Transcript

Q2 2018 Earnings Call

July 18, 2018

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 Jesse, and I will be your conference operator today. At this time, I would like to welcome everyone to the Canadian Pacific's second 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, to begin the conference.

Maeghan Albiston

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

With me here today is Keith Creel, our President and Chief Executive Officer; Nadeem Velani, Executive Vice President and Chief Financial Officer; and John Brooks, Senior Vice President and Chief Marketing Officer. The formal remarks will be followed by Q&A. And in the interest of time, we would appreciate if you could limit your questions to two.

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

Keith Creel

Thank you, Maeghan, and welcome to the call today. Certainly pleased and honored to represent our CP family in reviewing these results of the second quarter which reflect, in my mind and in our team's mind, a solid operational performance underpinned by some pretty solid demand across most of our business units, which we'll expand upon and address in our comments.

With that said, we came out of the first quarter as expected into the second quarter creating some pretty strong operating rhythm, established that coming out of the winter, but obviously not without some headwinds and without some noise, so to speak, in the quarter as we all know labor was a meaningful focus for is this quarter. We had experienced two service interruptions due to labor negotiations with two of our unions during the quarter. As you can imagine, winding down the railway, the start, the stop, winding back up the railway certainly created some inconvenience, some disruptions, some additional costs and some slowed momentum, so to speak, for that process that had an influence to the quarter relative to costs, as well as curtailing to revenue and certainly pain experienced and associated with that for our customers.

With that said, though, what has been a headwind, I think, and I'm confident and optimistic will become a tailwind creating some labor stability as a result of those. We've ratified our agreement with the IBEW, which are the employees that provide our signal systems across our network in Canada. And we're in the process now of a ratification vote with the TCRC, which are our conductors and engineers, ladies and the women that actually operate our trains. We'll get the results of that on Friday this week, Friday morning. We remain optimistic. It's been pretty solid feedback.

And what I'm most encouraged about in addition to the opportunity to renew the agreement is, symbolically, it's a very significant step in this company's transformation toward a renewed positive relationship growing forward together with the TCRC as well as the IBEW. You put that in concert with the other very progressive collective agreements we've ratified across the property in 2017 and what will now be 2018, and it sets this company up well for

the labor stability on a go-forward basis, with the workforce, top to bottom, officer to craft employee, we're all part of the CP family as we work hard to produce these results and create this value not only for our customers but for our shareholders and for the Canadian economy.

In spite of the labor disruptions, we still produced very solid results this quarter. Revenues were up 7%. Adjusted EPS grew 14% compared to 2017, coming in at CAD $3.16. Operationally, we were still able to deliver improvements both train weights and lengths, as well as the 2% improvement in fuel efficiency, which I speak – which I say and reflects bodes well for Robert and the team, the operating team, across the railway that have worked so hard each day to make that possible. And from a safety performance, very encouraging as well, with personal injuries down 7% year-over-year and train accidents down a very considerable 32%.

On the regulatory front, we had some developments as well in the quarter. Bill C-49 finally came to fruition. And as we said when the legislation was out and being discussed and debated, there were some things in it that we would accept. There's some things we liked. There's some things we loved. And as it's received royal ascent and became law, it's allowed us to fulfill our commitment for much needed investment in our grain hopper fleet. Over the next four years, we're going to be investing CAD 0.5 billion in hoppers, enabling CP to move more grain more efficiently across our network. And multiple stakeholders will have substantial benefits from this, which is very encouraging. Not only CP, but our customers, our farmers, Canada's reliability as the world's supplier of grain, this product or these hoppers will allow us to create additional capacity, faster loading and unloading for our customers, and a much more reliable fleet.

So that's one of the things that we really liked in this legislation that we're taking the cash that we're generating running this railway to invest in and will allow us to grow forward at a sustainable, profitable, reliable pace as we go forward.

And the thing I loved about it, the Bill also provides us an ability to make a significant enhancement on the safety side, enabling the use of data for locomotive voice and video recording equipment as a proactive measure to improve our railway safety. This Act is a step forward for efficiency and safety in Canada's rail sector and it's a quantum leap in safety, be good for our employees, good for the communities that we operate in and through, great overall for Canada, for the U.S. and for the industry.

With that said, I'm going to hand it over to John to bring some color on the markets before we turn it over to Nadeem to elaborate on the numbers and we take additional Q&A on the results. So, over to you, John.

John Brooks

All right, thank you, Keith. And, good afternoon, everyone. Total revenues were up 7% this quarter to CAD 1.75 billion. RTMs, as Keith said, were up 4%. Fuel was a 3% tailwind for us, but this was largely offset by foreign exchange headwinds of about 2%.

I pointed out last quarter that our renewal pricing was strong, and we've seen those trends certainly continue and flow through into our same-store price this quarter. Same-store price came in at the high end of our 3% to 4% targeted range. Now, as a reminder, the new regulated grain pricing effective August 1 will be 2.8%. That's going to put some pressure on our same store in Q3. However, renewal pricing I fully expect to remain healthy and should help act to offset the regulated grain. Also as a reminder, in 2018, approximately 40% of our book will renew. About half of these renewals are completed. We will renew the second half as we move over the course of Q3 and Q4.

Mix impacts were modestly negative driven by continued strength in our crude and potash business, which contribute dollar per RTM below our corporate average, but this was partially offset by some good growth in our automotive. As Keith noted, we had some top line impact from network disruptions related to the labor negotiations, which we estimate had about approximately a 250-basis-point revenue impact on the quarter. But I'm very pleased to say that I see no lingering effects from these events.

