Canadian National Railway

Industrials
TSX: CNR
Market Outperform | Hold

June 30, 2022

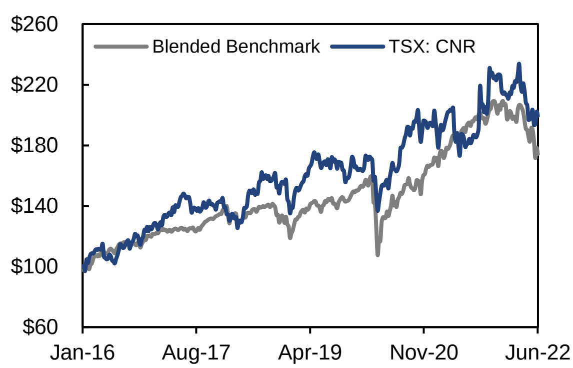
Eric Xiao, Portfolio Manager
Rebecca Butler, Investment Analyst

Return on Investment	
Current Share Price	$148.03
Target Price	$163.00
Dividend Yield	1.74%
Implied Return	12%
Conviction Rating	3

Market Profile	
52-Week Range	$129.65 - $173.01
Market Capitalization ($mm)	$100,969
Net Debt ($mm)	$13,332
Enterprise Value ($mm)	$114,302
Beta (5-Year Monthly)	0.70

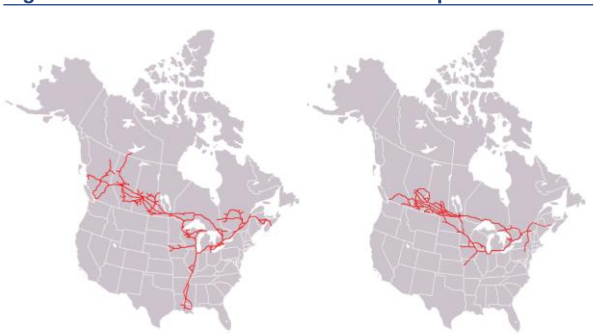
Metrics	2022E	2023E	2024E
Revenue ($mm)	$16,194	$17,091	$18,007
EBITDA ($mm)	$8,203	$8,901	$9,462
EPS	$6.99	$7.81	$8.63
EV/EBITDA	13.9x	12.8x	12.1x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: LHS CNR vs RHS CP Network Maps



Source: Company Filings

Business Description

Canadian National Railway (TSX: CNR) is a leading North American (N.A.) transportation company. Prior to the Canadian Pacific Railway (TSX:CP)-Kansas City Southern (KCS) merger, CNR's 32,000km railroad was the sole rail connection between Canada's eastern and western coasts, and the southern U.S. The Company transports ~300mm tonnes of natural resources, manufactured products, and finished goods annually. CNR's revenues originate from seven commodity groups: Petroleum & Chemicals, Metals & Minerals, Forest Products, Coal, Grain & Fertilizers, Intermodal, and Automotive. At Q1 2022-end, the two largest segments (Intermodal and Petrochemical & Chemicals) comprised 28% and 20% of total revenues, respectively. Intermodal transport involves the utilization of both rail and trucking services; trucking revenues are captured through CN-owned trucking companies TransX and H&R.

Industry Overview and Competitive Landscape

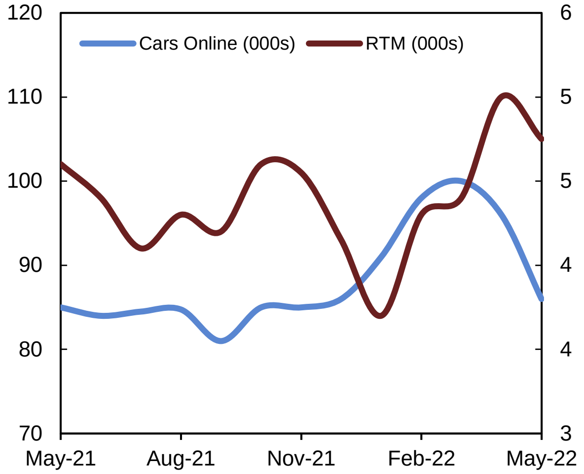
The Canadian railway industry is dominated by two major players: CNR and CP. CNR and CP are two of the seven Class 1 rail companies in N.A., operating the majority of tracks across the continent. In the first half of 2022, Canadian railroads experienced slower volumes of western grain as a result of extreme weather conditions in the previous year. However, in Q2, Canadian rails outperformed U.S. peers CSX (NASDAQ: CSX), Northfolk Southern (NYSE: NSC), and Union Pacific (NASDAQ: UNP) by more than 5% due to normalized volume expectations of western grain production. Geopolitical tensions and inflationary pressures have further impacted the N.A. rail industry in the form of rising average fuel prices. These circumstances have pressured competitors to address challenges to operating margins. In an emission-intensive industry, railway companies are expected to position themselves competitively through fuel efficiency and sustainable operations. In response to increasing government regulations, all Class 1 railroads have identified emission targets to reach by 2030.

