Transcript

Q2 2019 Earnings Call

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Corporate Participants:

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

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. My name is Adam, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the Canadian Pacific's Second Quarter 2019 Conference Call. All slides accompanying today's call are available at www.cpr.ca. [Operator Instructions]

I'd now like to introduce Maeghan Albiston, AVP Investor Relations and Pensions, to begin the conference. Please go ahead.

Maeghan Albiston

Thank you, Adam. Good morning, everyone, and thank you for joining us today.

Before we begin, I want to remind you that this presentation contains forward-looking information and actual results may differ materially. The risks, uncertainties, and other factors that could influence actual results are described on slide 2, in the press release, and in the MD&A that is filed with Canadian and U.S. regulators. This presentation also contains non-GAAP measures, which are outlined on slide 3. With me here today is Keith Creel, our President and Chief Executive Officer; Nadeem Velani, Executive Vice President and Chief Financial Officer; and John Brooks, Executive Vice President and Chief Marketing Officer. The formal remarks today will be followed by Q&A, and in the interest of time we'd appreciate if you could limit your questions to two.

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

Keith Creel

Thanks, Maeghan. Good morning. Listen, the team and I are extremely proud to sit here this morning to represent our 13,000 strong CP family. We get to share and discuss a record-setting quarter for this company. When I say a record setting, it's a mix of records.

Second quarter records are all-time records, records in OR, revenue, EPS; all-time record for workload on GTMs on the network; train length records; train weight records; locomotive productivity records; fuel efficiency records; and most importantly, quarterly safety record when it comes to – we had a very challenging first quarter, to bounce back the way this company has bounced back, to regain the momentum that sets us apart from the industry, most specifically in our train accident ratio, the way we run the railway safely every day speaks to the commitment and to the potential that this company represents. An all-time record as well on personal injuries for the company. So certainly, the culture when it comes to safety is strong and getting stronger, something we're extremely, extremely focused on and proud of.

You know this kind of performance demonstrates what a mature precision scheduled railroading company ran by the best team of railroaders in the industry can produce. That said, we talk about the records, something even more encouraging. This pursuit of operational excellence is something that I call it a journey. It's not just a destination.

Maintaining a constant pursuit, a constant constructive tension in the organization, even in the face of record volumes when we're focused on making sure that we keep our assets right-sized at the peak to accommodate and to allow for any kind of softening or muted demand that we might face, as well as our normal seasonal demands, which come down in July, this team is doing that. Within that quarter, taking out locomotives and taking out head count that's associated with those locomotives, reducing us down almost 10% in the locomotive fleet

alone.

So that being said, the quarter was not without its challenges. We talk about the things that went well. I can tell you this quarter we faced unprecedented pressures from the Mississippi River, much like our Class 1 partners. When I say pressures, the pressures did not let up, the duration of the floods that we experienced this year. 40, 50 years if you go back through history, you're going to be hard pressed to find anything that was that prolonged in the impact to this railway.

And our team, I tell you, the men and women that run this railroad day in and day out are inspiring. They battled the floodwaters. They kept the railroad open as long as they possibly could. Yes, we had to reroute some trains. Yes, we had some additional operating expense tied to, little bit of capital expense tied to it, and some foregone revenue. But for us to be able to sustain that kind of pressure and bounce back the way we did, again, speaks to the testament of the strength of this team.

Switching over to the commercial side, I'll tell you we continue to make progress. It's encouraging as well. We laid out a plan at our Investor Day in October. We told the market, we told our shareholders, we told our investors that we had a unique set of opportunities that we worked hard to set up. We had created the capacity and developed a strategic plan to convert it in the marketplace, and that is what's fueling this pace of growth that's unprecedented in the industry in a time of muted demand across the macro economy.

We call it self-help. We call it unique opportunities that allow us to be counter to what the balance of the industry is experiencing, and that's what you're seeing in these results. You read about the press release during the quarter of Yang Ming. That's one commercial success that John will talk about the specifics of. And, yes, we're super excited about the partnership and absolutely excited about the revenue and what it's going to do, driving earnings and growth in 2020 and beyond.

But from an operational perspective, I'm equally as excited, because what it allows this company to continue to do is setting itself apart from our competition, setting a new standard for service in our partnership, that specific what I call the third leg of THE Alliance, which is Hapag-Lloyd, Ocean Network Express, and now will be in 2020 Yang Ming, allows us to continue to fine-tune and create an industry-best service that will get you from Shanghai to Chicago with the lowest on-dock dwell time that can't be matched by our competition, whether it's U.S. West Coast or other Canadian alternatives, into the Midwest markets with our fastest transit time and our shortest routes and our reliable capacity. It's something that's compelling in the marketplace and it's something that will continue to make a strong difference in our operational ability to continue to drive margins and operational excellence within the organization.

To add benefit to that as well, you probably read HMM, Hyundai, which is – it's a customer that CP currently enjoys a partnership with, they made a strategic decision as well effective spring of 2020 they're joining THE Alliance. So that volume now currently calls on Centerm on the South Shore, which CP serves, that volume will shift to Deltaport, will be handled by our partners at GCT, and will be moving on the ships with THE Alliance, which again gives us another step to incremental improvement, takes out complexity in the terminal, takes out additional costs, and improves efficiency and velocity. Just as a proof point, if you think about this, if I go back year and a half ago, the share at GCT Deltaport had gone down to about 20% for CP and the balance for our competitor. With this new contract that comes online in January, we're going to be about 65% to 70% of the product that's being discharged on the dock at GCT. Again, enabling that reliable service, industry best service into the Midwest.

So when you think about all these things, you put them together, what does it mean? What does it mean for our customers? What does it mean for our shareholders and our investors? It's a solid proof point that when we say we're going to do something, we do it. It says that sustainable, profitable growth, it's not just a catchphrase. It's

woven into the DNA of how we run this business. And when you do it and you do it well, and you live and die and breathe by that principle, you do what you say you're going to do, you don't try to be everything to everyone, but those that you serve, you serve the best. And you do it with this kind of culture and this kind of discipline, these results are possible. And it allows you to grow this company now and into the future.

And as excited as we are about 2019, and the opportunities that John and the team put together for 2020 and 2021 from an investor standpoint, we certainly expect not only in 2019 to meet our guidance, but to carry strength and momentum into 2020 and 2021 as well. It's going to bode well for anybody who'd invest in this company, as well as our employees, as well as our customers. The perfect trifecta.