So, taking a closer look at the revenue performance on a currency-adjusted basis, grain was up 4% this quarter in spite of volumes being down about 3%. Over the last four to six weeks of the quarter, we've seen the Canadian grain

decelerate a little bit principally due to seeding and weaker commodity prices. We believe the supply overall, though, remains strong, and we expect carryout to be stronger than last year as we enter new crop. So – and although it's pretty early to tell and call the crop, generally speaking, as I look across production status in both Canada and the U.S. growing regions, it's trending to be, I would say, at or above average production levels at this point. Potash revenues finished up 8%, led by strong export volumes from both Canpotex and K+S. In spite of the strike, I can tell you we're proud that we moved a record amount of potash in Q2 and we feel confident that strong potash demand will continue at the back half of the year.

Fertilizers were a notable drag on the quarter. Revenues were down 18% and volume down 10%. The volume decline is largely a reflection of two unplanned plant outages, plus we had a delayed application season this spring. Further amplifying the revenue decline is some negative mix as a result of moving less NH3 volume.

The merchandise, energy, chemical and plastics portfolio saw revenue and volume grow across every commodity group. The ECP group led this at 33% growth. And while crude was a large contributor, with about 20,000 carloads moved in the quarter, I highlight that excluding crude, this line item was up 13%.

The metals and minerals portfolio was up 10% this quarter, led by sand and steel, and forest products were up 5% and are expected to remain positive through the remainder of the year, as construction forecasts remain strong and we continue to further leverage our Vancouver, Toronto and Montréal transload capabilities.

I'm pleased with our automotive performance this quarter as well. Revenues were up 21% in spite of a weaker automotive environment. We have a new team of sales and marketing staff leading this portfolio and they are getting great traction in the marketplace, leveraging our reliable service and our capacity to grow. I started out the year cautioning that automotive would likely be a drag, but given recent performance, I'm now cautiously optimistic we may have some upside.

So finally, finishing out in the intermodal side, revenues were up 8%. International intermodal led the way at 16% as we grew with our existing customer base and welcomed Ocean Network Express business to our franchise. Domestic intermodal finished the quarter just up modestly, largely a reflection of the strike and some time-sensitive shipments that were diverted. With truck capacity continuing to tighten in the anticipation of a strong fall peak, we expect both our international and domestic intermodal to perform quite well through the remainder of the year.

So as I look at the demand environment, I am to say the least, I think, very encouraged. It's definitely healthy, and most importantly, I'm very proud of my team's strategic and disciplined approach in the marketplace. As Keith mentioned, we're working with our partners, our customers, to maximize our network value. We're working hard to enhance our Total Transportation Product in all of our business units and we're pricing for the value that we provide in the marketplace. So, I'm incredibly excited for the opportunity to talk more about this with the team as we move towards our Investor Day in October.

With that, I'll pass it to Nadeem.

Nadeem Velani

Thanks, John, and good afternoon. As Keith and John noted, this quarter's results were impacted by network disruptions related to labor negotiations. This caused some missed revenues and some lost productivity which impacted the topline and the operating ratio. But also, as John mentioned, the strike impact is temporary and there are no ongoing impacts to the business. Rising fuel prices were also a headwind of about 180 basis points on the OR and also created a drag on earnings due to the lag in our fuel surcharge program.

The operating ratio was 64.2%, an increase of 140 basis points. Had it not been for the strike, the OR likely would have been flat year-over-year. The underlying performance of the railway is solid and we continue to drive productivity and grow at high incremental margins. As such, we are confident that we'll see core margin improvement in the second half of the year.

Taking a closer look at a few items on the expense side, I'll be speaking to the results on an exchange adjusted basis, which is shown in the far right column of the slide. Comp and benefits expense was up 3% or CAD 10 million versus last year. The increase is driven by higher volumes, incentive compensation, pension expense, training costs and labor inflation. These increases were partially offset by productivity improvements from increased train weights. Our workforce is 5% higher than last year at nearly 12,900 as we continue to hire for increasing demand.

Fuel expense was up 48%, primarily as a result of higher fuel prices and increased volumes. Fuel consumption, as Keith mentioned, improved by 2% driven by improved train utilization from higher volumes. Materials expense was CAD 53 million, an increase of CAD 5 million or 10%, driven by higher locomotive maintenance and higher wheel repair costs. Purchased services and other was CAD 284 million, up 5% from last year. Higher intermodal pickup and delivery costs and higher casualty costs were partially offset by reduced locomotive repairs. There have been no material land sales year-to-date. We still expect land sales to be approximately CAD 50 million this year, essentially all in Q4.

Moving below the line, excluding significant items, other charges was CAD 5 million higher this quarter, mostly due to currency impacts on working capital. Interest expense was CAD 10 million lower or CAD 5 million lower, excluding FX. The reduction is primarily driven by savings from debt refinancing. Adjusted net income improved 11% and EPS on adjusted basis grew 14%.

Taking a look at the free cash on the next slide, we continue to generate strong free cash. Year-to-date, cash from ops increased by 20% and free cash flow increased by 37%. Reinvesting in the business and maximizing returns on invested capital remain top priorities. As Keith mentioned, we're making a substantial investment in renewing and upgrading our grain hopper fleet, which will yield significant benefits for CP and our customers. We are in a very fortunate position to have a significant pipeline of high-return projects to invest in. And as a result, we now expect to spend approximately CAD 1.55 billion in capital this year. This is also impacted somewhat by a higher exchange rate.

We also completed a number of transactions this quarter. We completed our NCIB program where, over the last 12 months, we purchased 4.4 million shares or approximately 3% of our float at an average cost of CAD 214. We also completed a new debt offering of $500 million, allowing us to refinance at lower coupon rates and generate annual interest savings of $20 million. We also announced a 15.5% increase to our quarterly dividend. To note, since 2016, we have increased our dividend by 86%.

