Canadian Pacific Kansas City

Industrials
TSX: CP
Market Outperform | Hold

CPKC

Calgary Portfolio Management Trust

June 30, 2024

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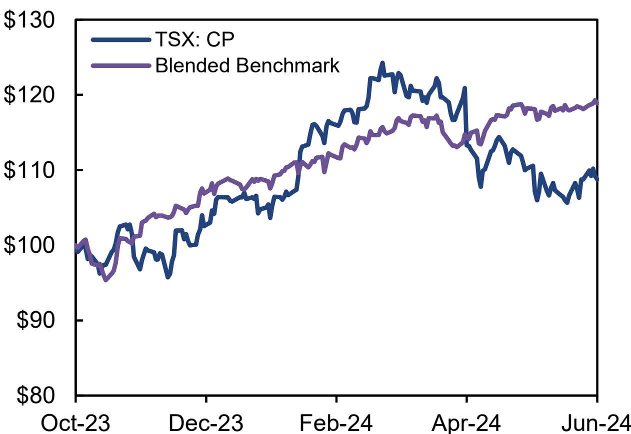
Return on Investment	
Current Share Price	$107.74
Target Price	$138.00
Dividend Yield	0.76%
Implied Return	29%
Conviction Rating	1

Market Profile	
52-Week Range	$94.45 - $123.37
Market Capitalization ($mm)	$104,677
Net Debt ($mm)	$22,209
Enterprise Value ($mm)	$126,886
Beta (5-Year Monthly)	0.77

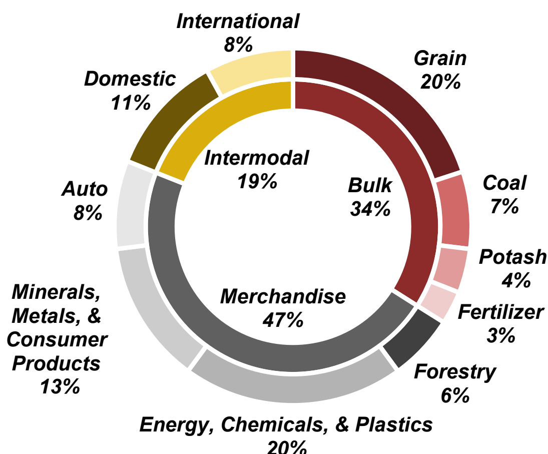
Metrics	2024E	2025E	2026E
Revenue ($mm)	$15,277	$16,603	$18,399
EBITDA ($mm)	$9,385	$10,515	$11,682
EPS	$4.83	$6.10	$7.14
EV/EBITDA	12.9x	11.5x	10.4x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: FY2023 Segmented Cargo Mix



Source: Company Filings

Business Description

Canadian Pacific Kansas City (TSX: CP) owns and operates extensive freight railway networks across North America. The Company provides direct rail and intermodal transportation services over a 20,000-mile network, connecting more than 30 ports and over 200 transload facilities. In 2023, the Company completed the US$31B merger with Kansas City Southern (KCS), establishing the first transcontinental railroad connecting Canada, the U.S., and Mexico. CP operates across three main business lines: (1) Bulk, (2) Merchandise, and (3) Intermodal.

Industry Overview

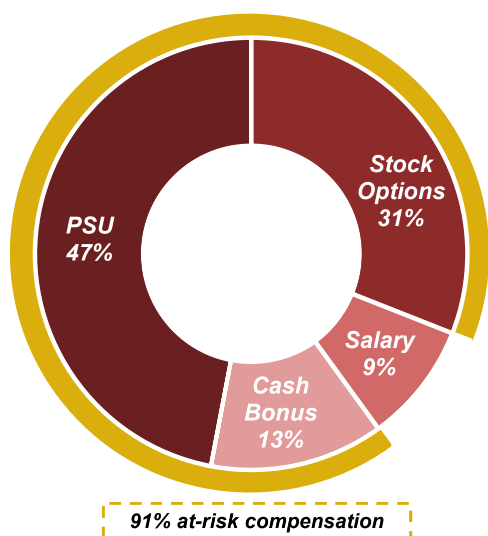
Within the transportation industry, the two primary shipping modes are truck and rail. Trucks offer flexibility with adaptable routes and schedules, while railroads excel in efficiently transporting heavy loads. As a result, railroads predominantly handle bulky freight such as coal, grains, chemicals, and metals, leveraging superior fuel efficiency and lower unit labour costs to provide cost-effective transportation compared to trucks.