Original Thesis

The original investment thesis was predicated on cash flow stability provided by CNR's diversified revenue streams, in addition to operational expertise quantified through its best-in-class operating ratio relative to peers. CNR is the pioneer of Precision Scheduled Railroading (PSR), which involves the fixed scheduling of freights, instead of dispatch being dependent upon a set minimum length of the train. This results in more reliable freight schedules and a reduction in the number of idle cars and crew members needed.

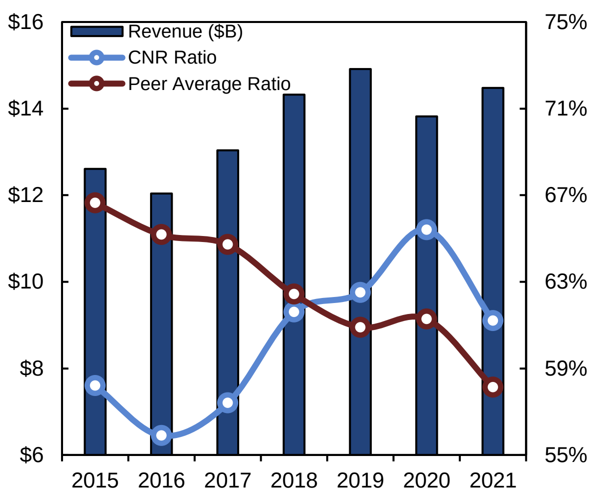
Revenue generation continues to display diverse characteristics; as of 2021 year-end, no single commodity group accounted for more than 30% of total revenues. Regarding operations, CNR's operating ratio has risen by 3% over the last six years, as the Company focused on the pursuit of "Operational and Service Excellence," attempting to strike a balance between operational efficiency and customer service. The Fund believes CNR lost operational discipline, and views this as the primary explanation for its significant underperformance. Over the five-year period, CNR returned 38%, while its peer group (NASDAQ: CSX, NYSE: NSC, UNP, TSX: CP) returned 58%, 82%, 91%, and 121%, respectively.

Figure 2: LHS CNR Cars Online (000's) vs RHS RTM



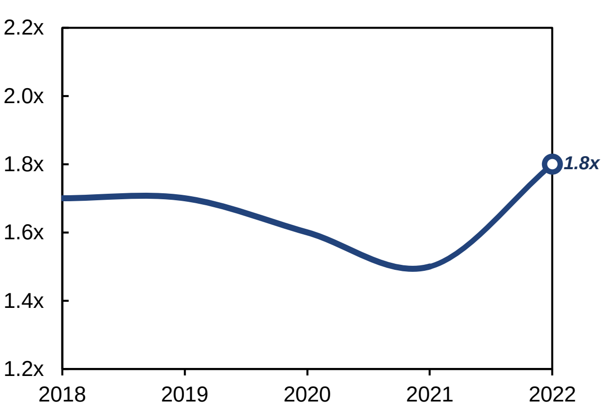
Source: Company Filings

Figure 3: LHS Revenue vs RHS Operating Ratio



Source: Company Financials

Figure 4: LTM Net Debt/EBITDA



Source: S&P Capital IQ

Updated Corporate Strategy

Despite deterioration in operating efficiencies, the Fund believes that developments in late 2021 with activist TCI Fund Management ("TCI") have positively impacted CNR. A push towards the full re-adoption of PSR should drive operational efficiencies, resulting in long-term cash flow growth. If this occurs, CNR could deliver an operating ratio in the low-to-mid 50% range, re-positioning itself as a top operator. Among TCI's priorities is increasing the Company's promotion and awareness of rail transport as a cleaner alternative to truck; rail is four times more fuel efficient than trucks and produces ~75% less greenhouse gas emissions. The Fund believes this strategic approach may warrant an industry-wide multiple expansion.