So to wrap up, the first half of the year had its challenges, with some difficult Q1 with weather and some challenges from some stopping and starting from labor disruptions, but we are very excited to deliver a very strong second half.

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

Keith Creel

Okay. Thanks for the comments, John and Nadeem, and I'll wrap up by reiterating the obvious. This team remains focused on creating shareholder value through delivering our service plan, precision scheduled railroading, creating a valued product in the marketplace the capacity we have on this railway to drive profitable, sustainable growth. We've got strong momentum heading into the second half. We'll continue to see tremendous opportunities for this franchise over the next several years which we're approaching at a very disciplined and thoughtful manner.

Finally, I look forward to seeing many of you. Hope you can join us in our campus in Calgary for our October Investor Day so you can meet the team and gain a deeper appreciation for some of the exciting opportunities that lie ahead for this company.

So with that said, I'll open it up for Q&A. Thank you.

Question & Answer

Operator

Thank you. [Operator Instructions] Your first question comes from Fadi Chamoun with BMO Capital Markets. Your line is open.

<Q - Fadi Chamoun>: Thank you, good evening. On the growth and demand outlook, so far, you've been kind of guiding us to mid-single digit RTM growth year-to-date. You are at mid-single digit, and it feels from your comments today and the momentum going through the second half that you have an opportunity here to do a little bit better. Can you give us some guidance into the second half? What do you think that RTM will look like?

<A - Keith Creel>: Well, you made some good points, Fadi. I'm not going to suggest you haven't. The back half of the year definitely looks promising. But at the same time, there's still a lot of uncertainty out there. We think our current guidance is prudent. Given those uncertainties, we have outlined a lot of those at the start of the year, some of the question marks which have really played out for us, trade uncertainty, currency volatility, the size of the next grain crop. Things do look promising, things do look optimistic, but I think the prudent approach is to wait. Let's get a little closer into the third quarter. Let's see what the grain crop is going do from a harvest and what we think those projections are. And if we're in a position that we can raise guidance or change guidance, obviously, according to what may or may not happen, when we get closer to that timeframe, we'll certainly do that.

<Q - Fadi Chamoun>: Okay. That's fair. Kind of follow-up along the same lines, I think – I mean, we sense from the shippers community that capacity is fairly tight in the Canadian transportation, and then, the rail, even more specifically. And ultimately, this had proved to be a good currency if you have the capacity in the right kind of market or freight corridor then. And I just wanted to kind of get your thoughts on where do you think you have some kind of favorable positioning to leverage this demand environment, if you want to talk about it in terms of specific commodity or overall.

<A - Keith Creel>: You've got a very good read. Obviously, I don't need to tell you that, but certainly, as demand has increased and as the competitive landscape has played out across Canada and coming into the U.S, this transformation this company has gone through since 2012 has created and identified quite a bit of surplus capacity, which is benefiting CP extremely well now. We've got the cost base reset. We've created a very reliable service product. And strategically now, we are positioned – and regardless, I can make a case for several of the commodities and at very strategic locations – to grow with our customers.

The key is to take a disciplined and a thoughtful approach to that. And we can't be everything to everyone. I'm not going the suggest that we can. This growth is out there, but at the same time, I feel a very, very strong obligation to my existing customers to make sure that as we layer on growth, that we pick our partners – and that's the key word, is partners – so that when we grow, we grow together, we don't impede our ability to provide the service that our customers today expect and also to deliver on the commitments we make with our customers as we grow forward. So strategically in Vancouver, strategically in the Chicago marketplace, strategically in Toronto, strategically in Montréal, strategically in Edmonton, strategically in Calgary. I've got a story in each location where if the fit is right, it allows us to create profitable growth and provide the value for the customer. That's what creates the stickiness for this company, not only today but for the many quarters and years that lie forward, and philosophically, strategically, that plays well to our franchise and that's what our strategy is and I think we're going to execute it well. So from that standpoint, capacity is currency. We're going to spend it wisely, Fadi.

<Q - Fadi Chamoun>: Okay. Thank you.

Operator

Your next question comes from the line of Ken Hoexter with Merrill Lynch. Your line is open.

<Q - Ken Hoexter>: Great, good morning – oh, good afternoon. John you mentioned that pricing was at the high end of your target of 3% to 4%. Just given the market strength, I'm wondering if you expect to see or why you wouldn't have seen maybe even higher pricing in the near term.

<A - John Brooks>: Ken, actually, our renewals in the quarter were pretty solid. So, we were more sort of north of that 4% on renewals. And certainly then, looking back the same store kind of carried along with it, it caught that tailwind. But look, as I look into Q3 and Q4, I think we can – there's an opportunity to keep a fair amount of that momentum. It may be not charging forward at that pace because I know we do have some headwinds as I start looking into our grain franchise, and some of that pricing in the markets that we shift to is pretty competitive. But certainly, there's an opportunity to sort of carry a fair amount of that momentum as we look into Q3 and Q4.

<Q - Ken Hoexter>: Appreciate – okay.

<A - Keith Creel>: And that headwind that we're facing with the regulated grain increase being less than that mid-level number certainly is a sizable and one we've got to make sure that we take into account and the model should as well.

<Q - Ken Hoexter>: Fair point. And then, Nadeem, if I can maybe follow-up on your – you said ex-strike, you would have expected the OR to be flat, but yet, you expect margin improvement in the second half. Maybe you can delve into that and maybe talk about what leads that improvement and given that employees are up 4% or such, what – how do you offset that cost.

<A - Nadeem Velani>: Well, I think there's combination of – we didn't get a chance to realize our full productivity. So both in April and in May, we had to take the network down two times and that stop-start really has an impact on the overall productivity. So, we saw some gains but we would have seen a lot more. I'd say that from a productivity from your employees, there's a long lead time to train and get people up to where they can be productive employees for the company. So, we're kind of prepaying on that investment to get a return on our labor productivity in the back half of the year. So, we're absorbing those costs as we speak and we see the benefits of that later in the year.

