Maeghan. Good afternoon, and welcome, everyone, joining us on our first quarter earnings call. Let's not be remiss not to start thanking the 12,000 strong CP family that endured quite a challenging quarter. It's been one for the ages. In fact, all of the uncontrollable challenges that we had relative to the weather, which was a huge challenge. And obviously, this COVID Omicron spike, this company spiked up, we moved up to about 500 employees that had to face the Omicron challenge during the quarter, which obviously had an adverse impact to our network velocity and then finally had a very unfortunate work stoppage. But in spite of all those challenges, the tenacity and the grit of this team, the commitment that we have to each other to provide service for our customers and serve all of our stakeholders was untapped out, never short of an opportunity to step into that and to meet and exceed those challenges.

So let me talk about the results a bit. The quarter delivered first quarter revenues of $1.8 billion and operating ratio of 69.8% and core EPS of $0.67. On the train accident front, we are encouraged that we reduced our reportable train accident frequency by another 25% in the quarter. On the safety front, when it comes to personal injuries, we did have a bit of slippage there at 13% versus last year, which is always a reminder to myself, the team and the company that safety, it's not a destination, it's a journey. We can

never lose sight of the importance of making sure that every member of our family go home safely every day. So it was a tough quarter.

I'm not here to make any excuses this team is not going to today. We knew that it would be challenging the first half,certainly bore out in Q1. Despite those challenges, our outlook on the year remains largely unchanged. We continue to see a very strong and supportive macro environment. We still expect to deliver double-digit RTM growth in the back half and ultimately grow RTMs in the year. So the point that we made earlier that this was going to be a year of tale of two halves is playing out as expected.

On the CP-KC transaction, the merger front, the preparation of the planning to ensure we execute our integration between these two great companies from day one continues. We were excited to announce during the quarter that we successfully launched our first interline service from Lazaro Cardenas to Chicago in early March with a seven-day transit time from the time the ship hit the port docks to the time the first container was deramped in Chicago and hit the payment seven days, a pretty compelling product to test the market. It was a demonstration of a significant opportunity, obviously, to bring an alternative to the congested West Coast ports for our customers and for our marketplace.

This is a product that works when it's congested. This is a product that works when it's uncongested. It's an undeniable compelling product that these two companies will be able to bring to the marketplace. CP-KCS represents extremely meaningful opportunity to take trucks off of our highways to leverage our fuel efficiency that we enjoy on the rail side versus truck and to contribute, obviously, to a low carbon future for North America, Canada and Mexico.

Also I want to tell you we're even more excited about the potential that this unlocks for the North American supply chain, which is becoming increasingly more important, the additional outlets for North American resources that, in fact, are increasing in demand. We've got three very resource-rich nations, creating a network to connect to ports. 11 of those ports that will uniquely serve and ultimately get our products to tidewater to like-minded countries around the world.

To say, we're excited, I would suggest is an understatement as we look forward to the opportunities ahead of us. Our customers are looking forward to us as well for the prospect of this great single line service from Mexico through to Canada, and I'll tell you we're excited and looking forward to the path forward. And on that point, I know that many of you are following the STB process closely. Obviously, we all know the procedural schedule has been paused right now as we've been asked to clarify some of the data, which we have done.

We're certainly optimistic things will be restarted soon. I say that, and I'll remind folks as well, there's room in the overall schedule for the Board to take the time it needs to consider all the facts and the data. We do not see this materially delaying the combination. We still anticipate a ruling by the latest early 2023. So with that, let me hand it over to John to bring some color to the markets and Nadeem will close up before we open for questions, elaborating on the numbers.

John Brooks

All right. Thank you, Keith, and good afternoon, everyone. So as Keith mentioned, the first quarter certainly had its challenges. It was tough in the quarter to really build any momentum and rhythm despite what I would consider a very strong demand environment. But however, the CP team and the sales folks and the operating folks are experienced, I can tell you we stayed focused on the task at hand, selling to the value of our franchise.

And as now we come out of the work stoppage that happened at the end of March, we are seeing definite momentum building as we move through April. So looking specifically at Q1, revenues were down 6% in the quarter, driven by the 14% decline in RTMs. Grain contributed about 7% of the decline in RTMs with

the strike contributing about another 3%. Fuel and FX combined to be a 6% tailwind and the pricing environment continues to be strong. I'm very pleased with the sales and marketing teams' discipline in the marketplace and creating that value for our product.

Overall, our cents per RTM was up 9% in the quarter. Now I'll take a closer look at our first quarter revenue performance. I'll speak to the results on a currency-adjusted basis. Grain volumes were down 26% in the quarter, where revenues were down 20%. We are continuing to see the impact of last year's drought in Canada, which resulted in a 40% smaller crop. That will continue to be a headwind before we get to the back half of the year and hopefully a more normal crop this fall.

The challenging Canadian crop was again partially offset by continued strength in our U.S. grain franchise, which posted a second consecutive record quarter. In Q1, we moved 14,000 carloads of U.S. grain into Canada compared to fewer than 600 in the same period last year. I'm very proud with the nimble actions of the marketing and sales team to create this market and the operating team to deliver and execute it as we provided help in -- with the Canadian farmers in feeding their cattle.

