Transcript

Q2 2022 Earnings Call

July 28, 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 – VP Capital Markets

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. My name is Stephanie, and I'll be your conference operator today. At this time, I'd like to welcome everyone to Canadian Pacific's Second Quarter 2022 Conference Call. The slides accompanying today's call are available at investor.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 like to now introduce Maeghan Albiston, Vice President, Capital Markets, to begin the conference.

Maeghan Albiston

Thank you, Stephanie. Good morning, 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 the MD&A that are 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 Chief Executive Officer; Nadeem Velani, Chief Financial Officer; and John Brooks, Chief Marketing Officer. The formal remarks will be followed by Q&A and, in the interest of time, we appreciate if you could limit your questions to one.

With that, it's now my pleasure to introduce our President and CEO, Mr. Keith Creel.

Keith Creel

Thanks, Maeghan. Good morning, and thank you for everyone joining us today. Let me start off as I always do, thanking our entire CP family. I can tell you after a very challenging first quarter, I'm extremely proud of the resilience and the tenacity this team's demonstrated delivering these results over this second quarter of the year.

During the quarter, we produced second quarter revenues of CAD 2.2 billion, an operating ratio of 59.7%, and core EPS of CAD 0.95. As we expected with a more normal operating environment, the team delivered strong sequential improvement. A number of the metrics that drove the financial performance, we had sequential improvement Q1 to Q2 of 16% on locomotive productivity, car miles per day improved 15%, dwell improved 13%. Also, I'm very excited about the self-help business initiatives that continue to be accomplished by the marketing team, with some exciting developments on the customer front, new business announcements, and even a port expansion which John will get into more detail in his comments.

On the CPKC front, positive momentum continues toward our transformational merger. Last week, as many of you are aware, the STB announced dates for the public hearings. Going to be late September as we continue toward an early 2023 decision date. Customer feedback continues to be overwhelming. We continue to run test shipments on an interline basis in intermodal, grain, and metals, and continue to have very progressive and exciting exploratory discussions about new opportunities in export potash.

Another key development we're super excited about, announcement by the KCS. They successfully negotiated 10-year extension to the exclusivity rights. My hats off to Pat, Oscar, and the KCS team for this tremendous outcome. And again, the momentum continues as we do our planning to hit the ground running and exceed expectations for all stakeholders. So, we're in a good spot. We continue to gain ground and look forward to realizing the vision of that transformational merger as we march toward the

first part of 2023.

Now, looking at the back half of the year, from a demand standpoint, we continue to build momentum on the CP network. The upcoming grain harvest is looking better every day. The demand environment continues to be strong. We're resourced to deliver crews, locomotives, cars. We still expect to deliver double-digit RTM growth in the back half and ultimately grow RTMs and earnings for the year. With that said, let me hand it over to John to provide some color on the markets before he turns it over to Nadeem to elaborate on the numbers.

John Brooks

All right. Thank you, Keith, and good morning, everyone. So, let me start by saying and reiterating what Keith said. I'm very pleased with how Q2 played out. Looking at the results, revenues were up 7% on the quarter. Fuel and FX combined to be a significant 10% tailwind offsetting the 2% RTM headwind. Excluding the headwind from Canadian grain in the quarter, RTMs were up high single-digits during the quarter. The pricing environment continues to be very strong with inflation-plus renewals that actually are continuing to accelerate as we move into the second half of the year.

Now, taking a closer look at the second quarter revenue performance, I'll speak to the results on a currencyadjusted basis. Grain volumes were down 23% on the quarter while revenues were down 18%. As the current crop year comes to a close, we'll continue to see the headwinds from the 40% smaller Canadian grain crop until this year's harvest starts to come off the fields. We continue to offset some of that challenging conditions in Canadian grain with another strong performance in our US grain franchise which posted a third consecutive record quarter.

Now looking ahead, there's still a few months yet before the new crop is harvested, but the growing conditions have improved across all of the Prairies. Current expectations are for a crop above 70 million metric tons, which is in line or if not a little better than historical averages. With delayed seeding in Q2 from too much moisture in some areas, we expect harvest to be later than normal which could push grain volumes into Q4 or actually into 2023. Finally, we received positive news that regulated grain revenues will increase by 12.7% for the 2022-2023 crop year that starts August 1.

On the potash front, volumes were up 10% in the quarter while revenues were up 26%. We continue to see strong global demand for ag nutrients with the ongoing disruptions in potash supply from Belarus and Russia. We expect Canadian potash to remain a growth driver at CP.

Looking ahead, we see a strong likelihood for Canadian producers to continue to accelerate growth capacity and expansions to fill this growing need of potash supply. The increased demand for Canadian potash is creating great opportunities for the potential to move volumes south to new export outlets to reach the growing South American markets.

And to close out our bulk business, coal revenues were down 4% while volumes were down 14%.

Now, moving on to the merchandise side of our business, the energy, chemicals and plastics portfolio saw revenues decrease 10% while volumes were up 3%. Now excluding crude, core ECP commodities delivered record Q2 results. Now looking ahead, you can expect ECP volumes to perform well driven by new business with Independent Energy and IPL both in the process of ramping up and will continue through the second half of the year.

Forest products volumes were up 1% while revenues were up 12%. And in MMC, revenues were up 23% while volumes increased 10%, setting an all-time quarterly record driven by continued strong pricing and demand for frac sand as we see higher drilling activity continue as we also see higher WTI prices. Our sand producers are well-positioned on our network to meet this increased demand, and we are working closely with our operating team and customers to increase our train lengths to maximize our capacity and the potential in these markets.

Automotive revenues were up 19% while volumes were up 4% in the quarter. We saw a sequential improvement in Q2 and we expect continued improvement in the back half of the year. The growth we are seeing in automotive is driven by ongoing industry replenishment and self-help initiatives, including our new GM business that started up earlier this year.

