Executive Summary

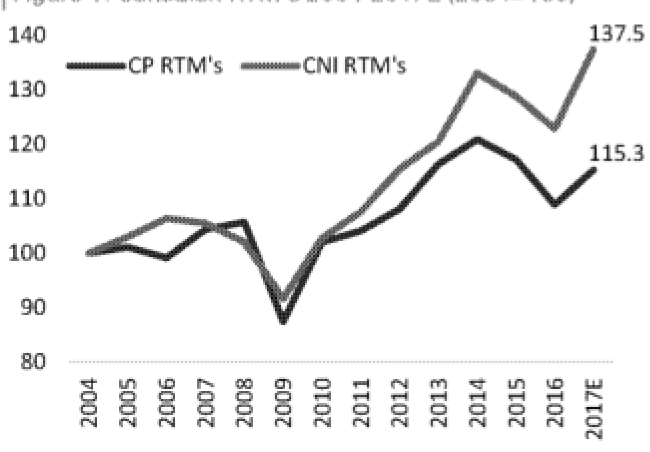
We are expanding our coverage of Transportation companies with initiation of coverage of the Canadian railroad industry. We are positive on **Canadian Pacific** (CP, Buy) and cautious on **Canadian National** (CNI, Sell), as we see overall market share and earnings trajectory driving a reversal in recent relative value trends. All told we forecast CP to grow EPS at double the rate of CNI (+30% for CP vs. +15% for CNI cumulatively through 2019), which together with capex and free cash trends should drive re-rating at CP and de-rating for CNI. In this report we present a primer on the Canadian rail industry, with deep dives on Canadian Pacific and Canadian National.

We do not believe current valuation appropriately reflects the relative earnings trajectory and shifting market dynamics within the Canadian rail industry. We believe CP is well positioned to regain market share from CNI as it leverages its lowered cost base, improved service levels, and recent capacity investments to retake market share. In our view, these efforts will help CP achieve industry-leading volume and earnings growth over the next several years (ex-CSX).

A lower cost base and better service levels should help CP regain share

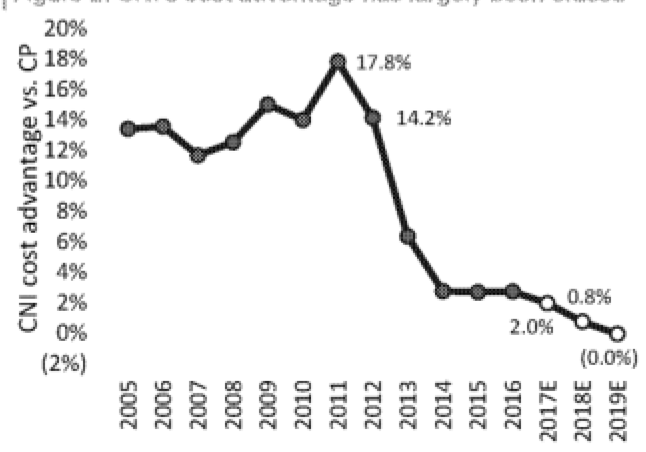
From 2012-2016, CNI increased volumes (revenue ton-miles [RTM's]) at more than double the rate of CP (+3.0% CAGR vs. +1.2% CAGR for CP). While mix likely played a factor, we believe the key driver behind this was CNI's ability to win market share as the lower-cost carrier with superior service. Further, this came at a transitional time for CP as the focus was largely on the implementation of Precision Railroading which likely pushed freight onto other transportation modes as well. As you can see below, CNI had nearly 18% points of cost advantage over CP (as measured by operating ratio) before CP began implementing Precision Railroading in 2012. This advantage has largely been erased, and we expect just a 200bps difference in operating ratios in 2017.

Figure 1: Canadian RTM's 2004-2017E (2004=100)



Source: Deutsche Bank, Company filings

Figure 2: CNI's cost advantage has largely been erased



Source: Deutsche Bank, Company filings

Moreover, CP has seen a significant improvement in service levels while CNI's service metrics are essentially inline with 2012 levels. Behind this improvement was CP's multi-year track upgrade program which was completed in 2015. While a more efficient railroad, better service, and lower costs typically all go