So with that, I'm going to turn it over to John to provide some more color on the commercial side and after Nadeem covers the financial performance, then we'll open it up for questions.

John Brooks

All right. Thank you, Keith, and good morning, everyone. So, total revenues were up 13% this quarter to CAD $2 billion, with six out of our nine lines of business being up double digits in revenue. RTMs were up 6%, FX was a tailwind of 2%, and fuel was flat. On the pricing side, as expected, we continued to land in that 3% to 4% range.

Now taking a closer look at our second quarter revenue performance on the next slide. I'll speak to the results on a currency-adjusted basis. So, as Keith spoke to, it was an extremely strong quarter for the bulk portfolio. Grain was up 11%. Canadian grain and grain products delivered a record second quarter, up double digits. And both April and May were record months for volume and from a tonnage perspective, this is the third biggest quarter of all time for CP in grain.

Seeding in Canada is now complete and as of right now, we expect new crop to be in line with the past couple years. Additionally, we project carryout stocks to be normal, but certainly more heavily weighted on the canola side. All this to say, we expect there to be good volumes of grain to move this fall. As a reminder, the new regulated grain pricing for CP taking effect on August 1 will be 3.7%.

But in contrast, U.S. grain volumes were down double digits, as the PNW export market continue to be challenged due to the lingering trade dispute with China. We are watching the U.S. grain markets closely though, because with the flooding and tough growing conditions that have emerged across the Central and Eastern U.S., actually this might present a pretty good opportunity for CP grains into these areas that are expected to be short production.

Moving onto the coal business. As a result of maintenance outages at both port and mine, Canadian coal volumes decreased this quarter. However, in spite of the supply chain challenges in Canada, we actually saw fairly strong movements of thermal coal in the U.S. and our revenues were up 5%. The demand environment for met coal remains strong and we continue to expect a strong back half of the year.

On the potash front, Q2 was an all-time record quarter for volume and revenue, as strength in our export potash outweighed weakness on the domestic side, that weakness being the result of flooding and, again, poor weather conditions in the Upper Midwest of the United States. But in spite of the weakness on the domestic side and certainly some tough comps we have coming into the second half of the year on potash, with strong global demand and still a very healthy pricing environment, we expect the opportunity for upside as we move into the second half of the year.

On the merchandise front, the energy, chemical, and plastic portfolio had another strong quarter with revenue growth of 22%. The growth included another strong quarter of LPGs, plastics, refined products, all moving on our energy train in the Vancouver. Excluding crude, ECP volumes were up 9% and revenues grew 13%. On the crude by rail, as expected, we came in at around 25,000 carloads or approximately 160,000 barrels per day as production curtailments began to ease and the fundamentals began to improve. Although crude by rail remains variable, we expect volumes will continue to increase as production and curtailment balance stabilizes and our new contracts and existing customers continue to ramp up the second half of the year.

In MMC, volumes declined 9% largely driven by our frac sand; however, revenues were only down 2%. Consistent with what I've spoken about a number of times in the past, we are executing a surgical strategy to re-home our frac sand from the Permian Basin to the Bakken. This market diversity yields higher revenue per carload, single line haul efficiencies, and improved margins. We currently have two unit train facilities in service and we're adding a third unit train facility in this region by the end of the year.

In automotive, certainly despite a weak North American demand environment, CP revenues were up 12% on the quarter. We continue to see success driven by GLOVIS, and the opening and ramp-up of our Vancouver auto compound that we've spoken about. As a reminder, this is only a portion of the GLOVIS business, with the full contract coming online to us in 2020. This, combined with continual growth at Vancouver, give us confidence in this sector well into next year.

And finally, in the intermodal side of the business, overall revenues were up 11%. Both domestic and international volumes were up low double digits. In fact, despite some softening in the retail sector, domestic revenues were a record in Q2. On the international side of the business, we continued to excel in the market and execute our playbook.

Most recently, I'm very pleased that CP was named Best Logistics Provider in Rail at the Asian Freight, Logistics and Supply Chain Awards in Hong Kong. And further, as Keith mentioned, preparations are well underway with Yang Ming for our 2020 onboarding of their volumes, which will move through GCT Deltaport, leveraging our capacity not only at the Port of Vancouver, but also at our capacity in our inland terminals across our network. We're also excited, as is Yang Ming, around taking a full advantage of our fastest routes into Chicago, Toronto, and Minneapolis.

So, look, I'm extremely pleased with the efforts of the team, the sales and marketing team in collaboration with the operating team to deliver this quarter. So while, well, there's no doubt, there's uncertainty in the macro environment and some softness in some of our lines of business. Between the combination of our strong bulk franchise coupled with new business that is moving now and new business that will be starting up in 2020, I have a high degree of confidence that we'll continue to deliver the growth and outpace the industry. The CP team is focused and we are collaborating with our customers to create efficiencies and convert opportunities in the marketplace.

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

Nadeem Velani

Thanks, John, and good morning. As Keith noted, this was a strong quarter by virtually any measure. When we reported in April, I was encouraged by how the volume and operating trends were recovering from a challenging winter. Those trends continued throughout the quarter and led to strong revenue growth, as John detailed, as well as very strong cost control.

The end result was a Q2 operating ratio decrease of 580 basis points to second quarter OR of 58.4%. Ignoring the impact that last year's labor disruptions had on the OR in Q2, we still saw an improvement of 440 basis points year-over-year. Adjusting for land sales, depreciation, and stock-based comp, we saw incremental margins of about 90%.

Taking a closer look at a few items on the expense side. As usual, I'll be speaking to the results on an exchange-adjusted basis. Comp and benefits was up 8%, or CAD $28 million, versus last year. The primary drivers of the increase were increased stock-based compensation of CAD $20 million resulting from the higher share price, as well as higher head count.

Fuel expense was flat year-over-year as increased volumes were offset by decreased price and record Q2 fuel efficiency of 0.93 gallons per 1,000 GTMs. Materials and equipment rent expense were both flat year-over-year. As expected, depreciation was CAD $183 million, an increase of 5%.

