Transcript

Q4 2018 Earnings Call

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Corporate Participants:

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

MANAGEMENT DISCUSSION SECTION

Operator

Good afternoon. My name is Jessie and I will be your conference operator today. At this time I would like to welcome everyone to the Canadian Pacific's Fourth Quarter 2018 conference call.

The slides accompanying today's call are available at www.cpr.ca. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator instructions]

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

Maeghan Albiston

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

With me here today is Keith Creel, our President and CEO; Nadeem Velani, Executive Vice President and Chief Financial Officer; and John Brooks, our Senior Vice President and Chief Marketing Officer. The formal remarks will be followed by Q&A, and in the interest of time, we'd appreciate if you could limit your questions to one plus a follow-up if required. It's now my pleasure to introduce Mr. Keith Creel.

Keith Creel

Thanks, Maeghan. And welcome to the call today. I think it is appropriate – let me start by thanking our 13,000 strong CP family that have produced the results that this leadership team has the honor to discuss with our shareholders, and with our investors today. As you can see from the release by every financial measure, literally, every financial measure this has been a record year both on a quarter basis as well as a yearly basis. Specifically for the fourth quarter, revenues CAD $2 billion, a CP record, up 17% versus the fourth quarter of 2017, a 56.5% operating ratio, an all-time quarterly record for CP. Adjusted EPS grew 41%.

From an operating and safety perspective, the results were equally impressive. We handled record GTMs, record RTMs at our network this quarter while we continue to drive improvements across all of our key operating metrics. Train speeds were up 3%; terminal dwell was down 6%; fuel efficiency improved 3% which is an industry best. And most importantly, above all else, we executed safely, driving personal injury improvement by 14% and train accident improvement 31% versus the fourth quarter of 2017. And with that said, on a full year basis, 2018 was a best ever year for FRA personal injuries at CP as well as the 13th consecutive year CP has reported the lowest train accident frequency ratio in the industry.

Now, beyond the immediate financial success for the fourth quarter 2018 was also a very meaningful year across the organization from a sustainability standpoint. As I highlighted back in our Investor Day, for those who truly understand our CP story, it's a compelling one. We've got the service, the cost structure, the capacity to grow in a profitable and sustainable way. 2018 was an absolute proof point of these facts and spades.

Our record performance in 2018 was an undeniable example of what our operating model can produce. We grew

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the top line to record levels by bringing on new customers while we grew with our existing ones without compromising our ability to provide capacity and deliver the service they deserve and that we've committed. And we've brought this new business on at lower incremental costs. Put these two key elements together, the natural byproduct is our best ever operating ratio and record earnings.

But again, from a sustainability point in 2019 and beyond, what continues to fuel my more confidence in our CP story is again fact based. We've got a committed team of first-class railroaders, who know what it takes to execute the precision railroad model which is a team that continues to get stronger as we challenge each other in the status quo. Rest assured this is not a team that I will allow to get comfortable and complacent. What we do and how we do it takes the right talent. They have to be led the correct way, motivated and inspired to make it happen for our shareholders, customers in the North American economy. We continue to build and deepen relationships in our 13,000 strong CP family. Most specifically, it was a busy and a very successful year on the labor front, not only ratifying our long-term deal with the TCR running trades earlier in the year, but concluding 2018 with the ratification of a four-year deal with Unifor in December before it expired.

The change we've driven has not been easy. We certainly have not gotten it all right but I'm pleased with the progress that we continue to make. The deals we sign provide mutually beneficial terms that will support our growth strategy while we provide CP, its employees, and our customers with the stability and the certainty we need to continue to execute and grow over the next several years.

I think as a side note it's also important to remind ourselves our next major labour contract in Canada doesn't come due until 2021 which gives us a significant meaningful quiet period to continue focus on deepening relationships even more at our company.

Speaking to the guidance, we entered 2019 with tremendous momentum. Rest assured we're poised for another record-setting year. As you've read in our press release, we're targeting mid-single-digit RTM growth, double-digit EPS growth for the third consecutive year. We did it in 2017, we did it in 2018, and we're confident that again in 2019 we'll meet or exceed those expectations. I've never been more confident this team's ability to deliver. We're never more excited about the potential for this franchise as we continue to write the next chapters of success in our CP story. So with that said. I'm going to hand it over to John to bring some color to the markets before Nadeem wraps up and elaborates on the numbers and then save the balance of our time for some robust and meaningful Q&A. Over to you, John.

John Brooks

All right. Thank you, Keith, and good afternoon, everyone. The total freight revenues were up 18% this quarter to, as Keith said, a record CAD $2 billion with record growth across every line of business for the second straight quarter. RTMs were up 9%. Fuel and FX were tailwinds of 3% and 2% respectively. And as expected, same-store price continued to be strong finishing at the upper end of our targeted 3% to 4% range. The pricing environment continues to remain healthy.

As Keith stated, 2018 was a tremendous year for CP as we executed our disciplined strategy to deliver sustainable, profitable growth. And look, it didn't happen by accident. On the backs of our industry best service, we had a plan, we picked our partners and we executed with precision in the marketplace. In October, we outlined at our Investor Day CP's unique strength that enable us to offer creative solutions to our customers; including our energy train from the Alberta Heartland to Vancouver, our new and expanded transload facilities in major centers such as Vancouver, Minneapolis/ Saint Paul and Hamilton, and leveraging our landholdings to create new auto compounds

at Vancouver and Wolverton.

We are executing our strategic playbooks, utilizing the principles of PSR. And frankly, the results speak for themselves. Full year total revenues were up 12% to a record CAD $7.3 billion. And at the risk of repeating myself again here, revenues were up in every line of business on a full year basis.

So let's take a look at fourth quarter revenue results on the next slide. I'll speak of results on a currency adjusted basis. Starting off, as expected, grain was sort of a tale of two stories. Canadian grain volumes were up 7%, surpassing last year's record levels. This was partially offset by continued weakness in our U.S. grain portfolio where volumes were down 18% largely as a result of decreased shipments to the U.S. PNW. So look, as we enter 2019 we expect continued strength in Canadian grain through the first half for the year given solid crop inventories and strong regulated pricing. And in the U.S., although January's off to a pretty decent start, we expect ongoing uncertainty in these markets.