While still in the early days of the outlook for the new crop this fall, we are cautiously optimistic that we will be returning to a more normal crop size by the time we get to harvest.

On the potash front, volumes were down 4% in the quarter, while revenues were up 3%. The decrease in volume reflects the impact of our work stoppage, and we believe all those volumes are recoverable through the year.

Looking ahead, strong global ag product demand, combined with the disruption in potash production in Belarus and Russia, have driven potash prices and demand to record highs. CP's partnership with Canpotex and K+S positions us well to deliver record volumes of Canadian potash to the world markets. I expect double-digit full year growth in potash.

And to close out the bulk business, coal revenues were down 15%, while volumes were down 24%. As we move through Q2, we will begin lapping the routing shift in Teck's business. And I expect upside in coal as we move to the back half of the year.

Moving on to merchandise. The energy, chemicals, plastics portfolio saw a revenue decrease of 20%, while volumes were down 17%. Most of the decline in the volume was a result of crude by rail and the challenging start to the year. You will notice a slight decline in cents per RTM, which was driven by the expiry of our crude contracts and the associated liquidated damages.

Moving forward, I expect strengthening in ECP volumes driven by new business with Independent Energy and IPL, both ramping up the second half of the year and through our initiatives to continue to develop our distribution network for refined products, renewables and biofuels.

Forest products volumes were flat, while revenues were up 8%. I'm proud to say it was our second consecutive record quarter in the forest product space.

In MMC, revenues were up 14%, and volumes increased 1%, driven by continued strong pricing and demand for frac sand as we are seeing higher drilling activity moving in line with higher WTI prices.

Automotive revenues were down 16%, while volumes were down 21% on the quarter. While the supply chain continues to see equipment cycle and chip shortage challenges, we are expecting improved performance in Q2 and through the back half of the year.

The new GM business we announced in Q4 is moving well, and we are excited about a number of new opportunities that are emerging that will further support growth in the automotive sector across our network.

Now finally, moving on to the intermodal side of the business, quarterly volumes were flat, while revenue was up 13%, a second consecutive quarterly record.

As we announced on Monday, we are very pleased that Hapag Lloyd will be adding another weekly call at the port of Saint John as they continue to leverage our East Coast advantage. This service will drive significant new volumes from Northern Europe through the port and will exclusively use CP service to access markets across Canada and the U.S. We're excited about this opportunity to continue to grow our intermodal product from Atlantic Canada with our partners at DP World, The Port and NBSR. This is exactly what we said we would do when we purchased the CMQ. We've taken that property, we've leveraged our route advantages, we've created a superior service product, and we're using the capacity on our network from Saint John to grow with our customers.

If you shift to the domestic side of the business, this was our sixth straight record quarter. We are clicking on all cylinders, not only from an operating perspective, but also working with our customers to restock the store shelves across Canada. We are watching closely the changing demand in the truck market. We're watching the demand with our consumers and of course, the most recent COVID-related shutdowns in China. Despite some of this uncertainty, I expect our domestic intermodal demand levels to continue strong, and our volumes will be further supported through our playbook initiatives.

So now let me close by saying the first quarter was certainly tough sledding, but we have built the momentum as we moved through April, and I'm starting to see our revenue and volume reflect the demand environment.

As I sit here today, excluding Canadian grain, volumes are up mid-single digits quarter-to-date, and we have over $200 million annualized of new initiatives starting up over the coming months. We said at the start of the year, as Keith said, that it was going to be the tale of two halves, and that's exactly what I expect to play out. While the Canadian grain headwind will persist into Q3, we still expect to deliver double-digit RTM growth in the back half of the year and grow RTMs in 2022.

Let me close by saying the team is energized, we're staying close to our customers and we are adapting to the environment as we move ahead. So with that, I'll pass it over to Nadeem.

Nadeem Velani

Great. Thanks, John. Good afternoon. Going into the year, we did -- we knew Q1 would be a difficult given the weakness in Canadian grain, but the quarter proved even more challenging than we had anticipated. This is largely due to a combination of the ongoing COVID impacts to our crew availability, the weakness in Canadian grain, as I mentioned, as well as the impact of severe winter operating conditions in January and February. And of course, finally, the labor disruption we had late in March. That being said, as we've moved into April, we are encouraged by the strong demand that John highlighted and definitely a more fluid operating environment.

You'll notice in our results that we've added two additional non-GAAP metrics. These metrics have been added in effort to provide transparency and give investors meaningful comparative figures to evaluate our underlying operating performance. The additional metrics, core adjusted EPS and core adjusted income remove the impact of KCS purchase accounting. Going forward, our key focus will be on core EPS and core income. Post merger, we will publish core OR, which will remove any noise from the depreciation step up.

Now looking at Q1, overall, the adjusted operating ratio was 69.8%. Clearly, this isn't up to the CP standard. The main drivers on the quarter were the decline in volume, which added almost 500 basis points of OR year-over-year. The increased fuel prices on the quarter added 140 basis points and the strike added estimated 120 basis points.

