Need-to-Know

VERITAS INVESTMENT RESEARCH

Company	Ticker	Rating	Intrinsic Value	Current Price
Canadian Pacific Railway Ltd.	CP	Buy	$79.60 USD $102.00 CAD	NYSE: $72.82 USD TSX: $93.31 CAD

Q1-F22: Near-term Headwinds, Longer-term Opportunities

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CP Rail had another challenging quarter as adverse weather, labour disruption, higher fuel costs, and a below trend Canadian grain crop all contributed to a 14% Y/Y decline in volumes and a 6% Y/Y decline in revenues. The company registered an uncharacteristically high adjusted operating ratio of 69.8% during the quarter. Looking ahead, Q2 volumes are likely to continue being weaker relative to last year before improving in the back half of 2022. Management also expects the company's O/R to trend back into the mid-50s range by then.

Despite the near-term headwinds, we continue to advise looking past the noise and focusing on the long-term potential of the CP-KCS combination. The merger will create a unique tri-coastal network spanning the entire continent that is likely to attract customers looking to de-risk their supply chains and bypass congested West Coast ports. Given recent delays in the regulatory process, we believe merger approvals are likely to come sometime in Q1-F23, in line with CP's expected outside date.

In the meantime, we are maintaining our BUY recommendation and $102.00 per share intrinsic value estimate. Our valuation is based on CP as a standalone company.

Need-to-Knows from Q1-F22:

- **Well positioned for global supply de-risking:** In light of recent supply chain disruptions and geopolitical conflict, we believe CP's high proportion of bulks (i.e., grain, coal, potash) positions it well for buyers seeking diversification and de-risking.
- **Bulk commodities as a hedge to consumer-centric freight:** In light of rising recession risks, we view CP's bulk commodity exposure as an offset to potential weakness in consumer-centric freight volumes.
- **KCS operations chugging along:** KCS' quarterly results indicated strong freight demand and solid execution. KCS upstreamed a US$265 million (C$334 million) dividend to CP in Q1.
- **CP-KCS merger approval process about to get back on track:** In March the STB paused the merger review process due to data inconsistencies. Last night's STB ruling paves the way for a resumption of proceedings. Despite the interruption, we believe approval timelines remain largely intact.

Near-term Headwinds, Long-term Opportunities

CP expects negative volume growth in Q2, largely driven by dwindling grain stocks. However, in the second-half of 2022 volumes are expected to rebound as a normalized Canadian grain crop is harvested, potash demand remains strong, new industrial customers come online, and intermodal volumes grow.

Longer-term, CP appears well positioned to benefit from global supply de-risking. In light of recent supply chain disruptions and geopolitical conflict, commodity buyers are increasingly looking to diversify their sources. Canada is one of the world's largest producers of grain, potash, and crude, all of which are in shorter supply as a result of the Ukraine-Russia conflict. We believe that buyers will be increasingly likely to look to Canadian sources for their commodity needs.

CP stands to benefit as it can easily transport these commodities to tidewater, and together grain, potash, and crude represent an estimated ~40% of the company's freight volumes.