Strong export volumes from both Canpotex and K+S marked our fourth consecutive record-setting quarter for potash with revenues finishing up 24%. We had an all-time record year in potash and we see opportunity as we move into 2019 as global demand remains strong. The energy, chemicals & plastics portfolio saw revenue growth of 46%. While certainly crude was a large contributor to ECP growth with approximately 25,000 carloads moved in the quarter, I would highlight that excluding crude, ECP revenues saw strong growth of 26% driven by LPGs, biofuels and refined fuels. As we head into 2019, we expect continued momentum in this line of business.

Based on the strength of our service, our energy train continues to create opportunities in the marketplace. We've entered into a new multi-year agreement with Suncor providing service from the Edmonton area to their expanding Vancouver export terminal. Also in the ECP space, we recently entered into a new multi-year agreement with a new customer to deliver refined fuels into the Southern Ontario market. This business leverages freed up capacity with the closure of our Expressway operation. As many of you will recall from our Investor Day where we spoke about this, the Expressway terminal is strategically located with direct highway access and distribution to the Greater Toronto Area.

So moving on, as expected, forest products were up 12% as we continue to leverage our Vancouver, Toronto, and Montreal transload capabilities. The Automotive business unit revenues were up 4% on the quarter in spite of weaker demand environment in the space. At the start of 2018, this was an area that I highlighted potential headwinds for the year so I'm pleased to report total revenue finished up 11% on the year as our new team focused on leveraging our strong service and customer partnerships to grow our share in this market. Heading into 2019, we see growth in this sector as we continue to attract new business through our network. Construction of our new Vancouver auto compound, which has Ford as our anchor tenant, is on track to be completed in Q1. This facility brought on by utilizing our existing strategic landholdings provides our automotive customers with a new option in the Vancouver market.

So finally, on the Intermodal side, revenues were up 11%. On a full-year basis, I'm extremely pleased with the strong growth we've had in both domestic and international intermodal. On the domestic front, we had a record year over on top of a record year and I expect continued growth as we move into 2019. In Q1, we will onboard our newest domestic intermodal customer, Dollarama, to our already very strong retail book of business. Additionally, this team, I can tell you, is laser-focused on continuing to leverage our demand management tools to create new valuable capacity on our existing train starts. We are confident that this will drive more over the road conversion to our intermodal trains.

On the international side, we're also projecting growth in 2019 as we leverage our service and the capacity brought on by GCT at Deltaport to grow with both new and our existing customers at the Port of Vancouver. And I'm also pleased to announce that we have recently extended our transportation agreement with our largest intermodal customer, Hapag-Lloyd.

So let me wrap things up now. As Keith commented, we accomplished a lot in 2018 and I am extremely pleased with how this team is maturing. We're delivering results and strategically executing our playbooks in the marketplace. The demand and pricing environment, as we see it, continues to be healthy and I'm extremely encouraged by the energy and momentum we have coming into 2019 and the opportunities I see ahead.
With that, I'll pass it to Nadeem.

Nadeem Velani

Thanks, John. It's an outstanding report. I'm proud to announce record results for the quarter. Total revenues were up 17% or 15% on an FX-adjusted basis, driven by RTM growth of 9% in the quarter. These revenues are coming on at a high incremental margin as evidenced by our fourth quarter operating ratio of 56.5%, an improvement of 370 basis points year over year.

As our numbers illustrate and Keith highlighted, the railway is performing extremely well and we have strong momentum as we continue to drive productivity and grow at high incremental margins. Taking a closer look at a few items on the expense side. As usual, I'll be speaking with the results on an exchange-adjusted basis which is shown in the far-right column of the slide. Comp and benefits expense was up 10% or CAD $34 million versus last year. A few specifics behind that number. Higher head count to support increased volumes along with wage and benefit inflation were drivers behind the increase. Although a key item to note, although the share price declined during the quarter, stock-based compensation was only a CAD $2 million reduction from 2017 levels as higher accruals were booked for long-term compensation as a result of the strong performance and future outlook.

Fuel expense was up 22%, primarily as a result of higher fuel prices and increased volumes. This was partially offset by improvements in fuel consumption up 3%, driven by improved train utilization from higher volume. This was a record Q4 fuel efficiency of 0.956 gallons per 1,000 GTMs and record annual fuel efficiency of 0.953 gallons per 1,000 GTMs. Our investment in locomotive modernization and our commitment to the principles of precision scheduled railroading were drivers behind the record numbers.

Purchased services and other was CAD $250 million, an increase of 1%. As previously highlighted, we had a land sale close in Q4 for a gain of CAD $35 million. However, this land sale was partially offset by a CAD $20 million contingent claim in the quarter.

Moving below the line, interest expense was CAD $2 million lower or CAD $6 million lower excluding FX. The reduction is primarily driven by savings from our debt refinancing in Q2 of 2018. Adjusted net income improved 38% overall while adjusted EPS grew 41% to CAD $4.55. To put that EPS figure in perspective, that is greater than CP's full-year EPS in 2012 prior to the transformation, which is pretty incredible to think about how far we've come.

Moving on to full-year results on the next slide, this record fourth quarter performance rounds as a record year for CP. The plan is clearly working. For the year, revenues grew 12% and adjusted operating income grew 15% compared to 5% revenue and 6% adjusted operating income growth in 2017.

Our full-year adjusted operating ratio was 61.3%, which is a 110-basis-point improvement over 2017, demonstrating our ability to grow volumes at a low incremental cost. This led to adjusted income growth of 25% and the benefits of a lower share count from our share repurchase program helped us achieve EPS growth of 27%. Moving on to free cash to wrap things up, 2018 cash from ops increased by 24% and free cash flow increased by 47% to nearly CAD $1.3 billion. Shareholders are being rewarded as we remain opportunistic in our share buyback, taking advantage of volatility in the equity markets. We have completed around 40% of the buyback program we announced in October at prices below where we are currently trading. Additionally, a 15.5% dividend increase in May marked the third straight year the dividend was raised.

Our approach to capital remains disciplined. In spite of currency headwinds and our opportunities for growth, our capital spend finished in line with expectations. As mentioned in our press release, we plan for the same level of capital investment in 2019. When we give guidance on capital spend, rest assured we have a well-thought out and detailed internal planning process. You should not expect negative surprises from us.