Now taking a closer look at a few items on the expense side. Comp and benefits expense was up 2% or $8 million versus last year. The primary driver of the increase was higher stock-based comp in the quarter. Fuel expense increased $67 million or 33%, primarily as a result of higher fuel prices, which were up 46% on the quarter. Materials expense was up 3, 5 -- sorry, it was up 5% or $3 million as a result of cost inflation, largely in non-locomotive fuel.

Equipment rents were up 6% or $2 million as a result of winter weather and the work stoppage creating a drag on efficiency. Depreciation expense was $210 million, an increase of $8 million as a result of a higher asset base. Purchased services was $290 million, an increase of $49 million or 20% when adjusted for acquisition costs. The main driver of the increase is lapping the gain related to the Chicago Tollway transaction, which was $50 million in Q1 2021.

Moving below the line. The equity pickup from KCS was $251 million when adjusted for KCS' acquisition-related costs and purchase accounting. Other components of net periodic benefit recovery increased $6 million, reflecting higher discount rates compared to 2021. Net interest expense is up $50 million as a result of a higher debt load related to the KCS acquisition in Q4 2021. Income tax expense decreased $106 million or 55%. Excluding KCS-related items, the effective tax rate was 24.25% on the quarter.

Rounding out the income statement, core adjusted EPS was $0.67 in the quarter. We continue to generate strong free cash and along with a dividend from KCS we repaid over $500 million of term debt and finance leases during Q1.

We'll continue to utilize our cash flow, return our balance sheet to our targeted 2.5x leverage, at which point we'll revisit our capital allocation strategy. The quarter was certainly a challenge, but we expect to deliver a significantly stronger performance starting this April. The network has recovered from the challenges we faced in the first few months as well as the strike. As John mentioned, we continue to see a path forward to volume and revenue growth for the year, and I fully expect a much stronger margin performance with improvement in volumes and see a path to core EPS growth for the year.

With that, let me turn it back over to Keith and go into Q&A.

Keith Creel

Yes. Thanks, John and Nadeem. Operator, let's open up the line to questions.

Question & Answer

Operator

[Operator Instructions] We'll take our first question from Jon Chappell of Evercore ISI.

<Q – Jon Chappell>: Thank you, good afternoon everyone. John, you kind of laid out the mid-single-digit improvement in volumes April to date. Is there any other metrics you can give around the network as it relates to whether it's velocity, cars online, just to kind of help us understand that, the impact of the strike is completely over. The mainline is completely up, post the washout. There's no other issues whether it's related to weather or Omicron that you're running where you want to run or at least you're on your way there?

<A – Keith Creel>: Let me take that one. I'm going to let John focus on the revenue. I can tell you the railroad, the network overall is in really good shape. If we go back to January, actually, first six weeks of the year were extremely challenging with Level 3, Level 4 cold temperatures. And essentially, what that means is we run shorter trains to run safely, which means your operating costs are going to go up. It means your needs for assets, crews, locomotives is going to increase and all that happened at the same

time that we had Omicron surging. So we came out of that, and I can tell you, coming out of February into March, we were starting to gain a bit of rhythm then when the weather broke.

We are in really good shape overall as a network when we had to face the strike. And I say that, you can look at our metrics and our numbers since then because we bounced back quick. We restored service for our customers. We're at CP-like numbers now. Cars online are down. Train length is up at or above what it was last year. Train weight at or above what it was last year. In fact, both those metrics were above. Our cost per GTM on a crew basis, which we measure, back to a favorable place versus last year. So everything is normalized. It all says that the engine is running well, and you should expect the demand point under this network. We have the resources, we have the assets and we have the team to execute, and you're going to see more normalized and improving CP performance numbers.

<A – John Brooks>: I just might add, on the revenue front, I look at last week, in particular, versus, I want to say, I went back 40 weeks, and it was one of our best performing weeks we've had over that time period. And if you look at really our asset utilization of our fleet that we own, that services, our center-beams and our mill gonds and those types of sort of CP-owned assets, seeing that velocity pick up, we may able to create more loads in those revenue areas that's starting to shine through.

And as you guys know, that's what we've done, and that's how we are successful at CP and turning those assets and working our customers to maximize to generate those revenues.

<Q – Jon Chappell>: Got it. I appreciate all that. Thanks, John. Thank you, Keith.

<A – John Brooks>: Thank you.

<Operator >: Your next question comes from Fadi Chamoun of BMO.

<Q – Fadi Chamoun>: Good evening and thank you for taking the question. Keith, you've talked in the past about engaging with some of the other railroads in terms of maybe addressing some of the concern they've highlighted in their filings and perhaps finding some common ground to move this merger process forward. Is there an update that you can share with us on those conversations?

<A – Keith Creel>: Well, I'll tell you, we're keeping an open mind and an open line of communication, Fadi. There's a couple of positions, the CN's position obviously. We've always said we're willing to make reasonable agreements with reasonable folks, with reasonable arguments, that's not a reasonable argument. So I don't see any hope with that position to be able to come to any meeting of the minds. We'll just not to agree to disagree. We intend to grow that railroad, but certainly not going to divest that railroad.