Purchased services was CAD $265 million, a decrease of CAD $23 million, or 8%. Primary driver behind the decrease was a land sale of CAD $17 million, which we guided to on our Q1 call; decreased rolling stock costs and other operating efficiencies was a further tailwind. Additionally, the casualty line under purchased services reverted back to historical levels.

Rounding out the income statement, adjusted income increased by 33% and adjusted EPS grew 36%. Below the line, you'll note that there was an CAD $88 million income tax recovery related to changes in the Alberta corporate tax rate. This benefit was excluded from normalized earnings and will have a negligible impact toward 2019 Effective tax rate. As the benefits are phased in over the four years, we will start seeing more meaningful benefit to our effective tax rate.

Turning to the next slide, our leverage in the quarter came in at 2.4 times adjusted net debt to adjusted EBITDA, within our target range of 2 to 2.5 times. In May, we repaid our debt maturity, which we refinanced early in March. With the strong operating performance and growth the last two years, we've worked our way back into our target leverage range. While CapEx increased sequentially given winter flooding and network investments, we will keep our capital spending within our guidance of CAD $1.6 billion.

We continue to take a balanced approach to shareholder returns. In May, we meaningfully increased our dividend by 27.5%. This marks the fourth straight year we have raised our dividend as we gradually move towards our targeted payout ratio of 25% to 30%. On the share buyback front, as of the end of Q2, we have completed nearly 70% of our current share repurchase program at an average cost of roughly CAD $272 per share. We will remain opportunistic and disciplined in our deployment of capital. Combining this discipline with our strong operating performance, we delivered an ROIC of 16.8% the last 12 months. This will undoubtedly be the strongest ROIC in the entire industry, which is a tremendous achievement by the CP team.

The railroad is operating as well as I've ever seen it, and our team of railroaders is getting stronger and deeper each day. We continue to watch the demand environment closely and should the macro environment change, we'll continue to adapt our cost base quickly. As Keith mentioned, we are confident in our full year guidance, expect to deliver another set of strong results when we speak again in October.

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

Keith Creel

Hey, thanks, Nadeem, John. Just to wrap up, looking forward, lot's been made about our tough comps in back half of the year, but tough comps are what happen when a company performs. We're realists. We're going to stay humble. We're going to stay focused. We understand the demand environment is not without its challenges, but you can be rest assured this team is going to be focused, disciplined and committed, and confident to delivering our guidance for the year. These results are a testament to the power of our operating model and CP's ability to execute operationally, financially, and commercially all at the same time.

With that being said, let's open it up for questions.

Question & Answer

Operator

[Operator Instructions] And your first question comes from Chris Wetherbee of Citi. Chris, your line is open.

<Q – Chris Wetherbee>: Hey, thanks. Good morning, guys.

<A – Keith Creel>: Good morning.

<Q – Chris Wetherbee>: Maybe I wanted just to pick up on that comment about the second half and the comps that you guys face. If you could talk a little bit about some of the key commodity groups that you feel most confident about in terms of maintaining the mid-single-digit RTM growth as you face some of those tougher comps? And if there is some sort of demand sluggishness, maybe what are the areas where potentially you could see that kind of flow through? Just kind of curious about what your outlook is there on the volume side.

<A – John Brooks>: Chris, I can start off. This is John. Look, we turned in a really strong Q2 in the bulk side of the business, and I see that tailwind continuing. As I mentioned, we're kind of in the grain trough a little bit right now in July, but I expect upside as we move through the quarter in the grain. The potash demand environment continues to be strong, where certainly some weakness in the domestic side, but we think that picks up through the quarter and the export side continues to be very strong.

Teck is for the most part sold out through Q3, so we'll continue to see some tailwind there. Our year-over-year comps as it results to international intermodal we still have, I think, some upside as I look through Q3 in that space sort of despite some of the challenge that others are facing. We haven't seen the blank sailings with our customers in that area. So I'm positive on all that space. I think we've outmatched the industry on the auto sector here now for the second straight quarter. And frankly, I think that trend continues as we move into Q3 also. And then, the crude side – and, yes, it's a variable and there's certainly some moving parts that need to be worked out here. But the contracts are in place. And we're actually, I think, more optimistic today than we have been that these issues are going to get resolved and there could be significant upside in crude by rail.

<Q – Chris Wetherbee>: Okay. Okay. That's very helpful. And then last quarter, Nadeem, I think you were pretty constructive about the potential for the OR in the second half of the year even facing a more challenging comp than you had here in 2Q. Could you speak a little bit to sort of how you're feeling after getting the second quarter done? Obviously, really strong performance, you mentioned very high incremental margins. It doesn't appear that there was anything sort of blocking that as we move into the back half of the year, but if you could you put some color around that, that would be great.

<A – Keith Creel>: Let me set this up for Nadeem, we are still convicted, Chris, but over to you Nadeem.

<A – Nadeem Velani>: Yes. I think, Chris, I mean, we're doing what we say we're going to do in terms of – as Keith noted, our conviction comes from that, comes from the network that's running, as we mentioned, as good as we've ever seen it. It comes from what's in our DNA of strong cost control, and not getting lulled in a false sense of confidence. But in times like this, where you see a bit of softness, you can start putting assets aside proactively and only adding resources where necessary. So, same level of conviction in the back half. Yes, we have some tough comps, but we feel very good about what we can do from a cost control point of view. And those incremental margins will add to the bottom line.

<A – Keith Creel>: Yeah. The fundamental demands, Chris, that drove the performance the second half of last year exists the second half of this year with even more pent-up demand, so to speak, and an ability for us to execute given our investments. Think about the grain fleet alone. We talk about investing in our hopper fleet. The efficiencies we get from that. We'll just start to begin to realize some of those operational efficiencies; meaning, fewer bad orders; meaning, more velocity with the fleet; meaning, I don't need as many cars, I'm moving the same or more grain with fewer cars. We're looking at doing things with our potash fleet to respond to surging demand or record demand with our customer and partner in Canpotex, running 200-car potash trains to Vancouver, and even to a point we're testing with UP over Portland we ran 188-car train just recently. So we're going to continue to push the envelope squeezing what we can of our assets, to do more with less all within the mantra of precision scheduled railroading as we continue to deliver service. And as we do that, costs come down, capacity increases, velocity improves. It's just a different space to operate in with the same or better demand, in the second half you should expect better performance, which is exactly what this team is focused on producing.