Nowhere is that discipline more evident than in our adjusted ROIC, a record 16.2%. To put that figure in perspective, when we started this journey in 2012, our adjusted return on invested capital was just shy of 10%. Now, it's at industry best. As I told you at Investor Day in October, we're focused on generating quality returns for our shareholders, driven by our strategy of sustainable, profitable growth while controlling costs.

I'm extremely pleased with our performance, particularly in the back half of 2018, when we separated ourselves from the pack and demonstrated what a precision scheduled railroad and the best team in the industry can deliver. There is a great deal of momentum at CP and we are extremely excited for what's ahead in 2019.

And with that, I'll pass it back over to Keith.

Keith Creel

Okay. Thank you, John. Thank you, Nadeem, for that color. I think we'll take the rest of our time to open it up to Q&A and to robust discussion. So, over to the operator.

Question & Answer

Operator

[Operator Instructions] Your first question comes from Ken Hoexter with Merrill Lynch

<Q - Ken Hoexter>: Great. Good afternoon and congrats on the phenomenal results and great turnaround. But, Keith, maybe you can just delve into a little bit or John. At the Analyst Day, you talked about the potential for committed contracts in the year ahead based on things that were expiring. Maybe you can talk about the progress in negotiations as you built into that 5.5% RTM growth into 2019.

<A - John Brooks>: Well, Ken, I can tell you, we're deep into those; every one of them across those business units we spoke about at Investor Day. I could tell you it's probably to early to get into too many details on it, but I think the neat thing you've got to remember is part of the -- a lot of those opportunities set us up for 2021 and beyond, so a lot of that revenue and that opportunity aren't included at all as you look at our 2019 guidance and where we expect to be. So a lot of that I would consider sort of a future upside.

<A - Keith Edward Creel>: But more specifically, in 2019, Ken, I'll draw attention to what we really couldn't say back then. Loblaws closed and renewed. Canadian Tire closed and renewed. Hapag-Lloyd closed and renewed. Dollarama, closed, they're new. Those are four pretty meaningful proof points of our accomplishments in this story, revenue story at CP.

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<Q - Ken Hoexter>: Are those all ones that renewed or those are not new wins that you had talked about from competitive?
<A - Keith Edward Creel>: Yes. Dollarama is new. Renew in Hapag, Canadian Tire and Loblaws all closed and renewed which were – we were in the negotiating process obviously during that time.
<Q - Ken Hoexter>: Got it and then just as my follow-up, Keith, you kind of came out with some harsh statements in terms of what the government was looking at into the Port of Vancouver and progress. Maybe you can kind of follow-up a little bit in terms of where your performance is at at the port and what you think kind of drove that investigation.
<A - Keith Edward Creel>: Okay. I'll try to be fact-based and maybe a little bit pointed, but I think I'll be fair to the hardworking employees of this company that have created record service levels and capacity in that whole corridor. We went through some challenges in a capacity-constrained corridor to point back in the fourth quarter and into the beginning of January. We had to take measures to protect our overall health of our franchise. That's a key corridor for us obviously. We have a lot of customers that are served in that corridor. We've got not only the carload side, the chemicals. We've got the grain. We've got the potash. We've got the coal. So it's a key corridor for CP. A when we get to a point where we see certain business lanes with equipment tied up for a number of days, waiting to get their destination at a capacity-constrained location, we have a responsibility for all of our customers to take the appropriate surgical actions to make sure that we mitigate that damage. And we also took immediate actions not only to curtail some of that pressure, but to do some things ourselves to help our competitor recover quicker in that corridor because again, we have entered into agreements. We can be the greatest competitors but in that corridor we create capacity together. So when one succeeds, both succeeds, and we think that's the right thing to do not only for our shareholders, not only for the corridor, but overall, for all the business that goes into and comes out of Vancouver. So long answer to your question. Things have recovered quite nicely. I think for both railroads, I saw it as an episodic event. It's something that I think we've responded well to and we're going to go through the process. I think the CTA acted a bit prematurely. I think that we'll go in, the facts will speak for themselves and I think when it all comes out that everything that I've said, not only what I said, but what the facts prove to be true. CP is in good shape in that corridor. Our dwells are the lowest they've ever been. Our service is better than it ever has been and it's driving a lot of these results. So again, the rhetoric will fade away. The facts will get out on the table and CP is going to bode well when the facts stand on their own.
<Q - Ken Hoexter>: Wonderful. Appreciate the insight. Thanks for the time guys.
<A - Keith Edward Creel>: Thanks, Ken.
<A – Nadeem Velani>: Thanks, Ken.

[Operator] Your next question comes from Chris Wetherbee with Citi group. Your line is open.
<Q - Christian Wetherbee>: Yeah. Hey, thanks. Good afternoon, guys. Wanted to talk a little bit about the guidance. So mid-single-digit on the RTM side, presumably pricing is additive to that when you think about the top line and you even assert the double-digit EPS growth, which is I know a convention you've used in the past. Can you help us sort of square the circle here to a degree, maybe talk a little bit about the operating ratio, some of the moving parts there to give us a little bit of sense sort of where in that double-digit stack EPS potentially could be. Seems like obviously higher than 10%, but just trying to get a sense -- a better sense about where that might shake out.
<A - Nadeem Velani>: Well, Chris, I'd say that certainly, we have strong confidence in the volume outlook. Some of the unknowns, we'll see what happens with fuel prices, which is being pretty volatile. It could be a headwind on fuel surcharge. That being said, it's a non-event from an operating income point of view for the most part. Currency, we've given you our guidance, which would be pretty consistent with 2018, so at CAD $1.30. So assuming that comes true at current levels, potentially, there is a little bit of upside, but that's been very volatile over the last three or four months as well. So, we've been very positive in terms of our pricing outlook and our cents per RTM, very evident by Q4 results. Cents per RTM we're extremely strong and that the renewals and the pricing environment that John spoke to has been very supportive. So everything I pointed out there, perhaps with the exception of fuel surcharges, could be additive to revenue growth.