Certainly, as we see volumes accelerate here, we – it's early but we're on a very strong start in Q3. The operating leverage, the benefits from pricing, I think you get a much better weather scenario. We still had snow in April and some impacts in Q2. Certainly would expect a lot more operating leverage and a much more productive network in Q3. So, we're hitting our sweet spot if you look at our operating metrics, and leveraging that to bring it to the bottom line is what gives us the confidence.

<A - Keith Creel>: Yeah. If you look at the raw productivity, Ken, and I look at when I say raw productivity, train length, train weight, terminal dwell, train speeds, certainly deterioration has stopped. You may have a little off a little, a little up, a little down week to week, depending on how the network is running. But overall, this network is extremely fluid. And if you take that start-stop out and you allow yourself a chance to maintain that momentum, that's when this thing really works well. And to Nadeem's point, right now, those employees are a training investment. It's an expense item for us, but once they start operating trains and moving revenue, then that investment pays off and we don't have the same level of investment second half in a more robust demand environment. That's what allows us the confidence to say that we'll get this to margin improvement overall for the year.

<Q - Ken Hoexter>: Great. Nadeem, Keith, John, thanks. Appreciate the time.

<A - Keith Creel>: Thanks, Ken.

Operator

Your next question comes from Tom Wadewitz with UBS. Your line is open.

<Q - Thomas Wadewitz>: Yeah, good afternoon. Wanted to ask you a little bit about kind of framing the ramp in crude by rail. I think you had some helpful comments on that, but wanted to see if that's changed. Maybe you could offer what

the level was in second quarter and how that might progress in terms of crude by rail carloads, third quarter, fourth quarter.

<A - John Brooks>: Yeah. So I think I said, Tom, that we did 20,000 carloads in Q2, so roughly about 60 train a month run rate. As I look into Q3, I think we've got an opportunity to add to that. It'll incrementally come on as we sort of underpin that business with the resources we need to haul it through Q3. So, I think you can get a nice step function as we move through the balance of the year. It's interesting, though, the crude by rail has certainly presented us an opportunity and an opportunity that we think can span two, three to maybe upward to five years for us. But as part of that, it also brings a unique opportunity for us to really work with a different set of customers that allow us to sort of diversify our book. So a lot of these shippers, as you know, have pretty big transportation spends well beyond the crude business. And ultimately, this crude has allowed some of these shippers to test our service and opened up a whole lot of opportunities to – not only for crude, but deepen our partnerships into the future. So, that's sort of what it looks like. I think there is a good opportunity for us to expand this year as we go into Q3 and Q4.

<A - Keith Creel>: And Tom, if I could add to that, as we've always said, if I go back to 2013, 2014, we said then that there is a certain level of business in this country that this franchise could serve best from a service standpoint, and I'm talking about turning assets and velocity. The markets we serve best, that we can help our customers control their costs and earn additional business is going to do well for CP, but we had to earn that opportunity. We had to work hard to create a very reputable, dependable service model. We've done that now. We've got capacity. So as much as I appreciate crude, and certainly, we want to help solve that problem as much as we can, the most exciting part is the opportunity to develop respect and relationships with these customers, that they see the value in this franchise and it allows us, crude or no crude, to create significant value for both the customer as well as CP, the economy and our shareholders. That's a win-win solution to me. That's the value of low-cost reliable service. That's the value of precision scheduled railroading that keeps – the gift that keeps on giving.

<Q - Thomas Wadewitz>: Right. Okay. That makes sense. What do you think about the competitive dynamic? I think CN had – obviously had some big capacity issues for a period. And it seems like they're – if you look at their volumes and metrics and so forth, they've bounced back probably quicker than I would have anticipated. I guess it's hard to have granularity on how much demand they're not handling that maybe is out there. Do you think the competitive dynamic has changed as a result of them improving or would you say it's still kind of pretty favorable for you in terms of winning some new business and growing the book and everything?

<A - Keith Creel>: Listen, I would say this, Tom. I'm a bit biased. I've got a bit of knowledge on both networks. Number one, I've always said this, whether I was on that team or since I've joined this team, there's enough business in this country, these two networks from both railways to do well. CN, obviously, is very talented, very deep company. They've got great stretch. They reach markets sometimes that we don't reach. But as I said earlier, this franchise has its own set of unique strengths, too. The key markets in Canada, Vancouver to Chicago, Toronto to Vancouver, Montréal to Vancouver, if you look at the network and our best day versus our competitor's best day in those key markets, if we're doing our jobs, we should be able to win business to drive profitable, sustainable growth on this railway, which is exactly what we're going to do.

So, CN is a great company. They'll come back. Canada, in my mind, again, I'm a bit biased, Canada enjoys what I feel are two of the best run railways in the world, not just in North America. It's a good problem to have. They'll come back, and when they do, Tom, we're going to compete just like we always have. And again, the markets they serve best, they got a head start on us. The markets we serve best, we got a head start on them. But as I started, I'll close saying there's enough out there for us both to do well. Two well-run operations, two well-run railways, we provide value for our customers, and maintain discipline and run the operation in growing, and I think we all do well.

<Q - Thomas Wadewitz>: Okay. Great. Thank you for the time.

Operator

Your next question comes from Chris Wetherbee with Citi. Your line is open.

<Q - Chris Wetherbee>: Yeah, hey, thanks. Good afternoon, guys. Just wanted to get a sense of – come back to what your thoughts are around earnings performance this year. You guys still feel comfortable with the double digits, obviously, but first half of the year has been at that pace. Sounds like things get better in the back half. Just kind of want to frame up how you think about the earnings growth potential of this franchise this year.