<Chris Wetherbee>: Helpful color. Thanks for the time, appreciate it.

<Keith Creel>: Thanks, Chris.

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

<Q – Walter Spracklin>: Yeah, thanks very much. Good morning, everyone. I guess coming back to Keith, your comments about how much more improved the handling is, the complexity has improved. And I look back at your – just eyeballing the last few years going from second quarter to third quarter, you've done anywhere from – obviously, summer railroading in Canada is a lot easier and you've done anything from 200 to 600 basis points quarter sequential.

Nadeem, you've talked about 100 basis points on the year is something that you generally target. But, gosh, everything looking at it here, given the items, Keith, that you mentioned, it suggests that you could be well above the 100 to 200 that improvement year-over-year on the OR. And then when we go into the next year with Yang Ming coming in and the lower complexity of everything consolidating at Deltaport, again, my question I guess is, are we beyond the 100 to 200 that we've typically come to expect in operating ratio improvement on an annual basis?

<A – Keith Creel>: Walter, I love your optimism and your belief in the model. Part of this is the art of the possible with you. We exceed our expectations, they have in the past, but you're talking about quantum leaps in areas that we've made quantum leaps. And it's just hard to keep setting a world-record model redoing it every year. So we're going to continue to improve. We're going to sweat our assets, their puts and their takes, and we're going to drive in spite of the headwinds that we face in these areas. We're going to get incremental margin improvement for the next several years, given the business that I see laying on the railroad and you could say there's some conservatism in our guidance. We feel we need to be responsible and guide to what we feel confident that we'll be able to deliver. But at the same time, I don't want to be over exuberant and mislead and create a bar so high that we

disappoint. I don't want to demotivate my team either. But rest assured, you got a team here and you got a leader and a leadership team that will push this envelope in a responsible, constructive way, and we expect and we hope to exceed your expectations. But I can't tell you that I see 200 basis points of opportunity, given all the moving parts that we see out there and all the things that may or may not happen with winter. Can I make a case where everything goes our way, a euphoric case? I'd love to be able to control that, I can't. So I've got to be reasonable and I've got to be responsible in what my guidance is. And I see confidently ability to get that 100 basis points, but I'm not willing to extend this to the 200, not yet. I want to wait and make it happen instead of assume it's going to happen. I just don't think that's a responsible way to handle it.

<Walter Spracklin>: Okay.

<A – Nadeem Velani>: Yeah. Walter, the stock-based comps is probably the biggest headwind in terms of – so it's a first class problem and certainly something that our shareholders won't complain about in terms of bad headwind. But that adds a bit of a challenge when looking at year-over-year.

<Q – Walter Spracklin>: Fair enough. Appreciate that. And going now down to the EPS level, I know your longer-term – your double-digit for this year longer-term double digit. Double-digit is, obviously, a very unspecific wide range. Consensus is moving up now into that mid-teen, mid might after this go into the mid-to-high teen. Are you comfortable with that kind of progression? I mean, you did 36% in the second quarter. Are you comfortable with that trend, as you demonstrated very strong second quarter results that expectations go up into that mid-to-high teen range?

<A – Nadeem Velani>: I'd echo what Keith has conveyed on the OR side. I think it's fair to – we want to be able to deliver on what we're committed to. We've kind of talked about the double-digit, low double-digit type of range, call it conservative or what have you. Just mindful of the things we can't control, which is things that its curtailments. And if stock continues to run, that could be a headwind and if you have some sort of weather disruption in December or what have you. So, we're mindful that there's still a long ways to go. We're confident in our ability to grow double-digits. I don't want to get into the weeds of what level of double digits, so I'll just leave it at that.

<Walter Spracklin>: Sure. Okay. Appreciate it. Great quarter, guys.

<Keith Creel>: Thank you.

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

<Q – Fadi Chamoun>: Good morning. Thank you. John, you mentioned pricing in the 3% to 4% range. Is this pricing kind of broad- based? Are you seeing the strength across all the segment? I'm particularly curious about the intermodal market, the domestic intermodal market we are seeing some easing in the freight demand environment, I guess. So if you can speak to that, please.

<A – John Brooks>: Yeah. Fadi, so I was – actually we were talking earlier this morning. I'm quite pleased with the discipline the team has been able to show and the results we're producing on the pricing front really now going over the last year quarter-by-quarter. So we landed in that upper end of that range again. And as I look at the renewals pushing into Q3, I think I feel pretty confident that we're going to be able to sustain that. Certainly, as you called out, there's some areas where there's some weakness or little more challenged than others. We have seen, as you said, some weakness in the domestic sector, particularly retail type business. That being said, the pricing has held in there also pretty decent, maybe towards the lower end of that range specific for that area. I would also just call out, particularly for Q2, we did see some pretty positive mix, 1 point, 1.5 point in that space. It

had to do with some of our – less of our longer haul crude. We have some shorter haul crude that took place that impacted that. And then, frankly, just some of our new business pricing has been quite strong that we've brought on this year.

<Q – Fadi Chamoun>: Okay, great. Great color. Thanks. The second question I had is, I mean, you feel very positive, obviously, about the opportunities to grow well into 2020, and you have few new business awards that you have already communicated. Is the CapEx outlook kind of continuing to be in that CAD $1.6 billion range into 2020? Do you see that creeping up?

And as related to that maybe to Nadeem, the free cash flow conversion, like net income to free cash flow conversion has been just about 55%, I think, on average for the last few years. Can you talk about kind of the levers that you have to kind of improve that as we move into the next two to three years? I understand there's some improvement in the margin, obviously. But is there anything else maybe on the CapEx side that is unique that you can highlight that could help improve cash flow performance? Thanks.

<A – Keith Creel>: Okay. Fadi, if I can, I'll take the capital question. I'll let Nadeem expand on the free cash flow. So, when it comes to our capital envelope, the answer is no creeping. The same discipline in running the railway is the same disciplined approach on managing capital. So as we talk about the formula, what's the art of the possible, how do you get sustainable low-cost growth, you create capacity. You sell to the strength of your network. You're selling at the worth of the capacity you have. And when you sign up new customers to grow the book of revenue, you're in lockstep with the capacity or the capital that's required to create that capacity to be able to deliver the business. Because if you don't, you jeopardize the entire operating model and success across every line of business.