We're performing well. Our precision scheduled railroading model and our approach towards sustainable profitable growth has helped us with our incremental margins. You should expect our operating ratio to improve. We're not going to back off that approach of continually lowering that and we believe it would be a disappointment if we're not best in the industry in terms of the operating ratio. Certainly the back half of 2018, we were far and above the best in the industry and we plan on staying there. So all that to say some of the negatives in terms of the macro environments, where we are in January. Depending on which headline you read, the sky can be falling every now and then and it could -- we think it's prudent at this point to provide the guidance we have provided of 10% or double-digit EPS growth. So do we feel confident in that number? Yes. Do we want to give you more visibility than that? I'd say not at this point. The last few years, we've been able to outperform and update our guidance accordingly. I'm not saying that that's what we'll do, but we'd rather be conservative and rather put out numbers that we're going to achieve than the other way around. So, all that to say I'm not going to give you more color than what we did in terms of our guidance.
<Q - Christian Wetherbee>: Okay. No, that's super helpful. I appreciate the color. One quick follow-up. Just want to make sure I understand where CBR, crude by rail, sits in the RTM outlook. Most of that, I believe, is take or pay. I just want to get a sense. Are you seeing any impact on that business based on what differentials have done over the last month or so?
<A - John Brooks>: Chris, we hit sort of this hundred thousand unit run rate here in fourth quarter. My expectations is we hang around there into Q1 and then we've got some upside as the year goes forward. I do think certainly some of the actions that have taken place here, most recently in Alberta, have created some – I don't know if it's unintended consequences, potentially uncertainties in the marketplace. We've seen, I would say, some step slowing, some new additional business slower to come on. Overall, the volume – the base volume, has held in there, but it's something obviously we're taking very seriously, we're watching very closely and we have stayed in sort of constant dialogue with the province.
<A - Nadeem Velani>: And Chris, our guidance reflects conservative view on crude volumes.
<Q - Christian Wetherbee>: Okay. Thanks very much for the time. I appreciate it.
<A - Nadeem Velani>: Sure.

[Operator] Your next question comes from Steve Hansen with Raymond James. Please go ahead.
<Q - Steve Hansen>: Yeah. Hey, guys. Thanks. Just very quickly on the labor front, how are you feeling about the employee count for the year? The traffic growth has obviously been quite strong through Q4 and even into early parts of Q1. How do you feel about the hiring front for this year and how should we think about that in our modeling process as you think about incremental operating margins and leverage? Thanks.
<A - Keith Edward Creel>: Yeah. I think still it's seeing some incremental productivity improvements based on mid single-digit RTM growth. I think it's fair to assume low-single digit increase in the head count overall. There is still meat on the bone.
<Q - Steve Hansen>: Okay. Very helpful, thanks. And just to follow-up on the crude commentary then, it sounds like some of the spread closures that have happened might mitigate some of the shorter term upside to that. But as you look into the contracted volumes for the balance of the year, should we expect the cadence to improve slightly or improve – I'm trying to get a sense for that run rate to the balance of the year, just purely what's contracted.
<A - John Brooks>: Yeah. So, Steve, I think my expectation would be as we push into Q2, we make a move towards 120,000 car annual sort of run rate and then we push into the back half for the year, we'll see what sort of upside that presents. I think the key here is we've set ourselves up well with the right partners. There is a lot of investments that have taken place not only at CP but with our partners. We just want to make sure we've got a level playing field in the market place to sort of drive so we can all reap the benefits of our efforts to date. And again, I'm confident that we're seeing that but right now, I'm cautious until the whole thing gets worked out between the curtailment and certainly the government's interest in providing their own crude by rail service.
<Q - Steve Hansen>: Very helpful.
<A - Keith Edward Creel>: I think for that whole thing, the government, I know, they have the best of intentions,

but the reality, some of the unintended consequences, I don't truly think they understand. Put yourself in an oil company's shoes. How do they plan? How do they do contracts? How do they plan their resources? Put yourself in the railroads shoes. Where capacity is critically important to what we do and how we maintain our business model and our service for all players in those market spaces that deserve and that want that capacity. As we committed capacity, committed capital, for instance to locomotives, based on projected growth, which unintended consequence gets impeded or curtailed as a result of these actions, don't think that I'm just going to spend the money. Don't think that the money spent and invested in locomotives and if we have other areas of opportunity and demand by customers that we're just going to hold it in case. We've got a commitment and responsibility to those customers to maybe redeploy those assets. And then you wake up six months from now and you say, wait a second. What happened here? Railroad will need locomotives, we need capacity, we need people. Or you hurting the industry. You're hurting the province. Well, you know what? I don't want to hurt anything but I think we got to think a little bit further out. We got to think about unintended consequences and I think there is a piece of that that's either not understood or has not been considered that's going to come into play.
<Q - Steve Hansen>: Understood. Thanks, guys.

[Operator] Your next question comes from Walter Spracklin with RBC. Please go ahead.
<Q - Walter Spracklin>: Yeah. Thanks very much. Good afternoon, everyone. On the capacity, I want to ask a question on capacity. You had alluded or you indicated mid-single-digit volume growth in your guidance. If you do see higher volume growth than expected, what would you say is your current capacity? How much more could you handle and at what point do you start to see cost creep as you reach some of your upper capacity limitations?
<A - Keith Edward Creel>: I think it all depends on where it comes. As we said in the past, we certainly can handle capacity. We could double it if we had to.
<A - Nadeem Velani>: Yeah. I mean, if they look...
<A - Keith Edward Creel>: I mean, if you look at the RTM growth that we have, I mean, it's conservative, so worst case or best case, how do you want to put it? We can handle double the RTM growth and not be capacity-constrained as long as it's not doubled and stacked up, I guess, in one corridor. As long as it gets spread out the way we manage our business. There is no one pinch point that creates huge concern.
<Q - Walter Spracklin>: That's great and now, perhaps moving over to pricing, could you delineate between what was core? I think you said at the upper end of the 3% to 4% range, just want to make sure I heard that right, but going forward, is there any impact John that you're seeing from truck rates coming down or anything that could lead to a price pressure given the competitive environment that wasn't prevalent in 2018?
<A - John Brooks>: Yeah. So, Walter, yeah. We were right at the top end of that on the same-store basis. Our renewals were a little better than that based in Q4. Those contracts actually pushed 4.3, 4.5 type numbers.
If I look into Q1, I think for the most part, we're off to a strong start with sort of similar type numbers. Obviously, staying close to our wholesale customers that give us a good read on the trucking market. We're staying close to our customers and what they're seeing in terms of their demand environment and as it stands right now, with what I believe is prolonged tighter capacity, I think that pricing opportunity continues. And then, Walter, we get back into the back half of 2019 and then you start to introduce ELDs and that potential mandate coming on early in 2020 and what sort of effect does that sort of bring into play; all of which, I think, supports a continued robust pricing environment.
<Q - Walter Spracklin>: Okay. That's all my questions. Congrats on a great quarter.
<A - John Brooks>: Thank you.
<A - Nadeem Velani>: Thanks, Walter.