<A - Keith Creel>: Well, we're confident in our guidance at this point. I would say that for certain. And as I said earlier, we're choosing to take a more prudent approach. I don't want to get ahead of ourselves or get ahead of our skis. I don't know yet what the grain crop is going to do. I certainly don't know what this trade uncertainty may or may not do. I've got my own personal views but a prudent approach is, I think, the right approach. You might call it conservative. I call it prudent. I think it's the right thing to do. And as we get a little more clarity, if things are on a positive side of some of those positions, then we may be in the position to change this, but it's just not time yet. We don't have clear line of sight and I don't think it would be the responsible thing to do at this time.

<Q - Chris Wetherbee>: Okay. That's helpful. And then, just thinking – coming back to the crude by rail opportunity, it sounds like there's been some customer wins there and maybe it's sort of broadens that portfolio business with those customers, which is great. When you think about specific crude contracts, are there more incremental customers to go after as you sort of take that 20,000 carloads and move it higher? Just want to get a sense of if all of the contracting has already been done or if there is sort of incremental business left to win and sort of what you think the competitive landscape is on that business?

<A - Keith Creel>: Yeah. We're still having discussions, absolutely. We're always going have discussions to keep an open mind. But again, from a capacity standpoint, the most important thing we've got to remind ourselves of as much as the revenue looks great and I'd love to be the solution for everyone, I've got to protect those existing customers. If I bring on additional business, I've got to make sure that I've got the capacity to reliably control the cost and provide the service that I say I'm going commit to. And then, at the end of the day, too, the business case has got be there to justify the capital expense for the investments in the locomotives, as well as the investments in hiring and training people.

So yes, there's still ongoing discussions. Are we a bit constrained naturally and I think responsibly from locomotive and people standpoint, and is there a timeline and commitments associated with it? The answer would be yes to that as well. So, we're just going to take them one by one. Again, try to protect all those principles and do what we say – we've always said we're going do and provide a fair return for our shareholder and a good service for our customer.

<Q - Chris Wetherbee>: That's great. Thank you very much.

<A - Keith Creel>: Thank you.

Operator

Your next question comes from Benoit Poirier with Desjardins Capital. Your line is open.

<Q - Benoit Poirier>: Yeah. Good afternoon and congrats for the good quarter. Sorry, but to come back on crude by rail, could you talk a little bit, Keith, you mentioned the importance to serve the current customers, but on the other side, when we look at the outlook it remains pretty strong with some good expectation on the grain crop. So, what is your ability in terms of moving crude by rail? Maybe 2019, what type of maximum carloads we could see in the CP network over time? Sorry?

[Technical Difficulty]

<A - Keith Creel>: Okay. Any questions on that explanation, Benoit?

<Q - Benoit Poirier>: Yeah. Sorry, you weren't there. I was just wondering if you could provide some color on your ability to ramp up. You mentioned some color about making sure to serve current customers. So, is there a maximum in terms of volume you could handle? I mean, if we look back at the previous peak, you were at 110,000 carloads. So, how far could you ramp up the crude by rail and what could be the maximum level you could handle at CP?

<A - Keith Creel>: Yeah. Number one, we apologize for the phone there. It dropped the line on us, so our apologies for that. Benoit, I wouldn't want to commit to a potential number at this point, that old number. What I think about now in the real constraint that we deal with is as we make a decision to grow, to make the right decision based on those principles, I've got the make sure that we have the capacity within the locomotive industry to be able to feed our need and ability to remanufacture and overhaul locomotives.

So, there's a robust demand market out there. For the GEs of the world, the EMDs of the world, the capacity is constrained. So again, for them to be able to ramp up, I would be limited by that more so than anything else. I'll be able to hire employees. We've got capacity on the railway. The key is the locomotive piece. And again, that's a 30-year decision. That's not a short-term decision. So, we would be very reluctant to make significant meaningful decisions if the economics are not there to sustain it. So, that's why these discussions take a little bit of time. And when we say disciplined and deep, they're disciplined and deep discussions. They're not something that happen too quickly.

<Q - Benoit Poirier>: Okay. And the second question is on the volume side. Obviously, you came out of the gate in Q3 with very solid numbers. You're not willing to provide or quantify exact numbers, but when I look at potash quarter-to-date, carloads are up 56%. Anything special in those number or is the percentage kind of sustainable as we go through the third quarter and Q4, Keith?

<A - John Brooks>: Hey, Benoit, it's John. Yeah, so the potash has been strong out of the gate. It was actually strong in the first half of the year, too. Canpotex, we expect, is largely sold out through Q3. So, we think potash continues to sustain itself. K+S continues to ramp up fairly well for us. And our other domestic shipments have also sustained themselves fairly well. So, potash has definitely been a bright spot and I think it will be the second half of the year also.

<Q - Benoit Poirier>: Okay. Thank you very much for the time, gentlemen.

<A - Keith Creel>: Thank you, Benoit

Operator

Your next question comes from Matt Reustle with Goldman Sachs. Your line is open.

<Q - Matthew Reustle>: Yeah. Thanks for taking the question. Just wanted to clarify one of the earlier points that I think you mentioned. Do you have enough productivity potential in the back half of the year to still show a full-year margin improvement in 2018? And do you think that's, aside from seasonality, something that we'll see just sequentially improve into the end of the year?