So the business that we signed up for 2020 and 2021, the assets we need, be it a locomotive being remodeled, remanufactured; the surgical siding here, siding there; CTC here, there, CTC there; inspection truck here, inspection truck there; all that's in the plan. It's all baked into the plan, so you will not see a big swing in our capital envelope as we bring on this additional business in 2020 and 2021. And, in fact, after 2021 you'll start to see our need for capital, based on what we see today taking into account the growth, actually diminishing, come down, not go up.

<A – Nadeem Velani>: Right. And perfect segue to your second question there, Fadi, if you think about where we invested, where we continue to invest the opportunities right now on the covered hoppers, on locomotive modernization, what we did with Alyth Yard and will do in Minneapolis as well to support our service, to support our growth agenda. Those things start tailing off. And I think the next leg of the story is going to be a very positive one from a free cash conversion point of view. So if you look in the – once we get past the investment in covered hoppers in that 2022 kind of timeframe, you'll start seeing free cash conversion more in the 75% to 80% kind of levels. And so I think that that is something that's somewhat overlooked. And I think that's going to be a very impactful story to CP and what we can deliver. So I think you're right on in terms of what we can achieve and where there is next opportunity.

<Fadi Chamoun>: Thank you. Appreciate the color and great quarter. Thanks.

<Keith Creel>: Thank you.

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

<Q – Allison Landry>: Good morning. Thanks. I just want to go back to the question on the RTM guide and ask in a little bit in a different way. But if I'm just doing the math to get to, call it, 4% or 5% for the full year, I mean,

basically on a sequential basis, second half RTMs need to increase somewhere in the low-double-digit range versus the first half. That's a much bigger sequential increase than we've really seen historically. So, maybe putting the tough year-over-year comps aside, how can we think about the sequential ramp in RTMs in Q3 and Q4, maybe based on the commodities that you talked about earlier in your response to, I think Chris asked the question, potash, grain, crude, et cetera?

<A – Nadeem Velani>: I mean, Allison, we're up 2.7% year-to-date already. I don't think we need double digits to get to mid-single digits. So, I'm not sure...

<Q – Allison Landry>: Sequentially, I meant, not year-over-year.

<A – Nadeem Velani>: Sequentially, right, because of the tough comps in the back half. So, I'd point out to John's comments on the strength in bulk areas, like potash, you're going to see a ramp-up in crude, which is going to support a strong sequential RTM growth.

<A – Keith Creel>: You're going to see a pickup in Teck coal. I mean, the coal itself month-to-date, we're talking about some of the softness we see. The growth that we experienced in the second quarter, Allison, was in spite of actually shipping less coal due to some supply chain challenges. It's not a demand issue. It's just working out some noise that's in the supply chain, which is working itself out, we're realizing in the third quarter. We've shipped month-to-date more than we did last year. So all those things with a 3, 3.5 percentage year-to-date number, the second half sequentially – you can be at a little bit north of the mid-single digit and you're going to come to the math that we're coming to. Then it's not hard to get there.

<Q – Allison Landry>: Okay. All right. So it sounds like you guys are pretty confident there. Keith, I think in your prepared remarks you talked about basically hitting a record for workload in terms of GTMs on the network. Where do you think you are from a capacity or resource standpoint? Obviously, they have really strong incrementals in Q2. It seems like the network is in great shape. But if volumes and workload growth persists, at what point might you need to layer back in some resources, specifically on the head count side? Thank you.

<A – Keith Creel>: The only place that – we're not capacity constrained. We're capacity contained. We're trying to be in lockstep as locomotives. I mean, we've said that all along. We've got more than adequate track capacity, terminal capacity. We've made some strategic investments in Calgary that we'll realize this year and through the fourth quarter. We just converted what was an old hump yard into a very productive switching yard, and we didn't finish that until first week of January. So we haven't even realized the benefit of that in the fourth quarter. But, again, locomotives, that's it. We're training. We're hiring in lockstep with our demand to make sure we've got the running trades employees ready to pull and operate the locomotives, and we're bringing the locomotives online as we remanufacture them in lockstep with the demand as well. So, the game is not to be long on assets. We've got the right things, the right parts moving in the pipeline to be just on spot with assets. So when it comes to track and terminals, we're not there at all. And, in fact, our capacity, our flexibility, our ability to handle surges is drastically improved. We've got more capacity than we've ever had in partnership with GCT at Deltaport. Our South Shore is working extremely well. We're hitting records with our grain partners there, creating capacity. It demonstrates the fluidity of the network. We're talking about record volumes. We've put more stress on this network than has ever been put on this network in its history, in its 138-year history. And year-over-year, we've increased train speed by 5%.

That just tells you there's resiliency in this network. And if you're an investor, you don't need to get worried about this company getting into a trap or playing a catch-up capital game or we're overcommitting. It's a surgical execution of a strategic plan we developed two years ago in lockstep, in partnership with our customers, protecting our customer service, protecting our investors' trust and our employees' trust. That's what we're doing

day in and day out, and that's why we have so much conviction and confidence in our guidance.

<Allison Landry>: Great. Thank you, guys.

<Keith Creel>: Thank you.

<Operator>: And your next question comes from Ken Hoexter of Bank of America Merrill Lynch. Please go ahead.

<Q – Ken Hoexter>: Hey, great. Good morning and congrats on a solid quarter, Keith and team. Just the employees, how do you think about the trends as you grow and re-add cost? Should it stay low/mid-single digits with volumes and your thought on the impact to the OR with the employee base?

<A – Keith Creel>: Yeah. On the employee base, like this year, mid-single-digit RTM is 1% to 2% head count. We're up a little bit right now with capital work at its peak. That will come down sequentially and we'll be that 1% to 2% on a mid-single-digit RTM. That's the best way to gauge it.

<A – Nadeem Velani>: We were kind of pre-hiring and getting our people up in anticipation of the crude contract that the Alberta government that started June, July. So we've kind of pre-hired for that. So that was already in the cost base as we speak.

<Q – Ken Hoexter>: So, that seems you're ahead on employees then because of that?

<A – Nadeem Velani>: Yes.

<Q – Ken Hoexter>: Okay. And then my second one is on the crude by rail. Just given what you were just highlighting, Nadeem, on the Alberta's commitment and the shift of that potential. So I know that wasn't in your commitment for volumes, but maybe talk about what you expect to be the outcome or what you're seeing so far with negotiations and where do you see crude by rail volumes trending going forward.