And we think at the end of the day, those facts matter. They matter to the customer. I think they'll matter to the regulator. But obviously, the regulator will have to rule on that. When it comes to the NS, we've got -- we will, assuming that the STB approves this deal, and we believe they will. We're going to inherit a commitment, a joint venture that NS and KCS entered into back in 2006, and we're going to honor that, but that was a commercial discussion. A commercial relationship was established. We're going to honor what the contract says, but using the merger application to try to gain something that you didn't commercially negotiate is not something that we're interested in considering. So again, we think that's a very reasonable position to take, and we're going to maintain that position.

When it comes to UP and BNSF, obviously, some of their concerns happens to be around infrastructure. We believe that the infrastructure if used properly, in the Houston area specifically, is more than adequate for the level of business that we believe our synergies will bring. That said, should we exceed our synergies, should investment need to be made in cooperation and in partnership with BNSF and UP, there are mechanisms within those agreements now, those trackage rights agreements that allow for those investments to be had. So again, I think our position is reasonable, and I don't see that changing.

When it comes to the other CSX, overall, I think we're making some progress with CSX. I believe we're in a very reasonable place, and we're continuing to have very progressive discussions.

<Q – Fadi Chamoun>: Thank you.

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

<Q – Chris Wetherbee>: I was hoping maybe can you give us a little bit more clarity on what the strike was specifically in the quarter? And then I know you mentioned about core earnings going up, forgive me if I missed it. How do we think about the operating ratio for the core CP business this year? And maybe how quickly can it start moving back towards parity on a year-over-year basis?

<A – Nadeem Velani>: Sure. Thanks, Chris. So I mean, purchase accounting isn't going to impact the OR. So we just have our adjusted OR, not a core one. I think we're still going to have negative volumes in Q2. We're still seeing the impact of the drought. We'll probably run out of grain partway through the quarter and go into seeding in May. And so that's going to be a challenge.

That being said, I mean, I do expect a sub 60% OR in Q2 by all means. As we had in the back half of the year and assuming a more normal Canadian grain crop, and some of the significant opportunities that John highlighted, some of it just a return to a normal environment, but at the same time, some of the market share gains that we've had and some of the self help, we feel very good about the back half of the year and the operating leverage that comes with additional volumes. I think that's the key to how we're going to improve the OR is bringing on the volume at a low incremental cost.

So I'd say that in the back half of the year, you should expect a more kind of mid-50s OR that you've kind of come to expect from us. So that's kind of the cadence that we see the OR. As far as our earnings, yes, I expect us to have core EPS growth year-over-year. So that's kind of how it lines up for 2022. So we dug a hole here in Q1, but I have a huge amount of confidence, especially given how the network has recovered in April, how we're operating and the volumes and revenues that are coming back to the network and the significant demand environment that we have. So I'm pretty bullish for next 8 months.

<Q – Chris Wetherbee>: Got it. Thanks very much. Appreciate it.

<A – Nadeem Velani>: Thanks, Chris.

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

<Q – Walter Spracklin>: I just wanted to come back to Lazaro Cardenas. Keith, seven days, pretty compelling. Just curious as to whether there's a history when there's labor disruption in L.A. Long Beach going back a few years ago, I know the Canadian ports saw about a 13% lift in volume that was above normal due to some of that disruption and diversion.

Do you think that kind of -- do you see patterns in the past and opportunity here as you go toward this July date for some of that volume to shift to your new service? And how sticky would you see that? Would you be able to hold on to some of that diversion if it does come to pass?

<A – Keith Creel>: Yes. That's a great question, Walter. And I would say absolutely, yes. I see an opportunity once you get that service established and you make it reliable. And you make it reliable through the processes that have to be ironed out, obviously, customs processes, border crossing processes, then you follow that with investment. So you set the processes in place in lock step with investment. We're investing in the railway in line with our merger application process, and you create and unlock reliable capacity that, to me, stands the test of time.

It's never going to take all the business away from L.A. Long Beach, but I think it can complement and create a very reliable supply chain for a steamship customers that will be able to take product to market in

a very reliable, efficient fashion that, again, will diversify their book of business and make them not so dependent upon L.A. Long Beach and the ebbs and the flows of the challenges that occur on the West Coast. And I think it's there to stay once you establish it because it would be so compelling and hard to compete with.

<Q – Walter Spracklin>: Appreciate that color. Thanks. Thanks very much.

<A – Keith Creel>: Thank you.

<Operator >: Your next question comes from Tom Wadewitz of UBS. Please go ahead.

<Q – Tom Wadewitz>: I wanted to see if you could offer some thoughts on where customers maybe have the greatest opportunity for expansion when we think about the geopolitical, if you want to call it that, Russia-Ukraine, however you want to frame it? But a big step-up in commodity prices across a number of different markets. Which of those markets do you think that you serve customers? Where do you think those customers could expand? And maybe some thoughts on the timing for that? Just trying to think about the potential volume opportunity looking at it a little ways?