Now finally on the intermodal side, quarterly volumes were up 14% while revenues were up 28%, a third consecutive record and an all-time best quarter for RTMs, beating the previous record by 13%. New Hapag-Lloyd call at the Port of St. John began at the end of May and we are seeing strong demand for this service. The Port of Saintt John, in collaboration with CP and other stakeholders, were successful in securing additional federal and provincial funding to move the port from a 300,000 TEU capacity to 800,000 TEU capacity.

When we purchased the CMQ, just taking you back, we talked about growing this business from CAD 40 million to CAD 100 million in 24 months. As we look at it today, we're on pace to do over CAD 200 million in new annual revenues over that railroad. In Q2, we also announced new market share gains with CMA that started up July 1. And just recently, we extended our strategic partnership with Yang Ming. We expect to deliver continued strength in the international intermodal space.

For domestic intermodal, this was our seventh straight record quarter and our best all-time performance for RTMs, carloads, and revenue. We expect our intermodal franchise to continue to produce strong results in the back half of the year driven by our service, strong pricing, and self-help initiatives.

So, let me close by saying with the new business that we brought on and a more normal Canadian grain crop just around the corner, I continue to be confident in the double-digit RTM growth in the back half of the year. The team is focused on executing our playbooks, continuing to sell and price to the value of our servicing capacity because that's what we do. We are staying close to our customers and our operating team to ensure we are working closely to navigate any rapid change in demand.

Now finally, I continue to be extremely pleased with the support from our customers and the volume of opportunities as we look to open new markets across North America with our proposed CPKC merger. With that, I'll pass it over to Nadeem.

Nadeem Velani

Great. Thanks, John, and good morning. I'm extremely proud of the dedication the team displayed to produce these quarterly results. I said back in January we expected to deliver a strong Q2, which we did. And as we stand here today, the balance of the year looks extremely bright. We're building off this momentum in our expectation of double-digit RTMs in the back half to achieve volume and earnings growth on the year.

Now looking at the quarter, the adjusted operating ratio came in at 59.7%, more than a 1,000-basis point improvement sequentially. I'm very proud of how the team controlled costs and managed the railroad in spite of rising fuel prices and the continued headwind from grain. Taking a closer look at a few items on the expense side, I will speak to the variances on an FX-adjusted basis.

Comp and benefits expense was down 9% or CAD 35 million versus last year. The primary driver of the decrease was lower stock-based comp in the quarter. You'll see average head count on the quarter was up sequentially by about 6%. You'll see another step-up in Q3 as we continue to bring on resources to support back half volume growth.

Fuel expense increased CAD 146 million or 65% primarily as a result of higher fuel prices which were up 68% on the quarter. Increased fuel prices on the quarter added 220 basis points to the OR.

Materials expense was up 15% or CAD 8 million as a result of cost inflation, largely in non-locomotive fuel. Depreciation expense was CAD 211 million, an increase of CAD 9 million excluding FX as a result of a higher asset base.

Purchased services was CAD 294 million, an increase of CAD 35 million or 14% when adjusted for acquisition costs. The main driver of the increase was cost inflation and higher casualty costs in the quarter.

Moving below the line, the equity pickup from KCS was CAD 261 million when adjusted for KCS's acquisition-related costs and purchase accounting. Other components of net periodic benefit recovery increased CAD 5 million, reflecting higher discount rates compared to 2021.

Net interest expense is up CAD 59 million versus last year as a result of a higher debt load related to the KCS acquisition in Q4 2021. And finally, income tax expense decreased CAD 25 million or 11% on an adjusted basis. Excluding KCS-related items, the effective tax rate was 24.25%. Rounding out the income statement, core adjusted EPS was CAD 0.95 in the quarter.

On the free cash side, KCS has notified us we'll be receiving another dividend shortly and we continue to repay debt. While interest rates have been volatile, I'll remind you that 100% of our term debt is fixed rate. And as we're focused on paying down debt to return to target leverage, we have no near-term financing requirements.

We continue to invest in the railroad and are in a good place from a capacity and resource perspective. We said at the start of the year 2022 is going to be a tale of two halves, and that's exactly how it's playing out. While there are headwinds from rising fuel prices, inflationary pressures, and a slight delay in the grain harvest as John mentioned, this team is well-positioned to continue to navigate and execute the plan.

We are well-positioned to carry this momentum forward and deliver a strong back half. And as I look ahead to 2023 and our transformational merger with Kansas City Southern, I only get more excited about the opportunities in front of us. We have a unique growth story in front of us with the team to execute it. With that, let me turn things back over to Keith before we answer some questions.

Keith Creel

All right. Thank you for those comments, Nadeem and John. Let's go and open up the line for questions, operator.

Question & Answer

<Operator >: Thank you. [Operator instructions] Your first question will come from Tom Wadewitz with UBS.

<Q – Tom Wadewitz>: Yeah. Good morning. Wanted to ask you a little bit about intermodal. I think we've seen some, I guess, evidence of some constraints or indication of some issues at Montreal and Toronto in, I guess, drayage and terminal – I don't know if terminal issues or warehouse issues. But wanted to see if you could comment on that, whether that said you'd expect any effect on your volume in second half? And then also, how would you think about US consumer weakness and how that might affect the outlook for your intermodal volumes in the next couple quarters? Thank you.

<A – John Brooks>: All right. Thanks, Tom. This is John. Couple thoughts on the congestion piece. Well, certainly, I can tell you at CP, we're moving record volumes both domestic and international intermodal. I think for the most part, our network has stayed resilient on that front. It's not that we haven't had some hotspots, whether it be at the ports or inland as you described. But for the most part, I'm quite pleased with how the operating team and our commercial team have navigated through that.

I can tell you, we're working closely with the ports. We're working closely with our customers to pull the levers we need to pull to ensure that fluidity. We've got a unique circumstance at our inland terminals

where we have strong levels of capacity, not only greenfield space but just general capacity in those intermodal facilities. So, we'll watch it closely. We'll continue to work. If we need to pull other levers, we will. But right now, I feel pretty good about our positioning.