[Operator] Your next question comes from Tom Wadewitz with UBS. Your line is open.
<Q - Thomas Wadewitz>: Yeah, good afternoon and also, congratulations on the really strong results. Wanted to see if you could lay out what you think is the likely pass on the curtailments in Alberta. I mean, I guess you're implying, maybe, John, with your comments that the curtailment fees, when you get up to 120,000 run rate, is that the right way to view it? What are some of the puts and takes on the way things might play out given what you

know today, given what you think might change on the government actions there?
<A - John Brooks>: You put me in an area of the ultimate guesswork, Tom. Guessing what – between free markets and governments, the output is tough. Look, if the spread stays where it is now at CAD $8, CAD $10, I think I saw it today, there's going to be ongoing pressure. I think the government has said they're going to revisit curtailments sort of on a monthly basis. February's, I believe, requirement is the same as what January is. So I think right now, we expect a little bit of that ongoing pressure to continue through February.
I would say for the most part, the crude shippers in our terminals, though, are bullish; that that's going to get itself sorted out and we're going to get back to sort of the heavy demand profile that we had leading into it. In the midst of all this we've moved, I think, close to 80 crude by rail trains last month and I think we're going to do a similar type number here in January. So I expect that sort of run rate to continue and then as we've got some additional opportunities coming on in Q2, we'll go from there.
<Q - Thomas Wadewitz>: So does your comment on Q2 going up to 120,000 that assumes that the spread widens out or does that happen even if you stay at CAD $8 to CAD $10 a barrel spread?
<A - John Brooks>: No. Look, if this stays at CAD $8 to CAD $10, there is probably going to be some challenges. Look, we've purposefully structured the right contracts that had some backstops against this business for us so it's not like there's nothing if those contracts don't start up. But our expectation right now, in terms of resource planning, is to have those start-up as we come Q2.
Now, the other thing is those aren't going to just all click in overnight on April 1. There is going to be a ramp up period through Q2 to build ourselves up to that run rate. The other interesting sort of, I don't know, unintended consequence is the right way to look at it, but we've actually seen quite a bit of an uptick in activity out of the Bakken as a result. And my energy team is somewhat deep into those opportunities now, assessing that potentially. Again, we'll take a very disciplined approach as it relates to any sort of capital or people or locomotive needs to handle that business, but actually that could present either further upside or a backstop if some of this is delayed in coming up out of Alberta.
<Q - Thomas Wadewitz>: Okay, great. Thank you for all the perspective. Appreciate it.
<A - John Brooks>: Yeah.

[Operator] Your next question comes from Brian Ossenbeck with JPMorgan. Please go ahead.
<Q - Brian P. Ossenbeck>: Hey. Good afternoon. Thanks for taking my question. John, just a follow-up where you left off on the Bakken. Obviously, the spreads has come down pretty significantly since October, but I know you've been pivoting some frac sand into that region to take up some of the capacity you left when that crude by rail dried up. Does that limit you in any way from turning that back around, putting some capacity back in the ground if that market were to pick up as you just mentioned?
<A - John Brooks>: No, I think it's an area and Keith can comment on it, that we've got pretty strong capacity in that area. You look at it, our U.S. grain has been significantly off, right, and certainly, the China tariffs have limited the flow of our soybeans out of that region. So frankly, if we can backfill that with frac sand and a little bit of Bakken crude, that might actually fit our resource planning for that area quite well. And the team has done a heck of a job re-homing our frac sand. Certainly, it's an area that we see some headwinds in 2019 as the in-basin sand continues to fill some voids out in the Permian. But we have been successful, I think we had about 15% of our frac moving into the Bakken a year ago, and we're moving close to 50% of our frac sand into the Bakken now. So it's been a pretty successful story for us.
<Q - Brian P. Ossenbeck>: All right. Thanks, John, for that color. Nadeem, just a quick one on the margins. Going back to Investor Day, we're looking at 100-basis-point of improvement year over year through 2020. Now, clearly, you're looking at some good operating leverage from better volumes 2019 growth on the operating side though on productivity gains, what are some of the specifics that you're targeting there to help drive some of that improvement?
<A - Nadeem Velani>: Well, certainly, operating leverage is something that in this kind of volume environment I will be describing that will be supportive. We've made some very strategic investments very recently, for example, in Alyth Yard here in Calgary where we've spent probably CAD $40 million, CAD $50 million of capital in the fourth

quarter of 2018 to optimize not only that facility but some of the blocking and some of the work up in Northern Alberta and Edmonton area that's going to be kind of benefiting from that investment here in Calgary. So that's going to help us, allow us to improve our train speeds, improve our train lines, and overall our ability to move through the yards much more effectively and improve our overall labor productivity as well. So there's a number of these items that are going to be helpful. One thing I'd point out from a headwind point of view, our guidance doesn't assume any land sales so that's about CAD $40 million headwind, about 40 to 50 basis point type of headwind to the OR. But, yeah, we certainly expect to improve the OR irrespective of that. So some of the other things we talked about in terms of robotic process automation, some of the benefits from our investment in the locomotive modernization, et cetera, so rest assured the pipeline of productivity opportunities are still plentiful.
<Q - Brian P. Ossenbeck>: All right. Appreciate the color. Thanks, Nadeem.
<A - Nadeem Velani>: Thanks, Brian.