<A – John Brooks>: Yes, Tom. So you teed me up perfect on that one. So I spent last week touring essentially from Houston to New Orleans up to Baton Rouge with exactly what you described in mind. And I can tell you there is a, think about, as I said Belarus and Russia controlling 40% of the world's potash production. Canada, supplying right now, 40% of the world's potash production. Think about CPKC in the future and those export opportunities through the Gulf to service South America versus sort of the East Coast of Canada or even the West Coast of Canada, just lays out a compelling -- not only story in terms of diversification, enabling Canada's growth in potash for the future with Canpotex, K+S, maybe BHP in the future, but being able to do it on a single-line haul service to the Gulf of Mexico to service those markets, it's just that opportunity in itself jumps off the page.

But I can tell you, diversification from a grain perspective, the ability to backfill roughly 20-plus percent of the world's exports that come out of that Black Sea region and service by Ukraine and the Russian growing territory becomes, again, just a compelling story for our -- not only our Canadian franchise, but our U.S. franchise. And again, I think diversification of port, exactly what Keith described and what Lazaro brings to the table for our bulk business, I see tremendous opportunity. And that means, again, not only potash, but potentially grain and other products, our DRU today being able to get crude and safe crude products to tidewater, I think all lineup as huge opportunities for this combined network in the future.

<A – Keith Creel>: I'll give you a little snapshot, Tom. We took a look at this just to feed my interest, taking a look at the potash mines that are in Saskatchewan, that obviously would originate this potash to get it to market at tidewater in the Texas Gulf versus the East Coast, Canadian alternative. One way, depending on what mine you're talking about, minimum 240 miles line haul shorter up to 400-mile advantage. That's one way. Do that on a round trip. If you're a car hire owner, the capacity that's created with that single line service opportunity, from origin to destination, 1 railroad accountable, turning those assets in a closed loop, that's a needle mover, Tom.

<Q – Tom Wadewitz>: It certainly sounds that way. Is there anything on the crude by rail side? Would -- should we think of that as opportunity as well or not so much?

<A – Keith Creel>: Well, at this point, John can add a little bit of color. Obviously, it's all about the delta in the spread and the spreads driven by how much production and how much pipeline takeaway. Right now, production has not exceeded the pipeline takeaway capacity from the locations where the crude comes from. That said, as production comes back online and the demand increases, at some point, that's going to happen. And I think that puts us in a very strong position for normal crude movements, but outside of normal crude, we've created a niche market with this DRU. This

DRUs came up to name plate capacity we're running. It's doing what it said it will do. We were there last week. We took a look at it as well. John and I toured the facility down at Port Arthur. And it's expandable, it's scalable, it's ready to handle it. So it's just a little bit of work to get the infrastructure in ground to double the footprint. So again, I think that's a very compelling value opportunity for a niche market that we uniquely serve coming out of Hardisty going to the Texas Gulf.

<Q – Tom Wadewitz>: Great, thank you for the time.

<A – Keith Creel>: Thank you, Tom.

<Operator >: Your next question comes from Ken Hoexter of Bank of America. Your line is open.

<Q – Ken Hoexter>: Keith, just to follow up on that last one. Is there anything left to -- John, I guess. Is there anything left to clean out of the ECP in terms of crude by rail that you had any legacy contracts that are going to expire just to see if volumes are going to anything further drop off? But I guess my bigger question is just now it seems like, I guess, PSR is kind of under attack in terms of a lot of different ways of whether it's still the right way to run the network or trouble growing other companies in the U.S., still having trouble growing once they've implemented it, is that just different ways of running it versus your experience, Keith?

I mean it seems like your ops have rebounded post-strike, mainline fires. So operationally, not at the same point of what we see in the U.S. Or is there something you -- do you need to hire more? Or anything that's left to get this back on track? Maybe just your bigger thoughts on that.

<A – Keith Creel>: Well, I think at a high level, Ken. PSR is not PSR. It's not in name alone. To clearly execute PSR in the good times and the bad times, you've got to understand what it is. So you don't go get it off a shelf and say this is what I'm going to call it. It's all about identifying, making a plan, a service plan because if you don't provide service to the customer, you're not accomplishing anything. And you do it by determining what the process should be. You create the service plan based on defined -- the service plan defines the assets you need, whether it's locomotives, whether it's people, whether it's cars.

And then the last piece that's critically important, you've got to have the infrastructure to be able to execute it. I don't care -- I go back to my CN days, I'll go back to my CP days, you don't just say I'm going to be a PSR railroad to run 10,000-foot trains. If you don't invest in the infrastructure, it takes to execute it because it's all based on being able to turn the assets. If you can't move the trains, that means get them over the line of row, get them in your terminal, keep the assembly line moving, it clogs up, it backs up and the outcome is not going to be low cost, it's not going to be a good service.

So it's a formula that has to be managed. It's not going to manage itself. It has to be done with a disciplined fashion, and you have to ensure that you've got your assets and lock step with what your demand is. So you've got to understand what you're putting on your railroad. You can't oversubscribe your railroad. You can't ask the physical assets can only do so much. You've got to plan and build the service design around what your physical plant is capable of handling, and it requires investment and it requires measuring and it requires the discipline to execute that. That's how you do it.