Not like, and dissimilar that we saw over the last year, that intermodal space and particularly international intermodal has been choppy at times as we've navigated through COVID and certainly some of the challenges at the US ports or other ports, that sort of continues. So, that choppiness is still out there, but nothing I see tells me that we're not going to continue to deliver strong record results the back half of the year on the intermodal front.

Certainly, we're watching the news and hear all the reports and Walmart and others being pretty cautionary. We're talking to our retailers, our domestic team is talking to our retailers every day. And actually, I'm still quite optimistic. We see this year continuing to be strong in both of those books, domestic and international. And then we'll see, Tom, what plays out in 2023. But frankly, I'm still optimistic that at least the first part of that, we continue to see a tail on the strong demand that we're realizing right now.

<A – Keith Creel>: Yeah. I think the only thing I'd add, Tom, key point, key takeaway, our terminals, to John's point, we've had a little bit of choppiness at times but systemically no issues. We have capacity. We're not holding any freight at West Coast ports or East Coast ports to pace into our inland terminals. We have the capacity, we're open for business, and we're ready to generate the revenue for ourselves, our shareholders as well as for our customers.

<Q – Tom Wadewitz>: Great. Thank you.

<A – Keith Creel>: Thanks, Tom.

<Operator >: Thank you. Your next question comes from Fadi Chamoun with BMO Capital Markets.

<Q – Fadi Chamoun>: Yes, good morning. Thank you for taking the question. My question is on capacity as well. I mean, we've had almost five years now or even more of very strong growth, and I'm thinking about places especially on the western side of your network and Vancouver. With a strong pipeline for growth over the next two to three years, how are you thinking about capacity? Are you starting to feel the need to kind of look into capacity investments? Do you have the roadway to keep growing at the same pace that you have had in the last few years without making any big capacity investments?

<A – Keith Creel>: Yeah. The answer, the short answer to that and the absolute answer is yes, we do, Fadi. The last five years, if you look at the overall growth, we have grown better than the industry has. We've done better than others. But to me, it's still not an overwhelming amount of growth. And all along that period, we continue to spend money and invest in our infrastructure, extended sidings. We have a very robust planning process. We look at it from a three-year view, a one-year view, a six-month view. So, there's a very disciplined process that's truly fundamental, woven into the way a PSR railway works, should work where you plan ahead, you take a look at it lane-by-lane.

We clearly understand where our capacity opportunities are and we invest ahead. Just as we invest ahead of locomotives, we invest ahead in people sort of like a just-in-time approach. It's a very disciplined process but it's one that we've honed and we're very well-versed at executing, and it's how we navigate this railway day in and day out. So, I'm not concerned about oversubscribing this network. We're going to be a step ahead of that. And if we get to a point with capacity and demand that would cause us to have concern, we'll know ahead of time.

We'll plan for it and we'll be ready for it, much like I think about – I'll give you a case in point: that Maersk contract that we signed during the pandemic. That was a eight, nine-month planning process, part of that negotiation that we participated in. Myself and John met with Maersk and we said if we're going to do this,

we've got a responsibility to our existing customers. We do want to grow and we're going to grow with you, but we want to do what we say we're going to do. We're going to deliver for you as well as fulfill our commitments that we made previously to all customers. So, there was a very well-thought out executed capital investment plan that laid the groundwork to be able to onboard Maersk and grow with Maersk as we have since we implemented that very strategic contract win, and that's the approach we're going to take, we have taken and will continue to take, CP as well as the CPKC network pending the STB's approval of our transaction.

<A – Nadeem Velani>: And Fadi, the only thing I'd add is we – during the early part of COVID when volumes were down significantly, we did take advantage of the network being open in order to us to accelerate some of our capital investment and be more productive with what we're investing. So, that allowed us to do more with less and I think it's served us well.

<Q – Fadi Chamoun>: Thank you. Appreciate it.

<Operator >: Thank you. Our next question comes from Walter Spracklin with RBC Capital Markets.

<Q – Walter Spracklin>: Yeah. Thanks very much. Good morning, everyone. So, I want to go back to your point on intermodal. And I know in just some of the news here, 40 container ships sitting outside Savannah, obviously a lot of congestion in the US East, and your new option through Saint John and the CMQ looks like it's coming – couldn't come at a better time.

You mentioned you've gone up to 300,000 TEUs from certainly under 90,000 TEU and plans to go to 800,000 TEU. My question is could you be at 800,000 TEU sooner? In other words, is the demand there to use more than the 300,000 TEU you're using you've committed to right now? And is the limiting factor the capacity increase that you're looking to bring on and can that be pulled forward at all if that's the case? Or what's the earliest you see the full 800,000 TEU in capacity being realized in your new route through Saint. John?

<A – John Brooks>: No, good question, Walter. So look, the port is – the moment we received the funding, started the process. We're filling in some open water fingers that are really the first step of getting that dock space increased, and that is underway. They're working as fast as they can. There are some opportunities to incrementally step that up. We don't jump from 300,000 TEU to 800,000 TEU. We'll be able to do some of that work, and in 2023 we'll be able to take some step functions upward on that, Walter.

You're exactly right. I can tell you the Hapag-Lloyd original port of call service, the new service that started in May and even CMA's business that we brought on here in July, all those volumes are materializing at levels higher than I think us and the steamship lines expected. And I do believe that is a function of, look, these customers looking to diversify their books, the challenges on the US East Coast that you described.

And frankly, we've got a 200-plus mile shorter route into these markets, and it matters. And we've been able to in partnership with the NBSR and the port put together a really strong value proposition for these folks. So all that being said, to answer your question, yes, I do think there is some incremental steps and opportunities to grow that port in the meantime before we actually hit the 800,000 TEU mark.

<Q – Walter Spracklin>: Great color, John. Appreciate the time.

<A – John Brooks>: Yeah.

<Operator >: Thank you. Your next question comes from Jon Chappell with Evercore ISI.

<Q – Jon Chappell>: Hey, good morning. Nadeem, I wanted to ask you about head count and comp and benefits. And your head count on average in 2Q 2022 is roughly the same as 2Q 2021, but your comp

and benefits is down pretty meaningfully. So, kind of a two-part question. One, is there something kind of one-timey in the cost per employee in this past quarter? And B, as we think about how you're ramping up your resources over the next six months to meet this demand growth but ahead of the big transformational event next year, how should we think about the cadence of head count growth and cost per employee?