<A – John Brooks>: Yeah. So, you know what, I'm pleased with the progression of those discussions with the Alberta government. And we're seeing a good expression of interest from a number of shippers in terms of commercializing, if that's the right term, that capacity. There's efforts underway with the major producers and the government to try to find a workable solution – you probably read about it, I'm sure – around the production levels matching curtailment. And if they can prove that that's going into a railcar, they would get that sort of equal relief. So, those discussions are ongoing. My guess it's probably at least another couple of months, maybe more of a Q4 story in terms of resolution and getting ramped up. But all that being said, we did about 25,000 carloads in Q2. I can see that jumping up to 30,000 carloads with potential for upside as we look at Q3. So we've got a fairly steady ramp-up of sets coming online as we move forward here.

<A – Keith Creel>: Yeah. I think the only thing I'd add, Ken, is listen, this is a space – we're realists – it's been volatile. It's been unpredictable. But I would agree with John, I'm cautiously optimistic. And I've seen the parts moving in a favorable direction for a favorable resolution. I mean, the fundamentals are, we've got a lot more oil being produced than pipeline capacity to take it away, and there's a demand for it in the market. We've just got to work through this and we'll continue to work in lockstep with the government to get this issue resolved.

And I think you'll see fourth quarter some robust demand. It's just going to be in the marketplace, which will represent some upside. If all other things work for us and all other things line up right, and Mother Nature is good to us, then there's a bit of optimism in the fourth quarter. But all those things have to happen. But again, there's more for us lining up than against as far as trying to get this resolved in the crude space.

<Ken Hoexter>: Great. Thanks for the time, guys.

<Keith Creel>: Thanks.

<Maeghan Albiston>: Thanks.

<Operator>: And your next question comes from Tom Wadewitz of UBS. Tom, please go ahead.

<Q – Thomas Wadewitz>: Yeah, good morning and congratulations on the strong execution in the quarter. I wanted to ask you if you could give me kind of a high-level frame, perhaps John or Keith, on share gains this year and how you might – I don't know if share gain is the right term, but new business let's say. And what the revenue contribution is if you kind of put it together for this year maybe at a high level and how we think about that in 2020, whether that revenue contribution from new business would be larger or similar? Or just kind of some high-level frame on the new business impact.

<A – John Brooks>: I think it's a good indication of, Tom, why you see what we've been able to do in Q2 and our confidence as we look into Q3 and Q4. We've added Dollarama. We've built an auto compound. We've seen significant upside with K+S as they continue to ramp-up. Potash, the bulks remain strong. That albeit not new, but I think we're performing well in terms of our share in those spaces also. We've talked and I've talked quite a bit about wanting to further develop and grow over transload business. I can tell you we've had quite a bit of success as you look at in the Eastern markets with refined fuels business growing strong through transload. Our Hamilton steel facility has grown double digits in terms of that throughput.

You start adding all those things up – I just looked the other day, we've added about CAD $35 million of annualized new business with our short line partners so far this year. That's sort of low hanging fruit that's been out there for quite some time and you put a little focus to it, and that sort of singles and doubles start adding up.

So I think those are some of the things that are helping propel us today. As I look into next year in 2020, of course, we've got the Yang Ming and the further auto opportunities that we've spoken about, as GLOVIS hasn't even fully ramped up yet. You got the G3 terminal opening up next year. We've got project for refined fuels with Suncor that we've spoken about publicly that will start up next year. And again, you got – we forget about this business, but K+S is really ramped up well. And they expect another big step function of growth as we look into 2020. You start putting all that into a blender and it becomes a pretty compelling story.

<Q – Thomas Wadewitz>: Well, let me ask you little bit differently. So just do you think it's a bigger impact this year in terms of the revenue contribution from new business or a bigger impact this year than next year? Is it kind of similar next year, or how do you just frame the magnitude?

<A – Keith Creel>: I think it frames the magnitude in mid-single-digit RTM growth and double-digit earnings confidence, Tom. That's probably the best way to summarize it.

<Thomas Wadewitz>: Okay. Fair enough.

<Keith Creel>: Okay. Thanks, Tom.

<Q – Thomas Wadewitz>: Yeah. And I guess the second one just on, Keith, can you add a little more to your comment on Hyundai in terms of what that means, if they are changing and is there kind of new business for you

on the volume side with Hyundai, or that's primarily efficiency? Or just maybe build a little bit more on your comment that you started at the beginning of the call.

<A – Keith Creel>: Yeah, I think it's both. I think it's growth and volume for Hyundai. I think that it's also efficiencies. And I'll say this and explain it. So they're served at Centerm. Through all the consolidation or the shipping's industry over the last several years where they landed with their partners, they weren't benefited. They haven't realized the same cost synergies that some of their competitors have. And although we haul their business out of Vancouver, the size of the pie has been reduced, because they've been at a cost disadvantage. So moving forward to 2020, they sign up with THE Alliance, they're enjoying industry-best service. They're going to enjoy industry-best cost. They won't be at a disadvantage anymore. And we firmly believe that as a result of the cost advantage and the service improvements, they're going to grow in the marketplace. And when their ships get fuller, then our trains get fuller.

So it's a quality revenue problem or opportunity for us. And at the same time, any time we can complexity out of precision scheduled railroading, you minimize the moving parts. The remaining parts moving faster. The dwell on the dock is going to be lower. The trains are going to discharge larger and on time more frequently. That allows me to move my assets faster. My crew costs are going to be optimized. My equipment cost is going to be optimized. My velocity is going to be optimized. It creates capacity and it just hits you across every business unit incrementally, because it's moving in some of our highest density corridors.

So it's a positive, positive, positive that I get just as excited operationally, because not only does it allow us to enjoy the benefit now, it allows us to sustain constant improvement as we go forward and as we become better railroaders and as we get better through our investments and through our execution – executing our operating model day in and day out. It's a win-win not just for intermodal, but for CP and for all of our business lines that go through Vancouver, given it's such a key corridor for this railway.

<Thomas Wadewitz>: Okay, great. Thank you.

<Keith Creel>: Thank you, Tom.

<Operator>: And your next question comes from Scott Group from Wolfe Research. Please go ahead.