But it's -- again, to do it, it's easier said than done. You have to understand what you're doing, and it doesn't happen overnight. And I'm not going to suggest that the other roads and they are all at different forms of implementation. I can't figure this out because I'm telling you, PSR done right is the best way to run any business. It's effectively using assets to produce a consistent service that the customer values at a low cost so you can sustain the service, sustain investment and allow your customers to win in the marketplace. And that formula works in any business you want to apply it to.

The airlines, the train lines, the shipping lines, but again, it goes back to the service. And if you can't move the assets to create the capacity, you're not going to succeed at. So I'm not -- I understand

customers' concerns. It's my position in this company. We get this, we understand this, we've shown that. We're beyond trying to implement this. We're executing it day in and day out. And again, it doesn't just happen. It takes focused disciplined execution, and that's what we're going to stay committed to.

We're not going to oversubscribe our network. We're not going to ask the network or the assets to do more than what they're equipped to be able to handle. And if you do that and you balance that, then you're going to come out with a great product for the customer. And as a result of that, it's going to naturally be low cost, and it's going to be sustainable that allows you to continue to invest and to grow.

<Q – Ken Hoexter>: And then just, John, thoughts on the ECP. Anything just left on there to cut out? I appreciate those thoughts. That's obviously detailed and informative compared to the difference of what we're seeing out there.

<A – John Brooks>: Ken, I think we've -- in terms of crude by rail within the ECP, I think we've settled into sort of a pretty stable state in terms of those volumes. I'd say 40,000, 45,000 is sort of my projection in terms of carloads in the crude space for the year. So I think that's a pretty similar run rate to what we saw in Q1.

About half of that volume is -- or a little over half actually is the DRU. And relative to the liquidated damages in that, I think you should expect to sort of see that trend play out through the balance of this year. As those contracts served us right, they were put in place for all the right reasons to protect our investment, protect our capacity. And so we'll see a little bit of that headwind continue out through the balance of this year. And then it will run its course, we'll be, I guess, free and clear as we move into 2023.

<Q – Ken Hoexter>: Thanks Keith, thanks John.

<A – Keith Creel>: Thanks Ken.

<Operator >: Your next question comes from Scott Group of Wolfe Research. Your line is open.

<Q – Scott Group>: Hey, thanks. Afternoon guys. I just want to focus on a couple of things on the revenue side. So John, the price/mix/other was plus 2%. Is that just the LD headwind you were just talking about? Does that 2% get better as the year goes on. And then if the KCS guys are on, any update on the energy reform business? It was down bunch. Any signs of that business bottoming at all?

<A – John Brooks>: Yes. So Scott, that was reflective of that headwind there. You know what, I expect, obviously, you're going to see sort of the fuel surcharge level out a little bit, that tailwind level out as you move through the year. I expect pricing to continue to be very strong. Our renewals are hitting 6% plus. And my expectations sort of remain that way as I look out the balance of the year. We're definitely going to have to balance that out against maybe some slightly negative mix and these LD headwinds that I've spoken to.

<A – Michael Upchurch>: Scott, this is Mike Upchurch. I'll take that question on refined product. I think, as everybody knows, it's been a challenging environment for us since mid-year 2021 when the government took some incremental actions to pull back on some permits that were available, increased inspections of product that some shippers were shipping into Mexico and mislabeling to take advantage of not having to pay excise taxes.

And accordingly, you can see in the quarter, we had an almost 70% decline in that business. Still delivered, I think, really solid results across the rest of the business. We are seeing a little encouragement from the government here with some facilities that have been shut down, that are beginning to get their permits back for transload capabilities. So that is a good sign for us.

The macro environment really isn't a lot changed from what we've seen in the past where roughly 60% of the demand is still into Mexico. It just happens to be with rail terminals shut down that's now moving by truck and marine. So we're encouraged by some of the facilities reopening here. And we'll just have to see how that rebounds. We've been pretty conservative in our forecasting of that particular business. But the rest of our segments performed incredibly well.

<Q – Scott Group>: Mike, since you're on, any just high-level thoughts on revenue growth, margin improvement for the year that you can share?

<A – Michael Upchurch>: Well, we haven't provided any official guidance. But if you look across our business in the first quarter, Scott, whether it's industrial and consumer up 20%; revenue, ag-min up 31%; energy up 25%; intermodal up 18%; automotive up 23%. We've got a pretty solid demand taking place in our business, providing good service. We would expect that to continue. I would say it's a challenging environment to predict right now with all the macro issues. But we're pretty encouraged by what we're seeing and what we hear from our customers. Overall, we do expect that we would see OR improvement on a year-over-year basis, but I won't go into quarterly details there.

<Q – Scott Group>: Thank you guys, appreciate it.

<A – Keith Creel>: Thanks Scott.

<Operator >: Your next question comes from Konark Gupta of Scotiabank. Please go ahead.

<Q – Konark Gupta>: Good afternoon and thanks for taking my question. So I just wanted to go back to the STB approval process for KCS transaction. Keith, I wanted to ask you, was there anything in demands made by Class Is that you think is necessary to get STB's approval and that would either require you to make incremental investments or that might eat some of the cushion you have in the synergy targets?

<A – Keith Creel>: None that I'm aware of, no.

<Q – Konark Gupta>: Okay thank you.