<A – Nadeem Velani>: Yeah. There's nothing necessarily one-time in nature in the quarter. There were some quarterly accruals that you have as far as incentive comp and the true-up of stock-based comp that we do each quarter, so there was some of that that occurred. Beyond that, if you think about what we've talked about which is double-digit volume growth in the back half of the year, we've been hiring and training throughout the first half of this year, so we're actually absorbing some of those inefficiencies in terms of hiring, training and the costs associated with that, that we're not seeing the volumes and the top line benefit.

So, you're going to continue to see that through Q3 as we continue to hire and train, so we're going to have higher labor costs but not getting that efficiency. And that's why I feel good about the fact that Q4 and into next year, we're going to have a better overall cost performance and operating ratio just given the fact that we'll see the benefit of this pre-hiring that we're doing. So, that's kind of the cadence of what's occurring on comp and benefits.

<Q – Jon Chappell>: Okay. And just any figures on head count adds over the next six months to meet the double-digit RTM growth? And again, do we just kind of take this cost per employee in the second quarter and think about that being similar for the rest of the year? Sorry for the follow-up.

<A – Nadeem Velani>: Yeah, no worries. Yeah, you should expect us to continue to ramp-up. I think our average head count was about 12,500 in Q2. You should see that going up another probably 400 people through the end of the year kind of on an average head count basis. And what was the second part, sorry?

<Q – Jon Chappell>: Just the cost per employee. I mean, it was down pretty meaningfully sequentially, so how do we think about that?

<A – Nadeem Velani>: Yeah. The cost per employee is a bit of a tricky one, right, because depending on what the stock does to stock price does affect that. So, we've seen a strong July and I think we'll continue to see the stock perform well. You'll see additional costs kind of come up through that as we true-up for stock-based comps. So, you tell me what the stock does and we'll tell you what the cost per employee will do. That's a tough one.

<Q – Jon Chappell>:I'll try my best. Thanks a lot, Nadeem.

<A – Nadeem Velani>: All right. Thank you.

<Operator >: Thank you. Your next question comes from Amit Mehrotra with Deutsche Bank.

<Q – Amit Mehrotra >: Thanks, operator. Hi, everyone. Nadeem, can you talk about OR expectations for the second half just given the RTM inflection? Are we kind of solidly in the mid-50s? If you can just offer some color there? And then Keith, maybe more big-picture. Canadian National is talking about curating some business – that's their words, not mine – and they've talked about kind of growing too much in the wrong places and addressing that. Does that create opportunities for CP? If you could talk about that? I know you guys won a decent-size CMA contract from them recently, but just wanted to see if what's happening at CN creates incremental volume opportunities for CP and/or pricing opportunities? Thanks

<A – Nadeem Velani>: Yeah. So, let me just – I feel good about the combined back half, that we'll be in that mid-50s, maybe kind of upper side of mid-50s in the back half. I'd point out a couple things, just one

to the earlier question about the stock-based comp. I think we'll see little bit of that headwind in Q3. And I think that John's commentary about the delay in the harvest, so as the grain harvest gets pushed later into Q3, almost into Q4, we won't see the full benefit of operating leverage until kind of that October-November timeframe. So, it gives me some reason to say I'd rather point to a stronger Q4 than a Q3. But if you look at H2 as a whole, kind of upper mid-50s is probably the right place to think about.

<A – Keith Creel>: All right, Amit, let me just say this. What I'm seeing in the marketplace and what I hear CN say, and having a bit of experience in this and understanding this, business for the sake of business, if you can't make money on it, obviously we don't do this for practice. We've got a high cost of capital in this business. You got to pay the light bills, you got to be able to pay for your seat on the train for lack of a better term. And if in your pursuit of revenue you've made some very unnatural decisions for your network that don't serve your network well or in fact, in the end, serve the customer well, it's not really a win-win for either party.

So, as you curate or you take a look at what's unnatural, what doesn't fit, what doesn't work well for you, what doesn't work well for the customer, then yes, that does create opportunities for Canadian Pacific. But I can tell you this; the same disciplined approach that we've taken for the last eight, nine years when it comes to business and making sure that we're able to provide a value proposition for our customers and, in turn, they feel the same way about it is the same approach we're taking.

So, you talk about CMA, you talk about some of this business. Historically, if you look at the last same time period that swung one way to the other business that's not as sticky, these big contracts, when we took a look at CMA as we take a look at our book of business, we're going to make sure that what we're providing adds value for them and what they're offering and the rate adds value for us.

So again, we're not going to oversubscribe our network. We're going to do it smart. Low-cost sustainable growth is what this business model is all about, and that's the approach that we'll take on a go-forward basis. And in the end, that is best for the customer, that's best for the rail network as well because, again, you did no good if you oversubscribe your network trying to please one customer and you dissatisfy and disappoint the balance because you don't have the fluidity, you don't have the velocity on the assets, you don't have the service offering that running a true PSR railroad produces. So, that's a critical, critical ingredient to success. So, again, continue to expect that same disciplined approach in the marketplace from this company as we have and as we will going forward.

<Q – Amit Mehrotra >: Okay. I appreciate the comments. Thank you very much.

<A – Keith Creel>: Thank you.

<Operator >: Thank you. Your next question comes from Brian Ossenbeck with JPMorgan.

<Q – Brian Ossenbeck>: Hey. Good morning. Thanks for taking the question. Wanted to ask about Mexico and the US trade complaint that was just filed. Obviously, these issues have been simmering for a while, so just wanted to get your view on this dynamic headed into the CPKC transaction. And then, I don't know if Pat or Mike are on the call, but any sense in terms of the range of outcomes, how this might impact the refined products business or even longer-term some near-shoring or cross-border activity coming into the US.