[Operator] Your next question comes from David Vernon with Bernstein. Your line is open.
<Q - J. David Scott Vernon>: Hey, guys. Thanks for taking the question. Nadeem, similar kind of question. But I think at the Investor Day, you were laying out expectation for something like a 75% incremental margin and it sounds like things worked pretty well but you kind of fell short a little bit on what that incremental would have been. Can you talk about what maybe didn't go as well as you would have liked in the quarter and how that kind of relates to the outlook for the incremental margin guidance you gave for that last fall?
<A - Nadeem Velani>: Well, I wouldn't say that there was something that I'd point to that didn't work out well. Maybe you and Maeghan can compare notes after the call in terms of your calculation. We certainly see in excess of 70% incremental margins in the quarter. We had some one-time negatives as well that I pointed to during my comments. For example, we had a contingent liability in purchased services of CAD $20 million that was accrued and there was also some higher accruals for stock-based comps that was in the tune of CAD $15 million to CAD $20 million. That's probably where the differences lie between our calculation maybe where you're seeing things quickly…
<Q - J. David Scott Vernon>: I take out the land sales as well. So...
<A - Nadeem Velani>: Right. Right. So I think those are probably the key figures and depreciation is something that we back out as well. And so I don't think there was anything there that I would apologize for or any excuses to be made. We're very confident in our incremental margins and in excess of 70%.
<Q - J. David Scott Vernon>: Okay. But that was excluding – so that would be excluding the depreciation on land sales then.
<A - Nadeem Velani>: Right. Depreciation land sales stock comp. Yeah.
<Q - J. David Scott Vernon>: All right. And then maybe just as a quick follow-up, any commentary on the – what you're hearing from customers in the export coal outlook would be great. Obviously, with all the concerns about global slowdown, I'm wondering if you're hearing anything from Teck about sort of demand from metallurgical, coal off the West Coast of North America.
<A - John Brooks>: No. Things look pretty strong. We just recently updated our projections with them in line with what our guidance is and our expectations are for 2019. Teck, it's an efficient pipeline and they've got a longstanding strong book of existing customers and actually they seem pretty bullish is the right word but expect a pretty stable 2019.
<Q - J. David Scott Vernon>: Okay. That's helpful. Thank you.
<A - Nadeem Velani>: Thanks, David.

[Operator] Your next question comes from Matt Reustle with Goldman Sachs. Your line is open.
<Q - Matthew Reustle>: Yeah. Thanks for taking my question. Just back to the cost side, Nadeem you mentioned land sales, are there any other false headwinds that stop you from achieving the sub-60 OR that you've had as a run rate for the second half of the year?
<A - Nadeem Velani>: Fuel surcharges are always one of those unknowns, right? So when fuel surcharge comes on at 95%, 100% kind of OR, that can affect the math. That's something that I always point to. Stock-based comp, we

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expect the stock to go up. We've seen it come up since year-end. And our expectation is we'll execute on our plan and that the stock will continue to increase over the course of the year and that will create some headwinds on comp and benefits, a couple of things that I'd point out to.
<Q - Matthew Reustle>: Okay. Understood. And then, Keith, if you step back and just compare the demand environment today to where you were at the Analyst Day, are you seeing any slowdown in your end markets besides you guys mentioned the uncertainty around crude? But beside that, are you seeing any change in tone or shift from customers versus where we were just a couple of months ago?
<A - Keith Edward Creel>: Yeah. No negative sentiments we're obviously concerned in and around the crude space. That's the greatest degree of uncertainty outside of the macro environment uncertainty we have with all the rhetoric that's going on about what may or may not happen in the U.S. But no material impact, we still have very optimistic and robust demand reports from our customers. Until and unless I see consumer confidence really take a hit and consumer spending really slow down, I don't see it. Now, obviously, the big concern remains for us the grain U.S. piece there is some uncertainty in that but that was there in 2017 as well. We think we found the bottom. But who knows. We'll see what happens in the second half of the year. But at this point, outside of those couple of places, we see underlying strength and opportunity, optimism and no pessimism yet.
<Q - Matthew Reustle>: Very helpful. Thank you.
<A - Keith Edward Creel>: Thanks.

[Operator] Your next question comes from Fadi Chamoun with BMO. Your line is open.
<Q - Fadi Chamoun>: Thank you. Just a couple of clarifications. So, John, you mentioned the backstop in the crude by rail contract. I'm just trying to understand like the take or pay in the backstop. I'm assuming if you prefer to move the volume, but if we do end up in kind of spread remaining uneconomical, what is this backstop for relative to moving the volume? Do you recover your fixed cost? Do you – like how should we think about that relative to moving 100,000 carloads a quarter – a year?
<A - John Brooks>: Yeah. So you're right, Fadi. I wouldn't characterize it as take or pay. As typical with our contracts that have what we call a minimum volume commitment, we also have a sort of the give and the get. The commitment we ask them to make has a liquidated damage associated with it. So that's what we would have as part of these contracts. And as we certainly would always prefer to haul the traffic and earn the full revenue, but if we don't, the backstop for liquidated damage and those liquidated damages are designed to underpin and support whatever investments we've made towards that particular contract.
<Q - Fadi Chamoun>: Okay. But there's no way for us to kind of think about it in terms of number. Is it recovering half of what you would have made moving the volume or more than that or kind of any range that you can hang on that?
<A - John Brooks>: That is kind of tough and part of the issue is that it varies a little bit from contract to contract depending on the origins and the destinations, and certainly the customer and the amount of other business they have relative to it. I guess my only guidance would be, be assured of that if we brought on locomotives to support a contract, we've made sure that financially whatever we got out of that contract if nothing moved would support those capital investments. I have to leave it at that.
<Q - Fadi Chamoun>: Okay. Great. One other clarification. So it looked like you ramped up resources quite a bit in the back half of 2018. I think the head count is just under 13,000 kind of exiting the year. Is that the kind of work force you think is needed to handle the 5% or should we think that number goes up a little but as well as the year go in the context of the RTM guidance?
<A - Nadeem Velani>: Sure. So you might see a very small increase, as Keith mentioned, kind of we're doing mid-single digit, RTM growth may be low-single-digit head count growth. But one thing to keep in mind is it's usually a long lead time, as you know, to hire and train, et cetera. So last year, first half of the year, we were ramping up a lot of training but there's non-productive workforce. We had some stops and starts with the labor disruption and a very difficult winter, so there's some noise in the 2018, certainly the first half of the year. I would expect at this point are very small level of hiring in that 1% to 2% right now type of number, Fadi. And you won't see the same dynamic in terms of the non-productive workforce.