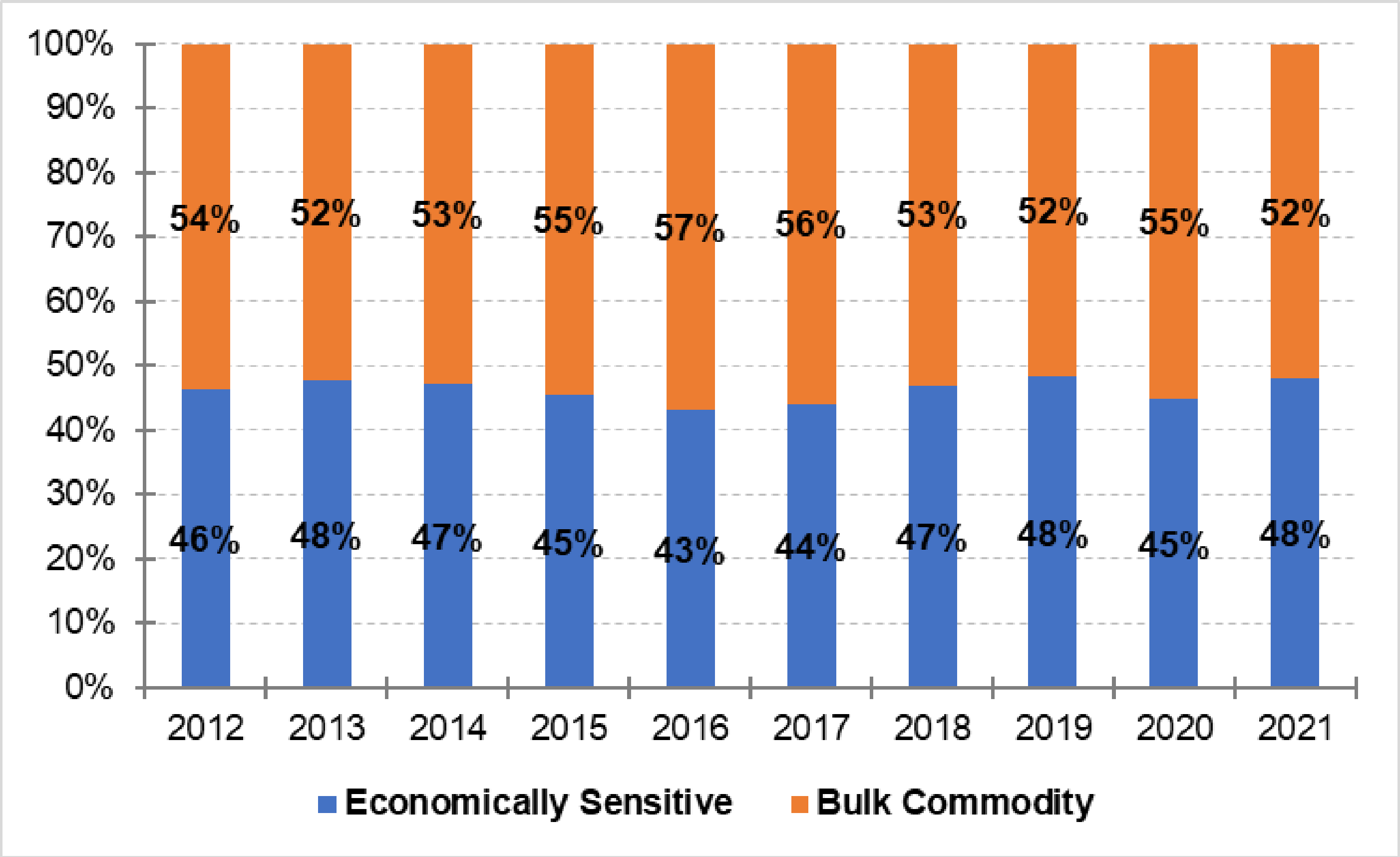
Bulk Commodity Exposure as an Offset to Potential Economic Slowdown

Global macro uncertainty, the Ukraine-Russia conflict, persistent inflationary pressures, and a flattening yield curve have increased recession risks. Should an economic downturn materialize, consumer spending and demand is likely to weaken and we would expect consumer-centric freight volumes to follow suit. However, in our view CP is relatively well positioned given that a larger proportion of its volumes are tied to bulk commodities vs. consumer-related freight commodities. Historically, between 50% and 60% of the company's volumes (as measured in revenue-ton-miles, or RTMs) have been related to bulks. Figure 1 illustrates:

Figure 1

Breakdown of CP's Freight Volumes: Bulk Commodity vs. Economically-Sensitive

Expressed as a percentage of total RTMs



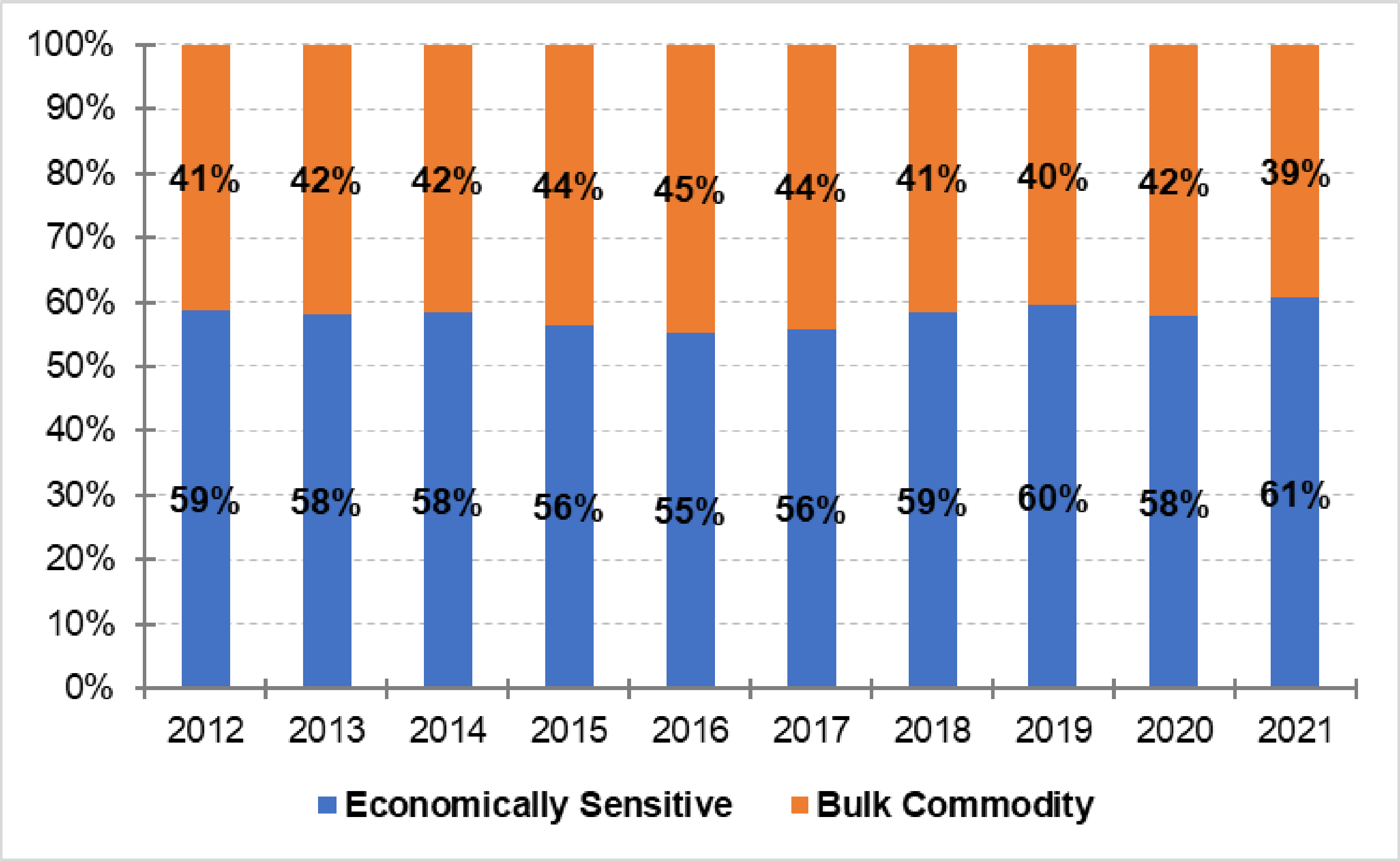
Source: Company disclosures.

In addition, we note that CP has typically derived 40% to 45% of its freight revenues from bulks. Figure 2 illustrates:

Figure 2

Breakdown of CP's Freight Revenues: Bulk Commodity vs. Economically-Sensitive

Expressed as a percentage of total freight revenues



Source: Company disclosures.