<A – Keith Creel>: Well, let me start. Pat and Mike are not with us today. But I can tell you, KCS is – in my discussions with Pat and the team and looking at – obviously, we had a lot of insight into this as we analyzed the transaction, their business has already been impacted by what's going on in the energy work environment, so to speak, in Mexico. And actually, in spite of this dispute which is part of USMCA, the refined fuels is increasing. They're actually able to bring more product than they were at the low point. So, the way I see this, USMCA provides the structure; there's a dispute mechanism in it. I believe that the

parties will work these things out.

I believe that even more so than ever in our country's, our nation's history, the world's history, there's never been a greater need for positive free trade between Mexico, Canada, and the United States. So, I think this is going to get navigated. I think at the end of the day that this transformational merger that we're putting together will allow additional free trade to flow between these three nations. And I think this is just a moment in time that none of us have to lose a whole lot of sleep about. It doesn't change the thesis at all and I think it's going to be full steam ahead, and we'll turn the page and we'll see these three nations grow together and benefit uniquely together.

<Q – Brian Ossenbeck>: Thank you, Keith.

<A – Keith Creel>: Thank you.

<Operator >: Thank you. Your next question comes from Scott Group with Wolfe Research.

<Q – Scott Group>: Hey, thanks. Good morning, guys. I don't know if it's a little too early to ask this, but as we get closer to the merger approval, any thoughts on how to think about sort of the cost and revenue synergy potential in 2023? And then, Nadeem, you talked about getting closer to the target leverage levels, and I'm just wondering if you see the potential to start resuming buybacks next year. Thank you, guys.

<A – John Brooks>: Scott, John Brooks here. So, I'll tell you; as I work through the synergy levels and we think about – initially, I think we've said that you can think of that USD 1 billion as maybe a third, a third, a third as you think about how it comes on to the network. And I can tell you, we continually are calibrating what that looks like specific to how we're going to invest, where we're going to have the capacity to haul that freight, how quickly we can generate an intermodal product that can effectively service three countries in and out of Mexico and certainly that Gulf and Texas market.

I can tell you as I go through business unit-by-business unit on a weekly basis with my team looking at those synergies as we talk to those customers, I continue to feel very confident that 2023, that's coming out of the chute. There's going to be significant opportunity to sort of hit that plan as we've described. Again, the traffic mix and what it looks like, and certainly some of those areas that may require investment like port investment or new transload facilities, that'll take a little time. Some of those likely, as construction could start after we get our final STB control, may take a year. Some of those opportunities roll into 2024 just because that investment and that construction needs to take place. But all in all, I feel real good about the opportunities that we can turn on I'm going to say very quickly to be able to hit that first year target.

<A – Keith Creel>: And Scott, on the cost side, I can tell you this. The KCS team, they're not waiting as far as improving their operation. They're in evolving chapters of their PSR journey. I can tell you, Jeff Songer leading into this and now John Orr leading the operating team, they're working hard every day to run a more efficient network, and you can see it in their numbers, you can see it in their performance.

They're investing in their infrastructure stand-alone in that lane going down into Mexico to the border. You think about the gravity of this transaction. We said USD 275 million of capital investment that essentially that's dedicated to extended sidings, new sidings, rail ties and ballasts, CTC, all hard asset infrastructure that will allow the network to run more efficiently, run safer, more fluidly. That's about 30 sidings kind of split evenly between the two railways.

That said, if you think about the KCS network alone, they're doing an additional 15, 16 sidings stand-alone before the transaction. At the same time, CP on our side of the railroad, we're doing things in that corridor, north of Kansas City that is sort of getting a step ahead so that as soon as we get these

two railroads together, the STB gives us a green light, we'll continue to invest in the infrastructure. But the investments we've already made, the traffic that rides it today, the operating plan that we have ready to engage and execute, you're going to see cost synergies that – again, this is not driven by cost synergies but just railroading better, being more efficient with assets, turning cars faster, putting these two networks together and benefiting on the backbone of those capital investments.

There's no doubt in my mind that we're going to overachieve when it comes to the cost synergy standpoint. So, again, we're getting ready. We're not sitting here waiting. The objective is when we get the green light, we're going to hit the ground running. We're going to be aggressive, we're going to be responsible. We're not going to over-commit, oversubscribe. It's going to be very methodical, but at the same time it's going to have a momentum to it that I think is going to exceed everyone's expectations. I feel very confident about that.

<A – Nadeem Velani>: And Scott, just on your leverage question. So, when we look at the outlook for our free cash for this year and the outlook that the KCS team has provided, I think we're in a good spot as far as continuing to delever according to our plan. Obviously, let's see what happens in 2023. But as you've heard, there's probably more confidence in synergies than less, so I think we'll be in a very good position to get our leverage back down to our targeted level by the end of 2023.

I'd just say that typically, we make our capital allocation decisions with the board in that January timeframe so when I look forward, probably look at that January 2024 as a decision point around what we do with excess cash flow once we delever back to our targeted 2.5 times. So, I wouldn't get too ahead of yourselves in terms of 2023, but 2024 is probably the right time to think about capital allocation.

<Q – Scott Group>: Super helpful. Thanks, guys.

<A – Keith Creel>: Thanks, Scott.

<Operator >: Thank you. Your next question comes from Ken Hoexter with Bank of America.

<Q – Ken Hoexter>: Great. Good morning. Hey, just a quick one for Nadeem. Did you talk about gains on the quarter from fuel, revenues, and costs? And then, Keith, a few big-picture thoughts. It seems like a lot I knew on PSR is getting cost out. Maybe your thoughts on one-man crews from the FRA and thoughts on PSR pressure as companies start to return hump yards, bring back employees and locomotives, ongoing pressure from regulators on service levels. Maybe just your thoughts on if companies are missing the PSR commitment or if there's something else going on that we've run our course. Maybe just talk a little bit about that? Thanks.

<A – Nadeem Velani>: Yeah. So Ken, just on the fuel impact, it was a headwind on the OR by about 220 basis points. But we did get a modest OI tailwind, modest in that around $30 million, so that's what I'd point to.