By the 1970s, decades of excessive regulation had pushed U.S. freight railroads to the brink of collapse. Bankruptcies were rampant, and tracks and equipment deteriorated due to the inability to cover maintenance costs. Recognizing the need for reform, U.S. Congress passed the Staggers Rail Act of 1980. This legislation led to rapid consolidation in the North American rail industry, reducing the number of Class I railroads from 40 to seven within 25 years. Today, six Class I railroads dominate the market, controlling ~67% of freight rail mileage, employing ~87% of the industry's workforce, and generating ~94% of its revenue. Alongside CP, the other Class I railroads include BNSF Railway, Canadian National Railway (TSX: CNR), CSX Corporation (NASDAQ: CSX), Norfolk Southern (NYSE: NSC), and Union Pacific (NYSE: UNP). These companies maintain sticky customer bases due to limited shipping alternatives for suppliers and benefit from substantial barriers to entry, such as high capital requirements and unparalleled access to densely populated areas, solidifying their market position.

Following the CP-KCS merger, other Class I railroads have turned to strategic alliances to stay competitive. For instance, CNR has partnered with Ferromex and UNP to create the Falcon Premium Service, a direct challenge to CP's transcontinental freight line. Although regulatory constraints limit future M&A, the trend toward strategic partnerships is expected to persist. Carriers are increasingly acknowledging the advantages of pooling resources and expertise to improve network efficiency, elevate service quality, and secure a larger market share in a highly competitive environment.

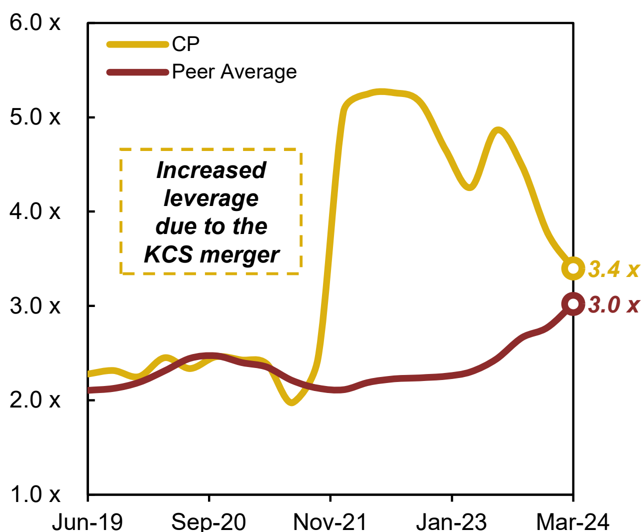
Nearshoring has become a key driver for the North American rail industry amidst post-COVID international trade tensions and supply chain disruptions. Companies are pivoting from offshoring to adopting nearshoring strategies, with Mexico emerging as a major beneficiary. This trend has sparked a heightened demand for freight shipping across the U.S./Mexico border. As manufacturers establish new supply chains for products flowing into and out of newly established facilities in Mexico, affordable transportation solutions are essential to support profitable nearshoring strategies.

Figure 2: CEO Compensation Breakdown



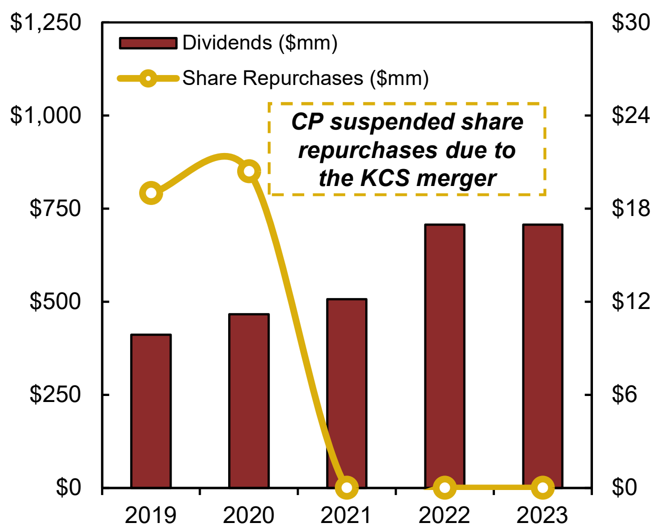
Source: Company Filings

Figure 3: Net Debt/EBITDA vs Peers



Source: FactSet

Figure 4: LHS Dividends vs RHS Share Repurchases



Source: FactSet

Mandate Fit

Quality Management: Keith Creel has been the President and CEO of CP since 2017, following a four-year tenure as COO. Prior to joining CP in 2013, Creel served as the COO of CNR and has extensive experience in the railroad industry. Mark Redd has served as CP's COO since 2022, bringing ~20 years of experience in the railway industry, beginning his career as a conductor. The Company's NEOs have been with CP for several years, bringing substantial industry knowledge and experience from other North American Class I railroads. Additionally, compensation for the CEO and NEOs consists of ~91% and ~80% at-risk pay, respectively.