<Scott Group>: Hey, thanks. Good morning, guys.

<Keith Creel>: Good morning.

<Maeghan Albiston>: Good morning.

<Q – Scott Group>: Nadeem, I wanted to ask a follow-up on the guidance. Do you think that we maintain double-digit earnings growth in third and fourth quarter?

<A – Nadeem Velani>: Yeah, I didn't hear the last part, in what?

<Q – Scott Group>: Do you think we maintain double-digit earnings growth in third and fourth quarter? I understand full year and we don't want to get into the double-digit versus strong double-digit. So I'm just trying to isolate second half of the year

<A – Nadeem Velani>: I certainly expect that that's a fair representation in Q3. Q4, it maybe a little bit difficult. I'm not going to give you a quarterly guidance on EPS, but looking at what Q4 was, it was an all-time record EPS

number for the company.

<Q – Scott Group>: Okay. That makes sense. And then, Keith, I don't know if I'm a little early to ask this, but I think that the 10-year Teck contract comes up next year. It's the first time sort of this management team has an opportunity to take a look at that contract. Do you think there's big opportunities either from an operating or pricing or just philosophically opportunities with that contract, since it's been 10 years?

<A – Keith Creel>: It comes up in 2021, so you are a little bit early, Scott. But rest assured, it's not something that we're not thinking about. Listen, here's the strategy of this company. It's our objective to become integral into the companies that we partner with, their success, because when they do well, we do well. We want to be part of their supply chains. We're part of the reason that Teck is able to enjoy reliability in the supply chain and low-cost producer and win market share in world markets. We're part of the formula. So as long as we continue to play that role, we continue to be good supply chain partners. We originate the coal. We have access to Neptune, access to Westshore. We're going to continue to be a key player, strategic player and create compelling value that's going to be hard to walk away.

So when you talk about huge opportunities, to me the opportunity is to strengthen the partnership and help them grow in the market space. Quantum leaps in productivity, listen, we're always going to push to move things better. And if we can knock out some of that noise, making the supply chain more reliability in partnership with the terminals at the coast, as well as in partnership with the terminals that load the coal and we do our part in the middle, then, yes, there's opportunities.

But as far as quantum leaps, no. As far as improving and protecting that revenue stream and helping them succeed in the world marketplace, I think we're very confident in our ability to be able to do that. And that's what gives us confidence at the negotiating table. We've just got to make sense. When you make sense and your part of what helps the company succeed in the marketplace, it's hard to walk away from that.

<Scott Group>: Okay, great. Thanks for the time guys.

<Keith Creel>: Thank you.

<John Brooks>: Thanks.

<Operator>: And your next question comes from Brian Ossenbeck of JP Morgan. Please go ahead.

<Q – Brian Ossenbeck>: Hey, good morning. Thanks for taking my question. John, I just want to come back to your comment on the mix, clearly it has been strong this quarter a couple of points as you mentioned. Can you just elaborate a little bit on what was driving that? It sounded like crude was a significant source, but also maybe a mix of new business. So if you can elaborate on would you expect to maintain that sort of clip in the back half of the year, and how much of that is reliant on continued ramp-up in crude?

<A – John Brooks>: Yeah. We definitely saw less long-haul crude Kansas City, more shorter haul over some of our Western gateways and Noyes. That had a material impact. Some of the new business in the crude by rail space that we brought on has also come on, as I mentioned, at very strong pricing levels. Though, I look at it like this, Brian, as I look at Q3 and Q4, I think that moderates. I'm not sure we see that mix tailwind like we had in Q2 as some of this other longer haul crude ramps back up.

<Q – Brian Ossenbeck>: Okay. So crude is the biggest needle mover?

<A – John Brooks>: It is.

<Brian Ossenbeck>: Okay.

<John Books>: It is, yeah.

<Q – Brian Ossenbeck>: And just another question for you, John, on the Canadian ELD mandates now effective June 2021, a little bit later than expected. I think you've typically referred to that as sort of upside outside of the guidance, but now it's been delayed a bit even past the 2020 outlook. Do you think actually having that in place will create any sort of shift as people start to get ready for that, maybe assess what that actually means for the business now that we had something approved and solidified, or is it still too early to think about any impact from that? Thank you.

<A – John Brooks>: No. I think having that certainty in the marketplace now is good. We expect it to be somewhat of a capacity sort of crunch driver when it is applied. And now that we know sort of a locked in date, we can have those strength discussions on when we get into the renewals and what our pricing looks like between now and then. And with the expectation that when ELDs do come about, how's that going to change and impact the marketplace. So, all in all, I think putting a line in the sand now and having clarity, actually, that's sort of helping us out.

<Brian Ossenbeck>: Okay. Thanks very much.

<John Brooks>: All right.

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

<Q – Seldon Clarke>: Hey, guys. Thanks for the question. Just getting back to the outlook for margins in the back half of this year, you called out incremental margins of 90% in the quarter, which is well above your longer term.

(Indiscernible)

<Nadeem Velani>: That wasn't us.

<Sheldon Clarke>: Oh, I'm sorry.

<Keith Creel>: Please state that if you can. You got blocked out a little bit somehow.

<Q – Seldon Clarke>: I apologize. So, just wanted to ask about the outlook for margins in the back half of the year in a little bit of a different way. You called out incrementals of 90% in the quarter, which is obviously well above your kind of longer-term range of 65%. And you talked about pre-hiring employees and you had some tailwinds from mix in the quarter. So just kind of given all those moving pieces, how should we think about your core incremental margins in the back half of the year?

<A – Nadeem Velani>: Yeah. I mean, when we guide to incremental margins, we've talked about that 70% to 75% level. We're comfortable with that. I mean, quarter-to-quarter, could it change, could be a little bit lower and a little bit higher? Yes, somewhat dependent on the mix of business as well and just how things are operating. So I think on the whole we're still confident with that 70% to 75% level.

<Q – Seldon Clarke>: Okay. Even with some of the headwinds from the pre-hiring in the second quarter, you still

expect that to kind of step down. I mean, there are enough positives to get that up to 90%?

<A – Nadeem Velani>: I mean, yeah. If you take out the pre-hiring, it would be closer to 100%. So that pre-hiring was done in Q2. That was in the numbers we just reported, right?

<Seldon Clarke>: Right. Yeah. It's kind of what I was asking, why it would step back down again or just...