<Q – Ken Hoexter>: CAD 30 million difference in revs and costs?

<A – Keith Creel>: Yeah, go ahead, I'm sorry.

<A – Nadeem Velani>: Yes. Correct.

<Q – Ken Hoexter>: Okay. Thanks, Nadeem.

<A – Keith Creel>: So, Ken on the – let me start with the FRA, the notice that came out yesterday. I would say this; it's disappointing. I've always been a proponent personally until and unless we get the components that we put our trains together with to become more reliable. And until and unless we can make sure that we can get that train over the railroad without a knuckle breaking, it's got to be an

extreme exception, not a normal occurrence. There's just – when you put a train together, there's a lot of moving parts and those moving parts historically have created some challenges.

So, if a train separates and it's 10,000-foot long and you don't have a man or a woman to assist the engineer, that can get complicated so that's something I'm very sensitive to. But that said, we work with our suppliers to improve those components. We should not be put in a disadvantaged place when technology allows safe and efficient operation, components allow safe and efficient operation, to be disadvantaged from realizing the benefits of that and staying competitive, and that to me is exactly what that smells of.

To put us in a place where all those things being accomplished we're at a disadvantage, a cost disadvantage, we're not able to do our very dead-level best to take trucks off the road, put them on the rail to allow the customers to enjoy the benefits of those cost synergies as well as the environment to enjoy the benefits of those less greenhouse gas emissions. We're talking about the environment matters, we're talking about zero carbon, we're talking about reducing greenhouse gas emissions but yet we're talking and looking at potential actions by the regulator that says we can't do that or we can't optimize that outcome.

And to me, that's troublesome. So, I'm sure that each railroad has their own view. Again, I'm not against the FRA; I've got to work with the FRA. I just hope that as the discussions evolve around this topic that we really think about the unintended consequences and think about the totality of what's being suggested.

So that said, when it comes to the regulatory environment around PSR implementation, PSR is not an operating model and a name alone. PSR to me, to truly integrate and implement a PSR railroad, it's a very well-thought out process. It is that in and of itself; it's a process. You got to have the right number of crews, you got to have the right number of locomotives, you got to have the right number of cars, you've got to have the physical infrastructure. So, it's not just as simple as implementing and integrating, and different railroads have had various levels of success. I can say that this pandemic and this manpower issue, if you don't have people, trains don't move.

And some things have occurred in the middle of PSR implementation that quite frankly stacked the deck against these other railroads. That being said, once they get their hiring done, once they get their infrastructure to match their aspirations for train sizes, and that's terminals as well as line of road, you don't do a lot of good to run a 10,000-foot train and it's got nowhere to land. If you're sitting outside of a terminal and you can't get in the terminal because the train is too large, there are unintended consequences.

If you're doubling trains out of terminals and parking them on main lines waiting on power because you're holding out one of those big trains because it can't get in the terminal, you have unintended consequences. And again, those are all growing pains. I know they're real pains. I know that, obviously, it's affected the railroads' overall ability to serve customers' needs, but I do see it getting better. I see the hiring helping. I see getting to a place that as these railroads get their cadence and their rhythm and they get more experience and muscle memory in these processes that it takes to actually effectively run a PSR railroad, I think it's the right way to run a business.

And I think at the end, we'll look back and we'll say this was a good thing. Hard to say that now. But with my experience, having done this for over 20 years, and I didn't get it all right either; we made some mistakes along our journey at Canadian National and Canadian Pacific and even Illinois Central. But we learn from those; we bake those into the way we railroad today, and I think you can produce a better outcome. And I think we're proof positive of that. We've managed this cycle with PSR on the downcycle. We've right-sized the railroad. We've grown like no other railroad has over the

last four, five years and we've created an infrastructure and a rhythm and an ability and a respect with our customers and our trust with our customers that we're helping them win in their marketplaces as we win for all stakeholders, and we're doing it as a PSR railroad.

I think it's a good thing and I think eventually, the industry will get there as well; it's just taking a little bit of time to get there. And the best thing we can do is continue to improve. The best thing I can do and we can do at CP is make sure that our story, our unique story and our unique outcome running a PSR operating model is understood, and that's exactly what we're committed to doing. We do it by what we say we do it, most importantly by what we do in the way we run the railway day in and day out for our customers.

<Q – Ken Hoexter>: Appreciate the color.

<A – Keith Creel>: Thanks for the question.

<Q – Ken Hoexter>: Thanks, guys.

<Operator >: Thank you. Your next question comes from Chris Wetherbee with Citi.

<Q – Chris Wetherbee >: Hey. Thanks. Good morning, guys. John, you mentioned I think in your prepared remarks that the pricing on contract renewals was accelerating in 2Q. Want to get a sense of maybe how you think about the pricing environment in the back half. I think there's probably been some sense that maybe we're getting closer towards a plateau of your ability to kind of get accelerating price, but it sounds like maybe you're having more luck. Can you give us a little bit of color on that, please?

<A – John Brooks>: Yeah, Chris. I know; when you flip on the TV, it might be counterintuitive in some sense with all the noise out there. But then again, inflation hasn't slowed down either, so we've got about 20% of our book left to go. And in just reviewing that, I spoke in the past of – that we're even 6%-plus, and I'm seeing that even accelerate in terms of my team's expectations on what the market opportunities are, so I don't see that changing.

You think about our intermodal franchise and in all the business that we have out there today, the demand, I think our trucking and length of haul is different than what maybe the US roads face day-to-day, and that adds some resiliency in that pricing space in Canada for us. And just frankly, the other lines of business continue to be strong. And as I said, we're going to get a nice tailwind on the Canadian grain front, too, with the VRCPI the back half of the year, too.

So, I don't – we're not taking our foot off the pedal at all on that front and we'll see what 2023 brings. But as Keith said and Keith spoke about the PSR journey, our sales discipline and how we approach the value of our service and our capacity doesn't change in good times or in bad times. And yes, the quantum isn't always 6%-plus, but the discipline to keep that – to make sure that we are inflation-plus and we are capturing the value in the marketplace for our service and capacity has never changed. And as you know, a big part of our compensation plan for my sales team drives them on that discipline, and that's not going to change. So, regardless what 2023 brings, we'll continue to be in I would say the top end of that pricing bandwidth.