Competitive Advantage: CP's competitive advantage resides in its best-in-class asset base, featuring exclusive ownership of one of the few railroad networks connecting Canada, the U.S., and Mexico. The next fastest North American transcontinental railway, Falcon Premium, operated by CNR and UNP, is approximately two days slower than CP's rail network. This unique network allows CP to capture additional market share by offering customers access to new and expanded markets through KCS's routes in Mexico. Prior to the merger, 80% of KCS traffic from Mexico to the U.S. was transferred to competitors. Now, with the integration of the legacy KCS network into a superior long-haul network, CP has enhanced operational efficiencies, cost structure, and travel time.

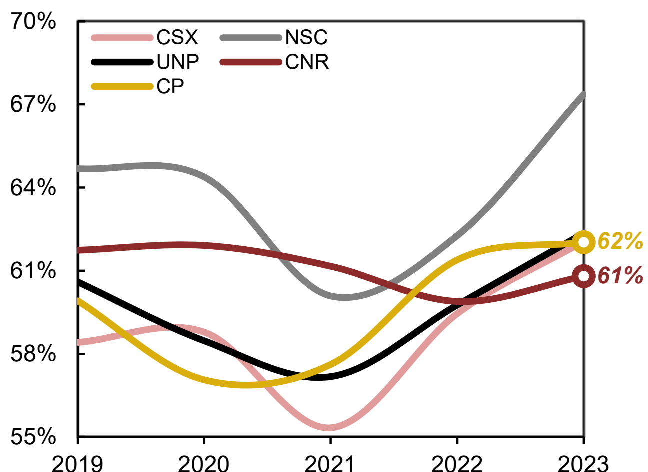
CP is better positioned than its peers to capitalize on the surge in freight demand fueled by nearshoring and improved North American trade facilitated by the Canada-United States-Mexico Agreement (CUSMA). With its transcontinental network, access to Monterrey and specialized services like the Mexico Midwest Express, CP is strategically prepared to address the evolving logistical and supply chain needs resulting from this economic shift.

CP holds exclusive access to the Port of Lázaro Cárdenas, Mexico's most technologically advanced container terminal. This strategic advantage allows CP to alleviate pressure on congested West Coast ports by leveraging the port complex. Additionally, through this access, CP offers shippers a compelling alternative to bypass the Panama Canal for shipments from Asia to Texas, significantly reducing transit time by cutting weeks off the all-water route.

Strong Balance Sheet: CP has a Net Debt/EBITDA ratio of 3.4x, slightly above its peer average of 3.0x. Following the KCS merger, the Company assumed additional leverage and held a Net Debt/EBITDA ratio of 5.2x. In response to higher debt levels, the Company has prioritized deleveraging by suspending its share repurchase program and currently aims to achieve a target Net Debt/EBITDA ratio of 2.5x. CP has available liquidity through a US$2.2B undrawn committed credit facility and a US$1.5B commercial paper program. The Company has fixed interest on 100% of its term debt and holds BBB+ and Baa2 ratings from S&P Global and Moody's, respectively.

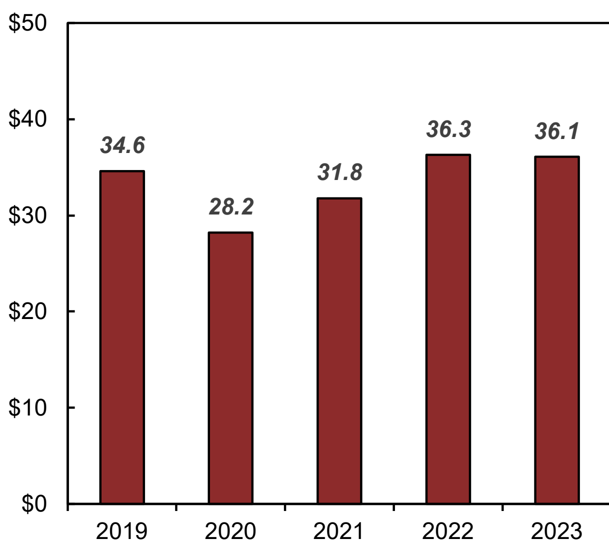
Growing Free Cash Flow: CP has realized a five-year FCF CAGR of 4.4%. The Company has been able to significantly grow FCF after acquiring KCS and has a trailing twelve-month FCF of $1.6B. The Company has consistently returned capital to shareholders through its quarterly dividend, where it has paid out $707mm over the last twelve months. CP's FCF growth has been bolstered by its intermodal cargo business, which has grown at a five-year CAGR of ~7% domestically and ~11% internationally. This has occurred partly due to growth in the North American automotive sector, on which CP has greatly capitalized.