Nearly concurrent with the announcement of TCI's plans, CNR announced the retirement of CEO Jean-Jacques Ruest. In January 2022, CNR announced the appointment of Tracy Robinson as CEO, who spoke at the Q1 2022 earnings call about the new near-term performance improvement plan. This initiative re-prioritizes the improvement of operations (namely velocity) and focuses on curating the customer base to better fit the network. Furthermore, investing in the network and capabilities will position the Company for top-line growth. Guidance surrounding the new plan did not involve specific targets, nor does this appear to be a full return to PSR. However, the CPMT believes this new mandate shifts the narrative positively from previous years. While all targets directly impact efficiency, they also benefit CNR's service, ensuring customer relationships remain intact in the long-term. Thus far in 2022, CNR's freight revenue per revenue ton miles (RTM) have seen an increase of ~15%, while cars online have fallen, providing some assurance on the realization of its operational goals.

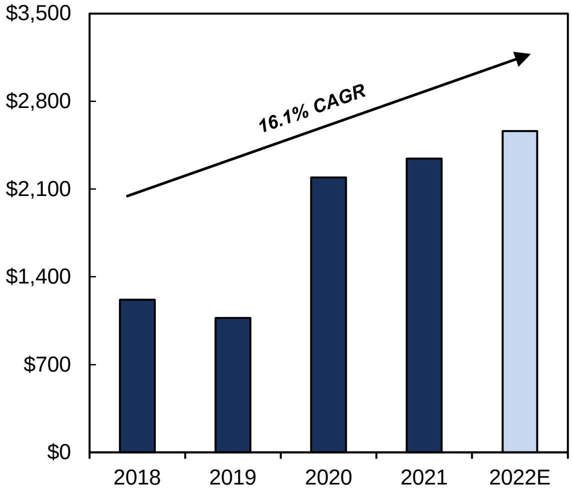
Mandate Fit

Quality Management: In Q1 2022, Tracy Robinson was appointed as President, CEO, and Director of CNR. Prior to CNR, Robinson has served as Executive VP at TC Energy (TSX: TRP) and has held various executive roles at CP. Robinson entered her role following concerns from TCI regarding an alleged lack of management railway expertise. With extensive experience through commercial, operations, and finance roles across multiple sectors, Robinson possesses the expertise required to target CNR's underperformance and support strong forward-looking results for the Company.

Competitive Advantage: CNR's primary advantage lay in the geographical breadth and unique efficiencies of its railroad assets. Prior to the CP-KCS Merger, its network was the sole N.A. tri-coastal connection; with the completion of the deal, CNR's competitive advantage is at risk. However, CNR does still have exclusive rail access to the third busiest seaport in Canada, the Port of Prince Rupert, which positions the Company strategically for long-term growth in the international intermodal business.

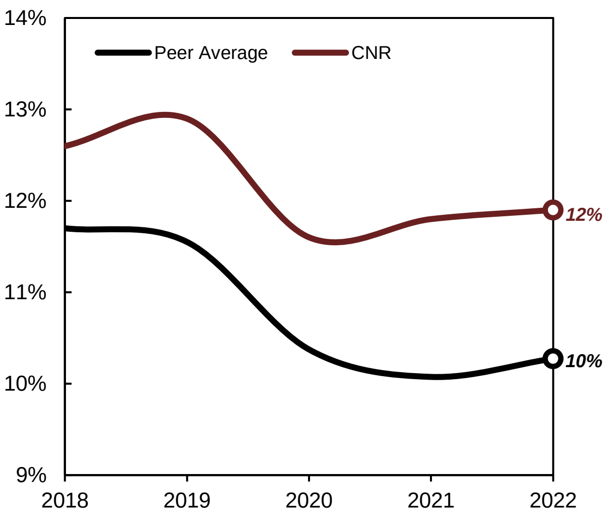
Balance Sheet: CNR has a strong balance sheet, with an interest coverage ratio of ~14x during the past four quarters. As of June 30, 2022, CNR had a net debt of $13.3B, with a LTM Net Debt/EBITDA of 1.8x, compared to its main competitor (CP) at 4.5x. In March 2020, the Company entered a $1.3B two-year unsecured revolving credit facility agreement, whereby it adopted a sustainability linked loan structure to achieve sustainability targets. This facility also serves to backstop for CNR's commercial paper programs in the U.S. and Canada, which had $1.2B of borrowings as of March 2022. CNR continues to maintain a strong credit profile, with corporate investment grade credit ratings of A (S&P) and A (Moody's).