<A - Nadeem Velani>: Yes, absolutely. I mean, I think certainly we'll see sequential improvements between Q2, Q3. Q3, Q4 will be close. Certainly, I said we had some land sales, so that – we'll get the benefit of that in Q4. But also from a core point of view, we still see margin improvement year-over-year. A few wild cards are out there, right? So fuel prices have hurt overall margins, haven't really impacted operating income. Although in Q2, we got hurt by a bit of a lag effect. So that being said, outside of anything further on the fuel side, stock-based comp can be a headwind if the stock goes up and so forth. So, outside of kind of those things that you can't really control, from a pure productivity point of view, I think we're well positioned from an operating leverage and from being disciplined and taking on the right business, that will be very supportive for margins.

<Q - Matthew Reustle>: Okay, great. And then just on pricing in the crude business, is the business that's going be coming online in Q3 and Q4, will that be at better pricing than what you're moving today? And can you get to a point where crude is not a negative mix impact?

<A - John Brooks>: Well, I don't know if we can get to a point where it's a negative mix impact. But I can tell you the existing book of business there's been opportunities to reprice. And I do expect all new crude opportunities to come in at better pricing. But given the characteristics of it, whether or not it can overcome that, might be tough.

<A - Nadeem Velani>: Yeah. We got the tank car business and that would be one way, but it's not going to get a return. So that's part of the problem with it. Part of it is the length of haul of course as well.

<Q - Matthew Reustle>: Got it. Okay. Thank you.

<A - Keith Creel>: Thank you.

Operator

Your next question comes from Seldon Clarke of Deutsche Bank. Your line is open.

<Q - Seldon Clarke>: Hey, thanks for the question. I just want to ask a longer term question about margins. It feels like you have a lot of momentum in terms of volume and pricing and really just the right formula for operating leverage. But you've been speaking this low-60s OR in the back half of 2018 and just some quick math kind of gets you to incremental margins in that 40% range. Are we bumping up against the floor here in terms of OR or do you see potential kind of longer term to bring that below 60%?

<A - Nadeem Velani>: Well, just to be clear, we're talking 60%, plus or minus, so maybe not low-60s, but a little bit better than that in the back half. I would say that – and keep in mind, from a fuel point of view, year-over-year, that's about 200 basis points of impact. So high 50s is – versus where we were a period ago, a year ago, you've got some impacts from pension accounting change and so forth. Bottom line is, no, I mean, we've talked in the past about kind of getting to mid-50s is a reasonable output.

But I'd say output is a keyword, right? So we don't look at the business from a – and manage the business from an OR perspective. We're returns focused. We're focused on taking on business at a strong margin or strong return in a disciplined manner. And at the end of the day, the OR is what falls out of moving traffic efficiently and moving traffic for your customers at the right service and under a controlled cost environment.

So I wouldn't say that the margin story is over at CP. I'd say that we're – we still see plenty of opportunities to improve margin over the long term.

<Q - Seldon Clarke>: Okay, that's helpful. And so, I guess, we should – should we think about incremental margins accelerating then in 2019 kind of above that 40% level?

<A - Nadeem Velani>: Yes. Yes.

<Q - Seldon Clarke>: Okay, that's helpful.

<A - Nadeem Velani>: It's tough to – we haven't had a kind of a normalized quarter, right? And I can understand...

<Q - Seldon Clarke>: Right.

<A - Nadeem Velani>: I mean, it has been a difficult first half. And that's what's exciting about where we stand right now. And we'll have the ability to show what this franchise and what the CP team can deliver. And this wise man said it's a good time to be a railroad.

<Q - Seldon Clarke>: Okay, that's very helpful. And then I just want to get back to crude for a second. I think previously you were saying in 2Q you were running about 50 to 60 trains per month of crude-by-rail and you really saw the potential to double this run rate by the end of 2018. And I think you mentioned 20,000 carloads of crude in the quarter. Is this still the right way to think about that or quantify that potential?

<A - John Brooks>: I think the runway into 2019, there's the potential out there to do that, yes.

<Q - Seldon Clarke>: Okay. All right. That's all for me. Thanks a lot.

Operator

Your next question comes from Brian Ossenbeck with JPMorgan. Your line is open.

<Q - Brian P. Ossenbeck>: Hey, good evening. Thanks for taking my questions.

<A - Nadeem Velani>: Hey, Brian.

<Q - Brian P. Ossenbeck>: So, just want to go back to the second half outlook for a second. Keith, you mentioned a few things that you're worried about, sounds like the grain harvest and trade. John, I was just wondering if you can give us some parameters of what volumes, what revenues are exposed to cross-border trade and whether it's auto from the steel export market, things that you would look at and be concerned if we do get some of this increasing, call it, trade tensions or some tariffs get levied. What would you be most worried about and how large do you think that could be put at risk from a CP book perspective?

<A - John Brooks>: Yeah. I think, generally speaking, a lot of these areas, if I look at our cross-border business, are fairly small as a percentage of our book. So that's a good thing. I think the things that really sort of I watch and we talk about are more the macro concerns of the uncertainty, right. So, we've got, in our steel business, we have roughly CAD 50 million that moves back and forth across the border. Am I concerned about CAD 50 million losing that business? No, I'm not.

Certainly, there might be flow changes and market differences that we're working with our steel customers to sort of diversify their books on their markets. But frankly, I'm just – the uncertainty, it concerns and drives with the consumers of these products from a macro perspective, is really the issue that could affect the rails maybe on a broader pace. Certainly, our grain business that flows to Asia and China comes to question. But the flipside is I look at our lumber business that has had a 20% tariff put on it for quite some time now, and we have the capacity and demand out there to set records in our lumber business right now.

So those are the key areas that we're watching, grain, steel, lumber, but again, it's more the macro side that we're also keeping an eye on.

<Q - Brian P. Ossenbeck>: Okay. So no real percentage of the book that you're...