<A – Keith Creel>: Thank you.

<Operator >: Your next question comes from Brandon Oglenski of Barclays. Please go ahead

<Q – Brandon Oglenski>: Hey. Good afternoon everyone and thanks for taking the question. Nadeem, can I come back to your earlier comments. I think your response to another question, I think you said getting back to like a 55% OR in the back half of the year, is that correct? And can you just give us maybe some more specific guidance on some of these cost items? I know purchased services was quite high this quarter, but what's the right level to be thinking going forward?

<A – Nadeem Velani>: Yes. No, it's correct, kind of mid-50s level in Q3 and Q4, confident about that. And as far as Purchased services, we're looking kind of in that $280 million to $290 million a quarter, excluding KCS transaction costs. It's probably a good run rate. So some of that, like I said, we had year-over-year the impact of the $50 million from the Chicago Tollway land acquisition or land sale that was part of a credit to purchase services.

So year-over-year, that's what's the big drag there. But the other consideration is Purchased services is kind of where a lot of the inflationary expense costs kind of come through. So that's why I'd say $280 million to $290 million is a good run rate.

<Q – Brandon Oglenski>: Alright, thank you.

<A – Nadeem Velani>: Thanks, Brandon.

<Operator >: Your next question comes from Jason Seidl of Cowen.

<Q – Jason Seidl>: Thank you Operator. Keith and team, thanks for taking the time. Wanted to get back a little bit to the Lazaro moves sort of 7 days into Chicago. One, what type of demand do you envision for this product if you guys can keep it consistent at 7 days? And do you think that you could also sort of run trains since you mentioned it over the Meridian Speedway into the Southeast from Lazaro, sort of giving it that Mexico to the sort of the fastest-growing population in The U.S.?

<A – John Brooks>: Yes. So look, I look at this very similar to our -- sort of our bellwether east-west trains that we run across Canada, Jason. It will start with a train today, and we'll build that volume from there. And I can tell you, Keith spoke to the opportunity that we ran. That's going to be an ongoing opportunity. That is now building upon itself, and we're going to see a regular movement there. And I can tell you, I can't name a name at this point. We've got another major steamship line that's testing that product this week actually.

So I'm confident we're gaining traction there. And again, it's not intended to replace that. It's really a complement to a West Coast access. It's about diversification. It's about solidifying some of these supply chains. And the fact that we can prove it on an interline basis only makes us, I think, more confident that as we put together with the STB approvals, this product, we can be successful.

And I could tell you, I did -- Keith spoke a little bit about the Meridian Speedway and that with the NS. I've been over that railroad, and it's a great product. I am increasingly excited in talking to all shippers in not only the international but domestic and auto and others around that route and the potential to hit that Eastern U.S. market, and frankly, both directions and linking it to Mexico.

So I can tell you, in terms of the intermodal space, it gets a lot of fan fare relative to this KC-CP opportunity, but it should. These are routes that are going to add, I think, unparalleled competition and more options that the shippers have than today.

<A – Keith Creel>: Yes, Jason, I was just going to say it's kind of eye opening to me, I grew up in the South. To be back down on that railroad, we took a trip across there, Meridian to Dallas. Think about the growth that's occurred, think about the trucks that are on that highway. And I think about our environment, it's not running down the railway and I see the capacity and the great service that KCS and NS has created on that Speedway and into Dallas. Literally seeing I-20, not far away, got me really excited about taking more of those trucks out that interstate and put them on that railroad. I think it's a compelling opportunity that this nation needs and that this railroad uniquely will be able to provide a solution to.

<Q – Jason Seidl>: Thanks for that colour Keith. How should we think about the yield on that intermodal on Lazaro to Chicago compared to maybe the average yield?

<A – John Brooks>: It's a little early to tell. Obviously, I'm only seeing half -- it's an interline movement. But Jason, I think I would ask you to sort of rest back on our principles of how we sell and approach our capacity and our customers in the marketplace. We're not going to be doing it for practice, I can assure you that.

<A – Keith Creel>: Yes. We're going to earn-in cost of capital, Jason, so we can continue to invest in the infrastructure and create a product that is not going to be easily defeated when it comes to competition, a great product at a low cost and it's a reliable service, again, that these 3 countries need that this combination uniquely will be able to unlock and create. It's very compelling. We see the compelling value not just to the railway but obviously to the shipper and to the nation.

<Q – Jason Seidl>: It's going to be interesting to see if you guys can unlock sort of one of the original dreams of what Lazaro was when it was created. So I appreciate the time as always.

<A – Keith Creel>: We certainly intend to do that.

<Operator >: Your next question comes from Benoit Poirier of Desjardins Bank. Please go ahead

<Q – Benoit Poirier >: Thank you very much and good afternoon everyone. Just to come back on your single-line service from Lazaro Cardenas to Chicago, how much does it represent or is included in the $1 billion of synergies that you've talked about? And I was curious also to learn more about your ability to add up more vessel in Saint John on top of the recent contract that you just announced with Hapag Lloyd.