<A – Nadeem Velani>: Well, again, it depends on the quarter-to-quarter there's other costs and other things that vary between quarter-to-quarter, right? So, if you hit 100% one quarter, doesn't mean it's going to be sustainable forever. So, that's why we guide on a full year basis, not quarterly.

<Q – Seldon Clarke>: Got it. Okay. And then just kind of a longer-term question on OR. Just given everything that's going on in the industry, as well as the PSR, it feels like the theoretical floor that management teams are willing to put out there is kind of high 50s for OR. But just given like what you guys have done the last several quarters, incremental margins at 90% range and your core incremental margins at 70% to 75%, what do you think the ultimate floor is for rail ORs over the next several years?

<A – Keith Creel>: I'd say this, I'm going to speak to what – I've got a good line of sight to what I know, and obviously I can't control it all and some things could be a little short or actually overachieved. But I see an ability annually to improve with our business mix and the growth that we're going to bring online with the share and with partnerships, organic and inorganic growth, a point a year for the next two to three years. So I see this growing annually from sub-60%, art of the possible, mid-50s.

<Seldon Clarke>: Okay. That's really helpful. I appreciate the time.

<Keith Creel>: Thank you.

<Operator>: And your next question comes from Benoit Poirier from Desjardins Capital. Please go ahead.

<Q – Benoit Poirier>: Yes. Thank you very much and congratulations for the good quarter. John, just in terms of forest product, obviously a very good performance when we look at the revenues up 8%. It seem a big discrepancy versus the industry. Could you maybe talk about what are the key drivers here in terms of forest product and what you see kind of for the second half?

<A – John Brooks>: Yeah, you know what, we've actually seen quite a bit of success in two areas. One is our pulp business has been quite strong, so that's sort of a derivative of our growth in our international business that has allowed us to grow the pulp business for export back out of Canada. So we've seen good success in that space. And then our team is focused really on asset utilization of our center beam fleet. So, the lumber market has, no doubt, been challenged, but I think we've targeted into the marketplaces that we do see sustainable business, and then really focused on asset utilization with our partners into those marketplaces. There's no doubt, as I look into Q3 and Q4, there's going to be some headwinds in that space. Certainly, we got the sawmill curtailments that are somewhat ongoing in B.C. The good thing is that has less impact on us. And frankly, because a big part of our network in the West is transload, origin transload, it gives us – we've actually got a little bit of insulation from some of that impact. So, I do expect that Q3 and Q4 in the forest product space will certainly be more challenged in the lumber space. But we'll see – we're certainly going to try to sustain it as we look into our pulp business.

<Q – Benoit Poirier>: Okay. That's great color. And maybe a high level question for Keith. When we look at the strength of the Canadian dollar, obviously, right now to CAD $1.30, still in line with your assumption for the year, so no material impact on the bottom line. But does it influence the way some of your customer think about their

business strategy? And is there a certain level where the Canadian companies could become, let's say, having more difficulty or more competitive issues, Keith?

<A – Keith Creel>: It's the same fundamental that exists. A lower Canadian dollar generally is going to favor the Canadian producer because it gives them a little bit of advantaged reach in the marketplace on exports. As long as that is there, I don't see whole lot of change. If the Canadian dollar were to get remarkably stronger, then could you see an impact? Maybe, but I just don't see that as a possibility or probability in the immediate future.

<Benoit Poirier>: Okay. Perfect. That's great color. Thanks for the time.

<Keith Creel>: Thank you, Benoit. Take care.

<Operator>: And your next question comes from Ravi Shanker of Morgan Stanley. Please go ahead.

<Q – Ravi Shanker>: Thanks. Good morning, everyone. I think there is lot of focus on crude by rail in the near term, but if I were to ask you a longer-term question in terms of the conversations you're having with your customers and the constant delays you are seeing in new pipeline projects. Is this still viewed as like a three-year opportunity or are you having constructive conversations for longer-term contracts and seeing those volumes extend beyond that initial window?

<A – Keith Creel>: I'll let John add color if he'd like to, Ravi, but discussions, when this all started that would have been two to three years, is based on pipelines that those expectations have been far missed. There's so much uncertainty with the pipelines, a three-to four-to five-year discussion is possible. So I think it extends the tail a bit. I still believe the pipelines will be built. There's too much of a critical need. There's just a lot of noise and a lot of hoops and obstacles to get through, but they will come. So there's a bit of a tail to our two to three when we started this thing, but it's not going to be forever tail, which I continue to remind John and the commercial team. We're making 30, 40-year asset decisions at this company. It's certainly not that kind of tail. And we're not going to overextend our capital, overextend our company based on a four or five-year opportunity on a 30 or 40-year decision.

<A – John Brooks>: Yeah, Ravi, Keith's bang on. Our discussions, just frankly, with the producers, these contract lengths are lining up in the three to five-year range.

<Q – Ravi Shanker>: Got it. And kind of when you kind of mention that long-term outlook, I think your peer is maybe looking at some growth opportunities beyond just the core railroad business, forward acquisitions and such. Can you just give us an update on what your M&A pipeline or non-railroad pipeline looks like, if there's any potential activity there?

<A – Keith Creel>: I guess, the shortest update is given our opportunities, our own unique story at CP, we're not interested in pursuing a strategy to buy trucking companies. We're railroaders. We're going to continue to play to our core strength. Does that mean that we won't look at partnerships? Does that mean that we won't take strategic steps to make sure that our customers have a level playing field and continue to win market share based on the strength of our service? We'll do that, but as far as buying trucking companies, we're not in the market.

<Ravi Shanker>: Understood. Thank you.

<Keith Creel>: Thank you, Ravi.

<Operator>: And we have no further questions at this time, so I will turn the call back over to Mr. Keith Creel for

closing remarks.

Keith Creel

Okay. To wrap this up. I want to thank everyone for their time this morning, for your interest, and for our shareholders, thank you for your trust and your vote of confidence. We've had a phenomenal quarter. It's behind us now. It's in the past. We're looking forward. We're focused on our convictions to make sure that we continue to meet or exceed our customers' expectations second half of this year, as well as our shareholders.

So with that being said, we look forward to sharing our third quarter results later in the year. Thank you.

<Operator>: And this does conclude today's conference call. You may now disconnect