<A - John Brooks>: Well, look, our lumber and forest products, it's about 1%. Our steel business, it's about 1%. As I look at soybeans to China, again, that's a little bit less than 1% of our book. So potentially, if things fell apart, death by a thousand cuts, maybe. But again, there's a lot of work. I think there's a lot of uncertainty how that's all going to unfold, number one. And number two, it's forcing our customers to diversify and look at other markets. And we're going to work with them on that.

<A - Keith Creel>: I think I'd add the only – to add a little bit more color, our largest potential exposure in our book of business is finished vehicles from Canada to U.S. And this accounts for only 3% of our revenues. So it's not that we're not concerned. We're paying close attention. But overall, our main concern and our primary focus and the biggest threat we think is more macroeconomic than micro for CP's book of business.

<Q - Brian P. Ossenbeck>: Okay. Great. Thanks for all the details there. Can I just ask one quick follow-up on the grain hopper investment maybe for Nadeem? What do you think of the return on that, the payback period? I mean, it sounds like you've got some opportunity to move more and move it more efficiently, increase productivity. So, it sounds like you've – and probably lower maintenance, fewer injuries and everything that go with the newer fleet. So how do you conceptualize that sort of investment that would be made, pretty big amount over the next couple of years?

<A - Nadeem Velani>: No, as you described. I mean, there's the capacity. There's the asset churn. There's the overall ability to even gain business from a market share point of view to have a better product for our customer. The overall train length on what you can move just having a bit of a shorter car increases the number of cars per train and so forth, so the more efficient movement of these in trains. And then when you look at what you can do from a future 8,500-foot model that we'll be pursuing as well, and we'll speak to more at our Investor Day, it all comes into a very – gives us good visibility now as with the change in C-49 and gives us the ability to have a better product for the customer. And it's a win-win situation. So, a reminder, I mean, our focus, as I've mentioned, as we mentioned, is return driven. And this fits right into our strategic principles.

<Q - Brian P. Ossenbeck>: All right. Great. Thanks for the questions.

<A - Keith Creel>: Thank you.

Operator

Your next question comes from Ravi Shanker with Morgan Stanley. Your line is open.

<Q - Ravi Shanker>: Thanks. Good afternoon, everyone. Keith, can you give us a little bit of color on the cadence of OR for the next few quarters? Just wanted to confirm that that has – that does not include any impact of the just-completed labor deals.

And also if you can just elaborate on that a little bit more, I mean, do the new deals give you the ability to do anything different with this contract that maybe you couldn't do before and maybe take you to newer levels of productivity and OR?

<A - Keith Creel>: Yeah. So the deal itself, assuming it gets ratified, the one that is ratified and the one that's out for ratification follow the patterns that we've set already with our existing other agreements from a wage appreciation standpoint. The deals themselves, without getting into specifics of them, are there any quantum changes in work rules? No. Are there some things in there, in both agreements, from a quality of life standpoint, that both unions benefit from, their members, our employees benefit? Yes. Are there some flexibilities within the work rules that did not exist before for the company so that we get a benefit out of that as well? The answer is yes.

So, at the end of the day, there's nothing material from a cost standpoint. It does not do anything to impede our cadence relative to some margin improvement. And if anything, it increases and improves quality of life for our employees, which increases and improves our ability to attract and retain our employees and, at the same time, provides an ability for us to provide reliable service to our customers.

So I truly believe it's a win-win. And again, back to the point of a renewed positive relationship, growing with our brothers and sisters and partners of our CP family with both these unions, it's truly exciting. It's a new day for the company. It's a new opportunity for the company as we grow together. And I'm very, very excited about it.

<Q - Ravi Shanker>: Got it. That's helpful. And just a follow-up on something that was discussed earlier which is opportunities for growth while, at the same time, talking about a fairly tight rail network in Canada. Kind of as you look forward to more volume growth in the next – second half of the year as well as into 2019, are you confident that you have the capacity to be able to take on maybe up to significant amounts of new volumes without running into operational issues that impact network fluidity?

<A - Keith Creel>: Yeah, absolutely. Conditional upon those comments I made, we just got to make sure that we hire the people, train the people, are lockstep with the growth and we bring the locomotives on in lockstep with the growth. And we're timing the business so that we can do that. We've got a commitment and an obligation to our existing customers. And as we grow forward, we're all smart enough to realize I'm not going to promise the sun, the moon and the stars just for the sake of growth. Decision makers and these customers make decisions to trust us with their business models, to trust us with their success delivering a product and end up falling on or face and jeopardizing them to failure as well as this company.

We've worked hard to establish this reputation for our service. We've worked hard to be able to sit at the table and have these disciplined productive discussions. We certainly take that responsibility with the gravity it deserves. We're not taking those discussions lightly, and we aim to do what we tell our customers we're going to do. So we're going to be very strategic again and careful as we grow forward. And we're doing that. We have done that in the past. We're exercising that discipline now and nothing's going to change.

<A - John Brooks>: Hey, look, and I'd add to it, my sales and marketing leadership team, we're tied to the hip with the operating team. So, to Keith's point, whether it's financial decisions with my sales and marketing team working with Nadeem in the finance side or the sales and marketing folks on the ground working with the operating team, we're going to grow in a lockstep function. And that's disciplined, sustainable growth, defined.

<Q - Ravi Shanker>: Understood. Thank you.

<A - Keith Creel>: Thanks, Ravi.

Operator

Your next question comes from Scott Group with Wolfe Research. Your line is open.

<Q - Scott H. Group>: Hey, thanks. Good afternoon, guys. So wanted to just start with the – one more on the operating ratio. So it looks like to get to OR improvement for the year, you need closer to like a 59%, maybe even sub-59% OR in third and fourth quarter. And I think you were talking closer to a 60%. And I know it's not a big difference, but just wanted to clarify. And, Nadeem, you said a couple times core margin improvement, is there anything that you're including or excluding from that calculation when you say core margin improvement?