<Q – Chris Wetherbee >: Got it. Thank you very much. Really appreciate it.

<A – John Brooks>: Yeah.

<Operator >: Thank you. Your next question comes from Brandon Oglenski with Barclays.

<Q – Brandon Oglenski>: Hey. Good morning and thanks for taking my question. John, I just wondered if you could follow-up on your commentary on the delayed harvest. Is that about Canada or the US as

well? And I guess, you still have a pretty bullish outlook on volumes. What are the favorable offsets that have developed in the interim?

<A – John Brooks>: Okay. Brandon, you were kind of quiet there, but I think I got most of it. So, the grain front, yeah. Again, in Canadian grain, I can tell you we fully subscribed our train product. I think our customers are chomping at the bit given such the year that we've had in Canada. Really, the key point we're watching right now is just simply timing. When will this crop start to come off? Is it mid-September? Does it push all the way into October?

But regardless, I think we are positioned well, Vancouver, Thunder Bay, US imports to service that market. The US side is not dissimilar particularly – Brandon, if you think about our network, we're so heavy-dependent North Dakota. So, the growing region, not a whole lot different than Southern Saskatchewan, Southern Alberta, so some of those same challenges persist there.

We'll see. I think we're in a little better shape in terms of a normal timing. We should start seeing wheat crop come off here in the coming weeks, soybeans in September. And it's really that soybean pushed to export that really will begin to drive those US grain volumes. So, again, we'll be watching tightly that timing. That is typically a second half of the year, September, but we'll see how these next few weeks play out. I think the projections look warm and hot, so that helps get that plant matured and ultimately the opportunity to bring that harvest along on time. You had a second part of the question, Brandon. I can't remember what it is now, or maybe you didn't.

<Q – Brandon Oglenski>: Yeah, John. It was just that if that's getting pushed back but you're maintaining your growth estimates, what have been the favorable offsets?

<A – John Brooks>: Yeah. So, as we talked about, that intermodal space continues to drive hard. But I can tell you, as I look to forward demand curves for our system equipment across, say, our merchandise sector, our center beams, our scrap gonds, our box cars, our pulp business, we're fully subscribed. That is more about velocity, customer discipline, loading on weekends, how we can spin those assets as fast as possible. And frankly, as some of our connecting partners' velocity improves, we get that equipment back sooner, we get another load, I think you'll see marked improvements in that.

We had a little bit of a choppy July in the auto space. Sequentially, we saw a nice improvement but it's sort of like what could've been if July would've performed better. We saw all our OEMs take some downtime, not unexpected but maybe a little longer downtime and continue to sort of muddle around with some of these parts issues. But I do believe we continue to see a sequential improvement in our auto business even as you just think through the quarter as we move into August and September in that space.

So look, the grain is what it is. It's not going to go away. If we don't haul it in September, we're going to haul it in Q4 and in 2023, and we're going to drive hard in all those other spaces. I didn't even mention potash, but we're full gas on in that space. Canpotex as I've spoke about is very bullish on their second half year volumes, so we're fully subscribed there also.

<Q – Brandon Oglenski>: Appreciate it.

<A – John Brooks>: Yeah.

<Operator >: Thank you. Your next question will come from Jason Seidl with Cowen.

<Q – Jason Seidl>: Thank you, operator. Good morning, gentlemen. Just some quick thoughts here. Keith, the Canadian government's proposal to cut fertilizer emissions by 30% in 2030, I'd love to know what you think that could mean for volumes. Do you think it's more of a cut on the domestic side and then a switch to some exports or is it going to be a cut overall? And then, maybe if you can put a little more

meat on the bone in some of your comments about running some more test runs with the KCS. I'd love to know to and from and how successful they've been.

<A – John Brooks>: So Jason, I'll make a few comments on the fertilizer announcement. Look, it's a little hard to tell right now what the true impact is. This is down to the farm level which is interesting. There's no doubt Canada has to be a prominent player in terms of providing food and feed for the world, particularly in what we've experienced here in the last couple years. So, the great news is whether it's a US farmer or a Canadian farmer, these folks have been resilient and figured it out.

Farming technology, acres farmable have only increased, and so I'm confident the Canadian farmer will figure this out. It's hard to tell what that means ultimately if it drives more of that production to export or maybe more in North America and maybe even Mexico. But the good news is CPKC will have the network that you do see some trade flows like that that I think we can capitalize on it.

And maybe the last point on that front is the reality is fertilizer prices have been really high lately anyways, so I think the farmer as it is today has made a lot of choices around crop rotation and different things to try to curb their use or maybe be more disciplined in their use to be to begin with. So, it's kind of a wait-and-see, but I think technologies and some of those techniques may in the end of the day make it a pretty small event.

<Q – Jason Seidl>: Fair enough. And the test runs?

<A – Keith Creel>: Yeah. I'll give you a couple, just a couple of proof positive points that are really creating a lot of attention and excitement around the potential of this network with our customers. And again, this is all on an interline basis and this is all without the benefit of all that capital investment that we're going to be putting into the rails, ties and ballast and infrastructure over the next two to three years.

So, the transits continue, the trips with the container ship coming into Lazaro; de-ramping, discharging for Chicago markets. So, we're running – we've ran now six, seven trains that have came up from Lazaro all the way to Chicago with seven-day transits. That's West Coast competitive. We ran – continue to run domestic moves out of Chicago intermodal that are going to the border at Laredo with 90-hour transit times. And again, that's against an industry-best service offering today which is 89 hours.

We've execute all the investment that we're talking about. Our advertised time in transit is going to be 80 hours, so a very compelling market opportunity going south. The other thing, we ran several grain trains that have came out of Manitoba that have gone as far south as Mexico City with super impressive cycle times, hand off at Kansas City with the KCS team and getting those assets back for that return trip.