<A – John Brooks>: Yes. So Benoit, I think in the intermodal side and I'm not going to drill down to specifics to relative to Lazaro to Chicago. But I want to say we had a couple of hundred million dollars tagged to our intermodal product. And again, basis what I've seen basis the enthusiasm from the steamship lines, the wholesale community, the retailers, quite comfortable in our ability to not only achieve and exceed as we build that product.

I could tell you, and I'm glad you brought up the Hapag Lloyd and Saint John opportunity. It's just a tremendous proof point of a $40 million revenue railroad that I see line of sight that now will exceed $200 million in a short 2-year time period. We have the marketing and sales team in combination with our operating, and our partners in Saint John have, for lack of a better way to say it, hit it out of the park with that acquisition and our entry into Atlantic Canada.

I can tell you that business alone is going to double the size of our train pair that moves between Saint John and Montreal. And the neat thing about that is if you begin to think about the power of that density on that line and what it does to the average cost per unit, what it does to the margin and that lane becomes quite powerful and frankly, only makes us more competitive on a route that we already have a 200-mile advantage against our competitor in that lane.

So this opportunity, I can't say it enough, is a big deal. It just strengthens our partnership with Hapag Lloyd. And it's another way for Eastern European producers to service not only Canada but the upper Midwest of the United States.

<Q – Benoit Poirier >: That’s great colour John, thank you.

<A – John Brooks>: Yep

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

<Q – Brian Ossenbeck>: Hey, good afternoon. Thanks for taking the question. So John, can you maybe expand a little bit on that $200 million of annualized revenue you have starting up in the back half of this year? I think you also mentioned there's some potential coal upside in there. So some more details on that would be helpful.

And then I don't know if you can answer this one. But STB just announced an updated schedule in terms of resubmitting the data for the acquisition, May 27 is when they expect it now. So just big picture, does that kind of still keep you on track for the time line you were talking about earlier?

<A – Keith Creel>: Yes. Let me take that, and I'll let John provide the colour on the revenue. The answer is yes. We still see an ability to get to a decision by the STB certainly within the regulatory time frame no later than February 23.

<A – John Brooks>: Yes. So Brian, on the revenue, sort of here's how it builds up. I guess, first of all, on the coal opportunity, I think we're going to begin to lap well, number one, some easier comps. We're going to begin to lap as that route switched as part of it is moving with our competitor. But also demand for Teck’s coal is very, very strong. And the -- last I saw, I think we we're looking at the potential for an additional 1 million tons roughly in 2022 versus 2021. So certainly upside there.

I can tell you just staying on the bulk potash opportunity is even bigger than that, 1 million, 1.5 million metric tons year-over-year in terms of opportunity. And certainly, we're going to get our big share of that with Canpotex and K+S. If you think about that $200 million, maybe simply think about it like this, 40% of that is new business that is starting up with IPL and Independent Energy and into the Toronto market for refined fuels. So it's ECP business.

And then the bulk of that opportunity really centers on the intermodal business. And that being the Hapag-Lloyd business we spoke to and some other opportunities, I can't speak to yet, but we're pretty excited about that are going to be joining in CP.

<Q – Brian Ossenbeck>: Alright thank you very much. Appreciate it

<A – Keith Creel>: Thank you.

<Operator >: Your next question comes from Steve Hansen of Raymond James. Please go ahead.

<Q – Steve Hansen >: John, just a quick question on the potash cadence. The markets are acutely tight as you described. Nutrien, Mosaic, have already announced augmented production to backfill some loss supply. But we really haven't seen the potash volumes move much at all yet. I'm looking at the weekly cadence. Has there been any restrictions beyond the weather, I guess, in Q1 and some of the COVID sort of curtailments that you've had? I'm just trying to understand the cadence there of how that ramps up and what restrictions have been thus far.

<A – John Brooks>: It's a good call out, Steve. It's been frustrating. I can tell you, it's been frustrating for Canpotex also. And we fully expect that ramp up now. And I think we have seen a little bit of improvement here in the last couple of weeks. I can tell you we're struggling a little bit on our Portland movement right now just with some of the off-roads struggling on cycles. That's held us back a little bit in that corridor.

So I think certainly a few hundred thousand tons over the last 3 weeks haven't moved in that corridor that we had fully expected. But I can tell you, there's no lack of desire from certainly Canpotex or K+S' perspective. I think we are in great position, CP, to be able to handle the volume. And I can tell you there's ongoing investment being made by those – both those shippers and equipment to be able to work with us and fill that demand as we move through the year.

<Operator >: We have reached our allotted time for question and answer. I would now like to turn the call back over to Mr. Keith Creel.

<A – Keith Creel>: Okay. Thanks, everyone, for joining us this afternoon. Let me close by saying, hopefully, you take away the sense there is an undeniable momentum moving forward at this company. We're excited about, I would call them industry unique opportunities ahead of us with our line of sight for our CP stand-alone opportunities and certainly the promise of a combined CPKC network, the future looks very bright, unique and exciting for this organization.

We're looking towards the future ahead with great optimism. We're going to continue to grow more confident and excited about the transformational possibilities that lie ahead. We look forward to sharing the evolving chapters of that on our next call as well as a much different outcome on our results given the demand and the operating condition of this network when we talk together again. Have a safe day.

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