Our definition of economically-sensitive freight includes commodities that are either consumer-centric in nature (i.e., intermodal and automotive) or basic materials used in the production of final goods typically geared for consumer use (i.e., lumber, panels, and forest products; petrochemicals and refined petroleum products; metals and minerals). These freight commodities are largely tied consumer spending, industrial production, and general economic activity. Bulk commodities (i.e., grain, coal, and potash) on the other hand, are largely tied to mine/farm production and underlying commodity prices. Given the positive outlook for these commodities, we expect freight demand from those shippers to remain fairly strong, even if a slowdown in economic conditions materializes.

Although the majority of CP's revenues are still generated from consumer-centric freight commodities (61% in 2021), it is still significantly lower than the company's main domestic competitor. In 2021, ~70% of CN Rail's volumes and ~80% of its revenues were tied to consumer-related freight. To be clear, we are not forecasting an economic downturn, however, comparatively speaking we would expect CP's volumes to fair better in that type of environment.

KCS Continues to Chug Along

Despite being a private company (operating independently in trust), KCS is still providing the market with quarterly updates. Based on our review, KCS appears to be performing well and experiencing solid demand. Its Q1-F22 volumes and revenues increased by 4% and 10% year-over-year, respectively, while its operating ratio improved by 160 basis points. Figure 3 summarizes:

Figure 3

Kansas City Southern Q1-F22 Highlights

	Q1-F21	Q1-F22	Y/Y Change
Volumes (in thousands of carloads)	555	575	**+4%**
Revenues (in millions of USD)	$706	$778	**+10%**
Operating ratio	64.2%	62.6%	**1.6pp improvement**

Note: According to KCS, excluding the impact of fuel surcharges and foreign exchange, revenues would have increased by 5% Y/Y.

Source: Company disclosures.

Demand was fairly broad-based, with double-digit volume growth in agriculture, metals, and automotive, and mid-to-high single-digit growth in industrial and consumer, energy, and intermodal freight. We believe KCS' outlook remains positive, which will help maintain upstream dividends to CP while KCS is in trust. In Q1-F22, KCS upstreamed US$265 million of dividends.

Worth noting is that CP and KCS recently launched a dedicated international intermodal service from the port of Lazero Cardenas to the U.S. Midwest. The new service is being operated on an interline basis, and provides steamship lines with an option to bypass congested U.S. West Coast ports. Reported transit time was 7 days. We believe that transit times and service levels are likely to improve after CP and KCS obtain STB merger approvals and operate as a single-line service, which should attract more carriers. Indeed, management noted that at least one other steamship line is already exploring options to utilize this service.

Merger Approval Process About to Get Back on Track

In mid-March, the STB paused the CP-KCS merger approval process to review inconsistencies between traffic density data contained in CP's merger application and CP's submission to the STB's Office of Environmental Analysis. Yesterday evening, the STB rendered a decision essentially requiring CP to use the OEA data in both submissions and to amend and update its merger application accordingly. CP has until May 27 to file its amendment materials. Interested parties (largely the other Class 1 railroads) will have 20 days after CP's amended filing to file their own responsive applications, after which the procedural schedule will resume.

Despite the ~3-month pause in the CP-KCS merger proceedings, we view yesterday's STB as a step in the right direction as the process now has a clear path to re-starting. Moreover, our review of the STB's decision indicates that final briefs are now due 130 days after CP files its amended application. Assuming that CP files on the May 27 deadline, final briefs would be due in early October, which would still be in line for a late Q4-F22 or early Q1-F23 approval.

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Explanation of the Veritas Investment Research Equity Rating System

Our analysts rate stocks based on their view of how the stock will perform over the next 12 months relative to their sector of coverage.

Rating	Description
Buy	Expected to generate a meaningful positive return or outperform analyst’s sector coverage over the next 12 months
Reduce	Expected to underperform analyst's sector coverage over the next 12 months
Sell	Expected to generate a negative return over the next 12 months

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