Figure 5: Operating Ratio vs Peers



Source: S&P Capital IQ

Figure 6: Foreign Investment in Mexico (US$B)



Source: Company Filings

Risks

Mexico Concession: ~14% of CP's asset base comprises two major railways in Mexico, which operate under government concessions rather than owning the real estate. This arrangement exposes CP to the risk of nationalization, which could potentially prevent the Company from operating under these concessions.

KCS Integration: Integrating KCS presents various financial, regulatory, and operational challenges. Due to the size of the railroad, the Surface Transportation Board has imposed several commercially reasonable terms to ensure competition is maintained while permitting CP to operate with minimal restrictions. CP might encounter larger capital commitments than initially budgeted, potentially leading to reduced capital efficiency and liquidity.

Labour Disputes: ~74% of CP's workforce is unionized, represented by 75 bargaining units. In the past, disagreements or challenges in negotiating mutually acceptable contracts with these unions have led to strikes, work stoppages, slowdowns, or lockouts. Such disputes could potentially arise again in the future, causing significant disruptions to the Company's operations.

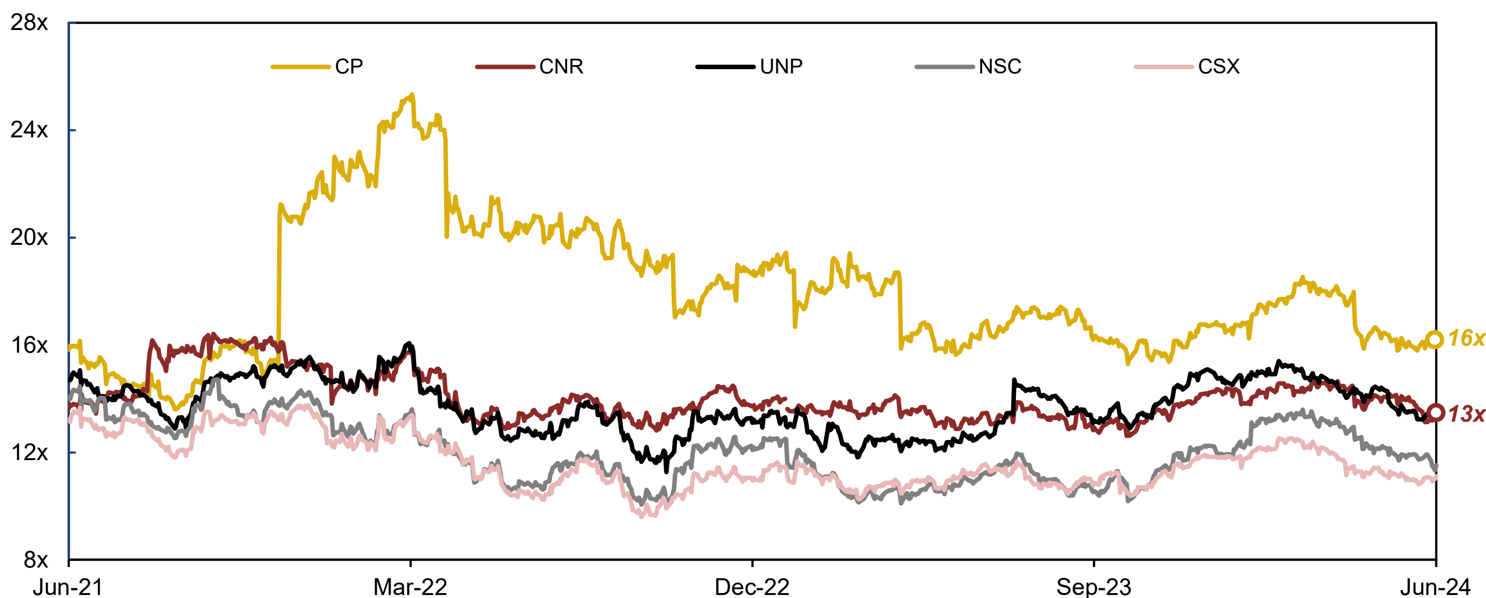
Investment Thesis and Valuation

CP was valued at $138 using a five-year DCF with a WACC of 7.61%. The terminal value was determined through a 50/50 blend of (1) the Gordon Growth method, using a 2.0% terminal growth rate, and (2) an EV/EBITDA exit multiple of 12.0x.

The CPMT views CP as a best-in-class operator poised for significant growth compared to its peers in the medium term. Following its merger with KCS, CP has enhanced its competitiveness across the continent and improved its capital efficiency. The Fund is confident in the name's ability to continue to achieve synergies and reduce its operating ratio as the network is optimized in the coming years.

The CPMT maintains positions in both CP and CN, recognizing each as fundamentally distinct businesses with unique exposures and strategies. Neither is deemed superior, yet both hold advantages over their American counterparts.

Figure 7: NTM EV/EBITDA vs Peers



Source: S&P Capital IQ