Figure 5: Free Cash Flow ($mm)



Source: S&P Capital IQ

Figure 6: ROIC[1] vs Peers



Source: S&P Capital IQ
(1) LTM NOPAT

Growing Free Cash Flow: CNR displays a strong FCF profile, with a five-year FCF CAGR of ~16%. With this positive FCF generation, management repurchased 280,000 shares for $40.9mm in Q1 2022.

Sustainability

CNR consumes ~15% less locomotive fuel (per GTM) than the industry average, positioning the Company as an industry leader in fuel efficiency. Rather than primarily using carbon credits, the Company focuses on lowering emissions through existing technologies. Sustainalytics' ESG Assessment continues to classify CNR as "low risk" regarding the potential impact on economic value.

Risks

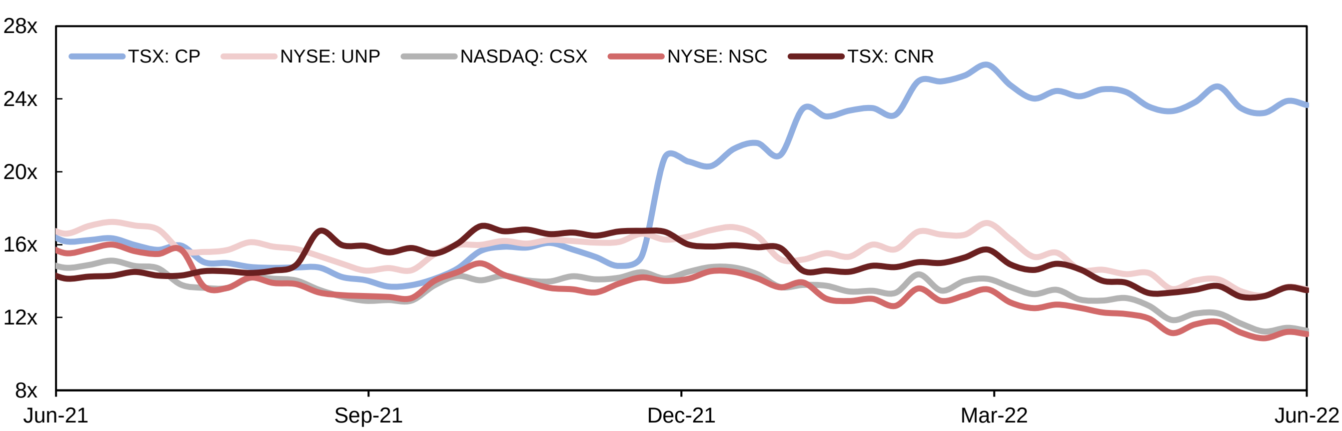
Similar to its railway peers, CNR is exposed to changes in fuel pricing, labour conflicts, poor weather conditions, and other factors affecting operations. Given that the railway industry is capital intensive, the inflation-sensitivity of labour and capex costs could negatively impact the Company's strong FCF margins. Additionally, the increasing risk of recession and a resulting slowdown in industrial production would negatively impact the freight cycle. Company-specific risks involve labour conflicts, as seen in CNR's recent union strike. Such disruptions to operations are likely to add pressure to supply chain issues resulting from reduced rail capacity.

Investment Thesis and Valuation

Upon review, it appears as though the Company's strategy began to deviate from the CPMT's original thesis, especially when identifying CNR as the premier Canadian railway operator. Despite the runway that was laid out for the Company in the form of PSR, a shift away from its full adoption led to operations that lagged peers over a five-year period. However, a transition in strategy has changed this narrative, and due to CNR's historic success as a leading N.A. railway operator, the Fund sees a smooth reversal to a focus on operations. In conjunction with realized operational improvements, the original thesis now appears to be intact; however, the CP-KCS merger still represents a major threat to CNR's competitive advantage. While the CPMT recommends a Hold at the current conviction of 3, further due diligence will be conducted to determine if other peers represent a better fit for the portfolio.

The CPMT valued CNR using a five-year DCF analysis with a WACC of 7.9%, consisting of a 50/50 blend of (1) the Gordon Growth method using a terminal growth rate of 2.0%, and (2) the application of an 11x EV/EBITDA exit multiple, yielding a target price of $163.

Figure 7: NTM EV/EBITDA vs Peers



Source: S&P Capital IQ