

RAILROAD WEEK IN REVIEW

February 3, 2023

“It’s an unenviable task this year given the unusual opaqueness of the macro outlook. None of the US railroads provided EPS targets (wisely) while CN put ‘low-single digits’ out there in terms of potential earnings growth. ‘Mild recession’ seems to be the consensus from railroad managements.” — Rick Paterson, Loop Capital, Jan 27

*“More than a century ago, the guardians of financial rectitude were decrying the rise of bucket shops, in which people of small means could gamble on stock prices, as distinct from stocks themselves and the businesses that stood behind the stock certificates.”
— Grants interest rate observer, February 5, 2021*

“We adjust our CP 2023 EPS estimate to \$3.41 USD from \$3.60 USD (largely due to the change in the KCS contribution now starting in Q2) and introduce our new 2024 EPS estimate of \$4.01 USD. We only modestly lower our multiple half a turn to 22x for CP given the company’s continued execution, a well-positioned bulk segment, and an on-track KCS merger that is poised to unite the North American supply chain. Using our 22x multiple and 2024 EPS estimate, our price target goes to \$88 USD. Reiterate Outperform.” — Jason Seidl, Cowen & Co., February 1

Canadian Pacific Pacific closed out the 4Q2022 earnings calls with solid results and an encouraging 2023 outlook. Freight revenue was C\$2.4 billion, up 21 percent (“FX and fuel combined to be a 15 percent tailwind”) on 713,700 revenue units, up nine percent. Operating expense increased 22 percent, mostly on fuel, materials, and rents. Operating income grew 19 percent and the OR tacked on 61 basis points to 59.8.

Below the line, there were credits from an equity pickup from KCS in Q4 (C\$287 million when adjusted for KCS’ acquisition-related costs), purchase accounting, and a gain KCS had from an interest rate hedge unwinding. Net interest expense was up \$32 million versus last year as a result of a higher debt balance related to the KCS acquisition in Q4 2021. GAAP net income more than doubled to C\$1.3 billion.

CP presents a much more detailed revenue unit analysis than any other Class I. The presentation slides break the franchise into three commodity groups: bulk, merchandise and intermodal. Bulk revenue increased 25 percent on Canadian grain (half the total gain), potash, and fertilizer. Merchandise revenue barely budged, up a point, with energy/chemicals/plastics (“ECP”) accounting for nearly half the merchandise group revenue.

Intermodal splits about evenly between domestic and international and posted a 29 percent revenue gain. For more detail about what's in each group, turn to CP's *Investor Fact Book 2021 Data Supplement*, available on their website at *Investor Resources*:

LINES OF BUSINESS

BULK



GRAIN
(Based on 2020 revenues of \$1,829M)

Canadian Grain	72%
Regulated	54%
Non-regulated	18%
U.S. Grain	28%
Domestic	19%
Export	9%



COAL
(Based on 2020 revenues of \$566M)

Canadian Coal	89%
U.S. Coal	11%



POTASH, FERTILIZERS AND SULPHUR
(Based on 2020 revenues of \$783M)

Potash	63%
Export	42%
Domestic	21%
Fertilizers	30%
Sulphur	7%

INTERMODAL



INTERMODAL
(Based on 2020 revenues of \$1,563M)

Domestic	58%
Canada	53%
Cross-border	5%
International	42%
Ports	40%
Other	2%

MERCHANDISE



FOREST PRODUCTS
(Based on 2020 revenues of \$328M)

Pulp and Paper	55%
Lumber and Panel	42%
Other	3%



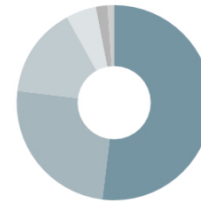
ENERGY, CHEMICALS AND PLASTICS
(Based on 2020 revenues of \$1,519M)

Petroleum Products	34%
Crude	21%
Chemicals	17%
Biofuels	17%
Plastics	11%



METALS, MINERALS AND CONSUMER PRODUCTS
(Based on 2020 revenues of \$629M)

Other Aggregates	33%
Steel	29%
Consumer Products	19%
Frac Sand	13%
Mines and Metals	6%



AUTOMOTIVE
(Based on 2020 revenues of \$324M)

Finished Vehicles	97%
Origin Canada	52%
Origin U.S.	25%
Imports	15%
Origin Mexico	5%
Parts and Others	2%
Machinery	1%

These are revenue numbers, but for our purposes revenue units can be more meaningful. The quarterly press release provides breakouts by commodity which one can then aggregate into these three groups. I prefer to use the year-to-date numbers which give a better picture of the franchise. From this one can see which commodities dominate each commodity group and the relative importance of each commodity to CP as a whole.

For calendar year 2022, grain dominates the Bulk group at 14 percent of total 2022 revenue units. In Merchandise, ECP is the winner at 12 percent and from the chart above you can see petroleum products and crude oil make up more than half. I prefer to lump

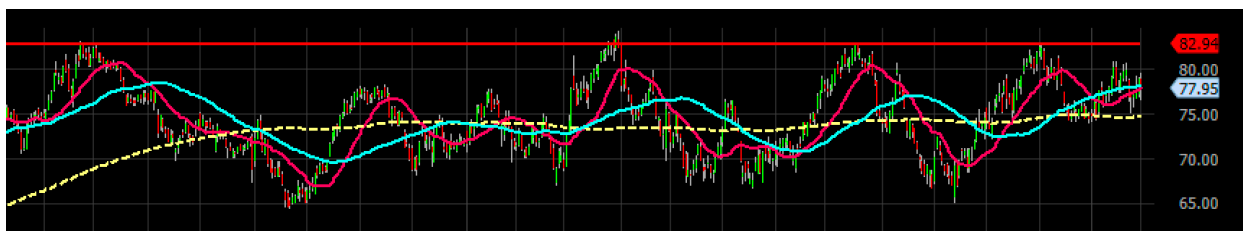
auto with intermodal as a “Premium” group that represents 46 percent of revenue units, all but three points of which is intermodal.

Lurking in the background of the call, not unexpectedly, is the CP-KCS merger. As one might expect, given the closeness of the next STB steps, not much was said on the call. On January 27 the STB issued its *Final Environmental Impact Statement for Proposed CP/KCS Merger* and “the Board will consider the transportation merits of the proposed acquisition, and the entire environmental record, including the Draft EIS, Final EIS and all comments received as part of its final decision in this proceeding.”

Said Creel, “I am extremely pleased to note the release last week of the final environmental impact statement. Certainly, that’s no small feat and a huge quantum of work by the STB to get that done in the meticulous thoughtful way that they handled not only just the environmental impact statement, but have been handling this entire file.”

To which CFO Nadeem Velani adds, “Looking at the year ahead, despite uncertainties with the macro environment, inflation and interest rates, I couldn’t be more excited. We have a transformational merger with Kansas City Southern and a strong pipeline of opportunities for the team to deliver.”

The investor community has had CP shares on hold for two years, starting with the May, 2021 peak of \$83 (far left). The Street is suggesting post-merger target prices of \$88 and up and I think that’s doable. After all, the numbers on a stock chart are from the analysts’ collective estimates of forward earnings, so as earnings do in fact increase, so will share prices that will be reflected in the chart. A breakout up and to the right seems right.



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