<A - Nadeem Velani>: So, I mean, we talked a bit about the land sales, right? So we expect to have meaningful land sale in Q4. We had some land sales in Q4 as well. So, year-over-year – in Q4 of 2017. So year-over-year, there'll be a benefit there. That being said, we see – don't take my numbers too literally in the sense of when I say 60%. I say 60%, plus or minus. So they were in that range of – could it be high 50s in a certain environment? Absolutely. Could it be low-60s if fuel continues to go up or you get stock-based comp headwinds or you get some weather in December?

Absolutely. And that's why we've been trying to be prudent with some of our guidance. So, year-over-year, do we have the potential to improve our operating ratio? Yes. And I think you'll see Q3 improve and the potential for Q4 with land sales to improve step down further. So, does that make sense?

<Q - Scott H. Group>: Okay. That makes sense.

<A - Nadeem Velani>: Okay.

<Q - Scott H. Group>: And then just in terms of CapEx buyback, how should we think about CapEx in the out years relative to the CAD 1.55 billion this year? And then with the buyback that's now exhausted, when do you think you'll announce a new one? And should we start to think about more material buybacks now that you've sort of de-levered the balance sheet?

<A - Nadeem Velani>: Sure. So – and certainly, it'll be a focal point of my remarks at the Investor Day in October. But we do have a number of significant capital opportunities that have very good returns. And right now, it's a matter of optimizing it and setting the right priorities. It's a good problem to be in. We raised it – we had talked beginning of the year, CAD 1.35 billion to CAD 1.5 billion. Now we've raised it to CAD 1.55 billion. And like I said, currency is a bit stronger and that's hurting us there. But we're trying to remain very disciplined in how we look at our opportunities.

At the same time, we – when we look at the business from a return on invested capital point of view, it can be some very accretive to our returns. And it's the right thing to do. We've always talked about reinvesting back into the business first, and that's our number one priority from a capital deployment. From a buyback point of view, our view was to kind of tie in our buybacks, align them with the free cash as we generate. So a lot of this, the free cash that's generated in our business, is in the second half of the year. So you can expect us – we will always have a buyback as an opportunity to reward shareholders. And I would expect us in the back half of the year, and in most likely in the Q4 kind of timeframe, we'll have the opportunity to lay out our view on buybacks for the end of the year and into 2019.

And I think that's the kind of timing that you'll expect from us going forward is align our buyback decisions with free cash that we generate throughout the year and always utilize the dividend as well is another way to give back to shareholders.

From a capital point of view, I mean, I think that CAD 1.55 billion, CAD 1.6 billion level of capital is a reasonable place to be at this exchange rate. I mean, could that come down materially if the Canadian dollar appreciates? Absolutely. But given what we talked about and given where we think we can get a very strong return, I think that that's an appropriate place to be.

<Q - Scott H. Group>: Okay. Very helpful. Thank you, guys.

<A - Keith Creel>: Thank you, Scott.

<A - Nadeem Velani>: Thanks, Scott.

Operator

The last question we have time for today comes from Brandon Oglenski with Barclays. Your line is open.

<Q - Brandon R. Oglenski>: Hey, thanks for taking my question here at the end. So just want to come back to the question around tariffs and trade. Can John or Keith speak to whether customers have actually conveyed to you that they're pulling back plans? Especially on the Intermodal side as we look at all the consumer goods coming in from Asia into the U.S., is that something that actually caused folks to rethink capital deployment yet? I mean, investors are very concerned that's happening in real time. We're not sure of this.

<A - John Brooks>: You know what, it's not discussions we've had. Right now, I would say, frankly, it remains, as we look at this fall peak season, actually quite bullish on that cross-border opportunity and those import goods. So...

<A - Keith Creel>: Hey, Brandon, I was in Toronto last week and met with several CEOs of our key customers in that marketplace that are served by those markets you speak of. Obviously, we all share the same concern about the overall economy, but there's no specific discussion about anything relative to what you're asking about.

<Q - Brandon R. Oglenski>: Okay. Appreciate that input. And then, I guess, lastly, John, if – could you speak to how the sales team is coming together? I mean, you've had a lot of new additions to the team I think in the last year, said you're working really close with operations. And what are some of the things that are exciting to you as you look out over the course of the next year or two?

<A - John Brooks>: Yeah. So I've just spent a few days talking about quite a bit my sales and marketing team. And if you saw me right now, you'd see a big smile on my face. We've got an A-team. We've assembled an A-team. And there has been a lot of change. So it has been a fair amount of effort building the culture and the discipline and how we want to take this team going forward. But I sit here today with a leadership of three vice presidents that run our business units that are very strong, aggressive and understand how we want to grow this business. And as importantly, they've developed a marketing team to go with a strong sales team that are executing specific playbooks on how we want to grow this business.

And I can tell you – and again, it's Keith's culture, it's a culture at CP, we do it collaboratively. And my sales force, my marketing force, the playbooks we execute, the leaders that run our business units and myself, we're working with Keith's leadership, the operating team, Nadeem's team on a daily business to grow this the right way. I'm very pleased.

<A - Keith Creel>: Brandon, you'll be impressed when you meet them in October. I guarantee it.

<Q - Brandon R. Oglenski>: All right. Look forward to it. Thank you.

Keith Creel

Okay. With that, we'll wrap up our Q&A. Thank you again for your time. Certainly, we hope that you recognize the value in these results that we produce. We'll continue to work hard to create long-term sustainable value for our shareholders. And we're extremely excited about seeing those of you that can join us at our headquarters campus in Calgary in October. Safe travels. Stay safe yourselves and we'll see you soon. Thank you.

Operator

This concludes today's conference call. You may now disconnect.