So, in each of those spaces we're demonstrating with our customers what the art of the possible is. And again, we're just sticking our toe in the water and this is not what we'll be able to do; this is what we can do today on an interline basis. We get these two networks together, get that infrastructure in and get those assets turning, it's going to be extremely impressive and compelling value-add to add a third option, and in some cases a second option or an option at all that some of these customers never have from a competitive standpoint that's really going to drive a lot of opportunity for this company.

<A – John Brooks>: Jason, I just would add, you think about our DRU product out of Hardisty down to Port Arthur that we do on an interline basis with KCS today. That product is running on a cycle of 12 to 13 days round trip; it's impressive. It is a catalyst for other products. Not only that we could look at exporting out of the Gulf, whether it be grain, whether it be coal, whether it be fertilizer, but it sort of sets up this proof-of-concept that is a real long-term piece of business that now we're able to take to the marketplace as we have these discussions with customers to sell that.

A lot of those equipment types of private equipment. So, the faster we can spin those assets, hit that

marketplace has been a compelling opportunity. And I'll tell you this; it's also compelling enough to where our partners in the DRU, thinking about the opportunity of this being a combined network and an investment that Keith spoke about, what that next second and third generation of that DRU capacity looks like, and we're deep into that opportunity.

<Q – Jason Seidl>: It sounds like you've got some good opportunities there, and I appreciate the color and appreciate the time as always, gentlemen.

<A – Keith Creel>: Thanks, Jason.

<Operator >: Thank you. Your next question comes from Bascome Majors with Susquehanna.

<Q – Bascome Majors>: Keith or Nadeem, you don't bargain with the US Rail Coalition, but there's some uncertainty as to how that union wage increase is going to play out 2024. I was just curious; as an interested observer, do you have any thoughts on the state of US rail national bargaining as this reaches its final stages? And any indirect impacts that could come out of this to CP that you're looking at? Thanks.

<A – Keith Creel>: Well, I've got a limited view but a very strong one in my limited view. I try to stay away from the national bargaining; I've had for the last almost two decades in my railroad career. I think that local bargaining, you come to the best solutions that fit your employment base. On a national level, how do you get four railroads and multiple unions and multiple different sets of expectations to all get aligned to one common vision I think in and of itself it's a challenge.

So, I wish them success. I know that both parties want to reach an amicable agreement and, through this process, put this thing behind us as an industry. But as far as something coming out of it that will have any kind of adverse impact to Canadian Pacific, I don't see it. We're going to continue to stand alone. We have a very unique and progressive, I think industry-best collective bargaining agreement with our running trades employees. It's unique in that it's hourly. We don't have separation between road and yard. Our employees are very productive and they make a lot of money for that productivity. My objective is to make them and make sure they're the highest paid railroaders in the business and at the same time the most productive because the productivity and the reliability is what allows us to execute for our customers and provide a service offering that again is unique.

So, I'm glad that we're not part of that. But at the end of the day, getting that resolved for the national group of railroaders that are – as well as the employees that they employ and the members of that union represents is in the industry's best interest, and I'm glad that it's getting to a point where we can put this behind us.

<Q – Bascome Majors>: Thank you for that perspective. And specific to CP, anything on the collective bargaining front that could be impactful that you guys are watching over the next one to two years? I don't know if it's related to the KCS merger and integration or just for CP directly? Thanks.

<A – Keith Creel>: Well, I'd say the only impactful – some excitement, some energy around this space. We just actually negotiated and ratified two contracts. One, the DM&E which is a property that goes from Savanna, Illinois down to Kansas City, actually into what will become part of the consolidated territories. That collective agreement, those employees are represented by the BLET. We gave them a pretty significant raise. It was an hourly deal. We've had it for some time. We inherited it when we bought the railroad back, but there was a gap in the wages between what those employees made and what our Soo employees make.

So, we've said all along as we invested in infrastructure and we built density from what was a short line railroad, taking it to a mainline railroad for the lack of a better explanation, that we're going to close that gap and that's what we've done. So, that bodes well for attracting and retaining employees. It shows our employees how much we appreciate them. We did that off-cycle. We did it in a way that we felt it was important to get it resolved, and it turned out well.

And then the other piece, east of Montreal and the CMQ, and those employees are represented by SMART, took the same approach. That was part of the CMQ property. Their wages were depressed compared to what market is, so we gave them substantial increase to get them up to market wages so that they're not at a disadvantage working for our company. So, they understand how much they mean to us, how valued they are as employees, and how critically important they are for us to realize our growth aspirations and deliver the service we've committed to deliver to our customers.

So, from a labor perspective, this company is in a good spot. Again, it's not perfect; these spaces never are. But our employees know we're committed to them and they're committed to us. And in turn, we can be committed together to our customers. That's the strategy that's worked well for us and it's the strategy again that we intend to deploy larger-scale on CPKC should the KCS employees on that railway be interested in that approach. And I think from a value proposition, when you can make more money and you get a better quality of life which comes with that collective agreement as well and scheduled days off and some of those things that have never meant more to employees in these hard jobs that we work on the operating side, I think that's a pretty compelling value proposition.

<Q – Bascome Majors>: Thank you, Keith.

<A – Keith Creel>: Thank you.

<Operator >: Thank you. We have reached our allotted time for Q&A. I would like to now turn the call back to Mr. Keith Creel.

<A – Keith Creel>: Okay. Well, thank you again for your time this morning. As you can sense from our comments, we're extremely excited about the momentum that we've created and we continue to march forward not only stand-alone for CP and executing our plan in 2022 and setting us up well for 2023, but especially so for this transformational merger that we're on the cusp of getting approved, we hope. Depending if the STB aligns with what our views are, this is a very compelling proposition for all stakeholders, public interest, customers, employees alike, and for these three nations commerce together to grow into the future.

So with that said, we look forward to executing as we said we would in the third quarter. We look forward to sharing those results when the time is appropriate later in the year. Stay safe, and we'll see everyone out on the rail. Thank you.

<Operator:> Thank you, ladies and gentlemen. This concludes today's presentation. You may now disconnect.