So all these, as you know, have been around long enough that the attrition is always there in your back pocket to support you and attrition is always there. It's something that you need to replenish so we're always hiring but we're not going to over-hire. And I think we've done a good job of being able to forecast and plan and not get caught whether it's from a people resourcing point of view or from an asset resourcing point of view and so we feel good about the visibility we have into the volumes and what we're resourcing to support that.
<Q - Fadi Chamoun>: Great. And congratulations on the strong results. Thanks.
<A - John Brooks>: Thanks, Fadi.
<A - Keith Edward Creel>: Thank you, Fadi.

[Operator] Your next question comes from Ravi Shanker with Morgan Stanley. Please go ahead.
<Q - Ravi Shanker>: Thanks. Good evening, everyone. The first question, can you give us a sense of what do you guys see in terms of the impact of trade and tariff headlines internationally and any impact you've already seen in the international intermodal business in terms of people building up in inventory in 2018 that could potentially lead to an overhang in 2019 or any sign of nervousness that you may see a decline in ordering in 2019?
<A - John Brooks>: Yes, Ravi. I guess I think we did see a little bit of late Q4 surge in international volumes as a result of the tariff. But I could tell you this, my team convinced me to take my January numbers and February numbers down a little bit and we haven't seen that happen at all. The volume continues to be, I would say, where we expect it or slightly stronger. I think the thing I'd point out is part of this depends on the partners you pick to associate with in that space and the operating performance you have for that business. And at the end of the day, we're secured in that area. We have no major contract coming up for renewal. We just renewed Hapag-Lloyd, they've been a very strong performer. The ONE business continues to grow with us. So we expect a tailwind to continue despite some of that rhetoric and noise. And then as I look ahead and this goes back to some of the earlier questions, there's opportunities for us to grow in that space as we move along in 2019 and into 2020.
<Q - Ravi Shanker>: Got it. Thanks for the color. And just a follow-up, thanks for the additional detail in the slides this time. If I can just ask you on slide 10 where you have the pie chart on your merchandise breakdown and energy chemical is 47%, do you have a sense of what the number was 12 months ago?
<A - Maeghan Albiston>: I don't think it's moved materially, Ravi, but I can follow up with that number after the call.
<Q - Ravi Shanker>: Great. Thanks, Maeghan.

[Operator] Your next question comes from Allison Landry with Credit Suisse. Please go ahead
<Q - Allison M. Landry>: Thanks for taking my question. And maybe just first going back to the comments about – Nadeem, your comments a couple of questions ago in terms of rightsizing the resources and, Keith, I think you mentioned earlier being able to handle 2x the RTM growth. Should we take this to mean in terms of there being some latent capacity in the network? If the macro does unwind maybe sooner than expected, will it take a little bit longer to right-size resources or is that a non-issue in your opinion?
<A - Keith Edward Creel>: That's a non-issue. If any of that were to happen and these opportunities were to reverse, hopefully this railroad can adjust and right-size resources the other way quicker than anyone else in this industry. We keep our finger on that routinely, daily. It's part of the DNA. It's well within our blood and we breathe and eat it. From a planning process, being going up, being going down, I'll make a case in a down market and I'll say this with firm conviction this railroad would be better than the other railroads within the industry.
<Q - Allison M. Landry>: Okay. And then as my follow-up, I wanted to ask a little bit about the U.S. regulatory environment and then specifically if you have any thoughts or insights on the potential regulatory implications of PSR in the U.S. given the change in Congress and the Transportation and Infrastructure Committee. Do you think that the misunderstood notion that PSRs are cost cutting and a CapEx reduction strategy along with maybe the fact that more rails are revenue adequate versus years past? Does this add a layer of risk from the regulatory standpoint that maybe the industry and the market hasn't seen in the number of years and how worried are you about that and how worried should we be?
<A - Keith Edward Creel>: Well, I think we have to be cognitive. There's always a risk and we have to manage that.

And I think you manage that by educating the regulators as well as the customers with the facts. You can look at our case in point, Allison. I mean, we started this journey in PSR in 2012. We fixed the engine. It's running like its own machine and we're a growth engine now, we're not a transformation engine. So we started going through the cycle, continue to evolve and continue to improve. We're not perfect, obviously. But at the end of the day, I think by and large, talk to our customers that may have resisted the change in the onset. Those are happy customers today because we've created precious capacity that's allowing those customers that have partnered with us to win in the marketplace. You look to some of the rhetoric and some of the concern about investment in infrastructure, we've never invested more money. You look at our safety record, it's never been better. So if you want a case and proof that PSR works, if it's executed properly, there's a case study out there.

Now, with that said, I know and I respect the other CEOs of these railroads, they understand some of those nuances. I see what the STB is doing. The STB is asking questions, they're trying to learn, trying to get educated. And I also believe that with a prudent voice based on fact, it's I think that action is necessary then they'll act. But the reality is it proves itself out. I mean, CSX again. I don't have to advocate for CSX. Their results advocate for themselves. They implemented PSR. There is, obviously, growing pain. Change is never easy for anyone. But at the end of the day, they've created capacity, created service. And by and large, if you talk to the customers overall, I think they would support those statements. So again, if it's fact-based and we educate and try to curtail some of the rhetoric and just speak the points, the fact and points of experience, I think that's going to outweigh the rhetoric that's out there and balance and offset the risk.
<Q - Allison M. Landry>: Okay. That was helpful context. Thank you.

[Operator] Your next question comes from Seldon Clarke with Deutsche Bank. Please go ahead.
<Q - Seldon Clarke>: Hey. Thanks for the question. Just in regards to your volume guidance for this year and just the different opportunity you've laid out for growth, how resilient do you think mid-single-digit volume growth is next year in a more sustained macro slowdown?
<A – Nadeem Velani>: How resilient?
<A - John Brooks>: How resilient?
<Q - Seldon Clarke>: Yeah. I mean just like could you give us some context around like some of the different opportunities that you see that are more insulated from if we continue like hovering around 1% GDP growth. I'm not talking about a recession or anything like that, but just maybe what the opportunities are that are less macro-sensitive versus like the typical industrial production carloads that the Class 1s move.
<A - John Brooks>: Yeah. Well, certainly, a big part of our business remains our bulk franchise. And I expect, for the most part, our grain business will fall in that category. Although we set record – had a record year in potash, I think all the signals remain very strong in that marketplace. As I already spoke about, I think Teck is, for the most part, expecting a pretty strong 2019, so that part of the business is pretty stable. And I look for growth opportunities there. We've already spoken about the crude by rail and where we expect ultimately that to go. Then you sort of layer on. We've got a proven track record in our domestic space. We've been growing at close to double digits the last now two to three years in that area. We're going to layer on Dollarama which will be now a significant new member to our strong retail portfolio in that book. That's going to provide a pretty nice tailwind and I think pretty much insulate us from any downturn that could affect domestic. I spoke about international and then I still think we've got some tailwinds certainly in the first half of the year around ONE. And we expect growth with our existing customers. Really I go down the list and I feel pretty good unless the sky completely falls that we're going to be able to achieve that guidance.
<Q - Seldon Clarke>: Okay. That's really helpful. And then just last one for me, do you have a target for free cash flow this year?
<A - Nadeem Velani>: Yeah. We should see – we don't have some of the land sales that we achieved in 2018, so you should see kind of marginal improvements in overall free cash.
<Q - Seldon Clarke>: Okay. So just a little bit of...
<A - Nadeem Velani>: Around CAD $1.3 billion in 2018, should see a modest increase in that kind of low-single

digits.
<Q - Seldon Clarke>: Okay. Even with – I guess you have a little bit of a headwind from CapEx.
<A - Nadeem Velani>: Yeah. I mean modest.
<Q - Seldon Clarke>: Okay. Was there any – I guess with the CapEx number you guided to is all gross and then the difference between, obviously, that is the land sales, but is that – was there any investments that were pushed out or delayed or anything like that or is it just strictly the land sales that makes the difference?
<A - Nadeem Velani>: It's truly the land sales, yeah.
<Q - Seldon Clarke>: Okay. I appreciate it. Thanks a lot.
<A - Nadeem Velani>: Thanks.

[Operator] Your next question comes from Scott Group with Wolfe Research. Please go ahead.
<Q - Scott H. Group>: Hey. Thanks. Good afternoon, guys.
<A - Nadeem Velani>: Hey, Scott.
<Q - Scott H. Group>: So is there any way to just quantify the size of Suncor, and the domestic intermodal contract? And then on this no land sales in 2019, have we sort of run our course on real estate or are we just being conservative?
<A - Nadeem Velani>: I'll let John speak first.
<A - John Brooks>: Yeah. So the domestic intermodal opportunity with Dollarama is a CAD $30 million to CAD $50 million opportunity. The Suncor opportunity will phase itself in through 2019 and carries with it some developments that will really sort of bear its maximum fruit as we get into the 2020. It's probably a CAD $20-plus-million opportunity near-term growing doubling as we're getting to the out years.
<A - Nadeem Velani>: Then on the land sales, Scott, sometimes, it can be very difficult to predict what – they're still lumpy and you're dealing sometimes with – between government entities or councils but that can be difficult to move along as we've seen in the past. So, difficult to predict some of the smaller land sales. As far as the larger pieces, one key item, that one key area that we originally highlighted is an opportunity as part of the longer-term kind of divestiture, we might target to utilize for internal kind of railroad ops that could create a good tailwind for our growth strategy going forward. So we revisited that book of business to see what makes sense today and what makes sense with our current growth strategy and profile of business. So you still see opportunities on that front, but they're longer terms. So that's how our categories are forecasted on that.
<Q - Scott H. Group>: Okay. That's helpful. And then, John, if I could just ask one just quick last one on crude. So at what level volume run rate would the liquidated damages kick in? Meaning we're in 100,000 run rate and we go to 90,000 run rate. Do we get liquidated damages on that 10,000 shortfall or is it we need to see a more material drop-off before liquidated damages kick in? I just want to understand like at what level they're really protected at.
<A - John Brooks>: Scott, it's contract by contract. So it would be really- well, it would probably be confidentially wrong, number one. But really difficult to sort of guide you to that other than to say, again, we built these on the premise of supporting any sort of resources that the company has had to acquire to support it. And it's not dependent on that but we would be backstopped on those fronts.
<Q - Scott H. Group>: But are those contracts running above those levels today?
<A - Nadeem Velani>: So Scott, I mean some of those contracts haven't even kicked in yet, right?
<Q - Scott H. Group>: Right.
<A - Nadeem Velani>: So some of these – so that's the difficulty in answering it as well.
<Q - Scott H. Group>: Understood. Okay. All right. Thank you, guys.
<A - Nadeem Velani>: Thanks, Scott.
<A - Maeghan Albiston>: Thanks.

[Operator] The last question that we have time for today comes from Bascome Majors with Susquehanna. Your line is open.
<Q - Bascome Majors>: Yeah. Thanks for squeezing me in here. Keith, about a month ago, you negotiated some updated employment terms and compensation with the board. You clearly – the performance of the business has

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been really great as of recent and looks forward to carrying into 2019. Can you just give us a little color on what led to the revisiting of employment terms and is this the whole agreement wasn't filed? For any investors who were worried about how long you're going to be at CP, kind of some of the commitments that you have made to the firm and related to that agreement. Thank you.
<A - Keith Edward Creel>: Yeah. I guess in simple terms, number one, the material terms of the deal relative to how long I've committed to CP has not changed. I'm committed on my current contract through first quarter of 2022. I'm telling you right now, I'm having a great time. This is something magical that we've created with this team and this opportunity leading this company. So I have no intention to do anything any differently.
And relative to my compensation, I think it was just a recognition of some shareholders' concern as well as the market criteria out there that if we're going to be the best performing railroad out there, it's probably pretty fair that myself as well as my team are compensated fairly relative to the market. So that's all it was, just closing the gap between what I currently make with the market. In light of that, it wasn't only I. Obviously, I'm the only one who gets filed but we took steps as well to recognize the record performance of this team, midlevel management-wise, senior level management-wise across the board. This isn't just Keith Creel, this is a collective effort with this entire company. And we're taking steps to make sure to protect the talent that's making this happen.
<Q - Bascome Majors>: I appreciate that color and well-deserved. Thanks for taking my question, guys.

Keith Creel

Thank you. And with that, I guess we're going to wrap the call up. I want to thank everyone for their time this afternoon. Certainly as you have an opportunity to digest these results, I think you will share in our confidence. If you have anything to clear up then obviously reach out to Maeghan and her team and they'll be happy to provide any more detail that they can.

And with that said, have a safe and productive afternoon. We look forward to revealing what we believe will be very strong first quarter result as well when the time comes. Take care.