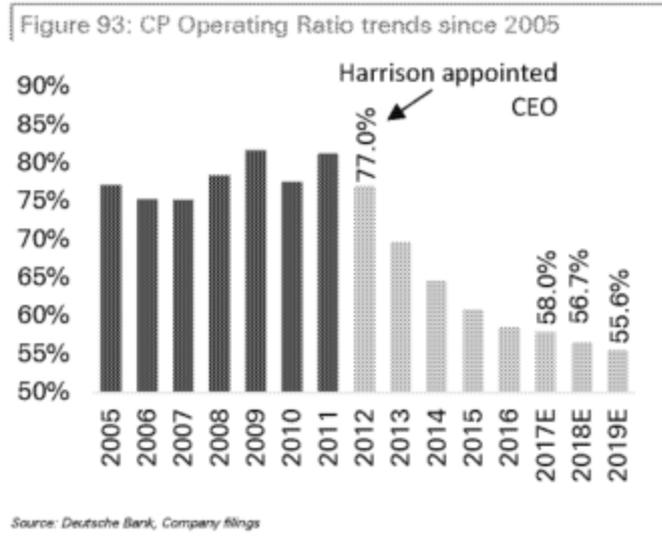
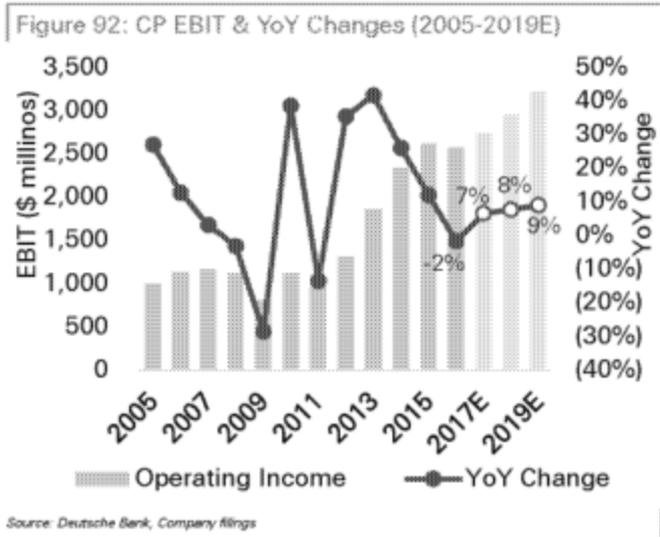




Profitability trends

CP reported operating income of C\$2.6bn in with a company-best and near best in class operating ratio of 58.6% in 2016. Over the past ten years, CP's EBIT has increased at an 8.6% CAGR on just 3.1% revenue CAGR as the company was able to reduce its operating ratio by nearly 1,700bps. The majority of this improvement came during Hunter Harrison's tenure as CEO (see figure below) when the operating ratio improved 1,600bps from 2012-2016. Harrison's Precision Railroad model helped transform CP through a relentless focus on asset optimization, network connectivity, and cost controls. To put this into context, CP reduced its locomotive fleet size by 40% from 2012 to 2015 while maintaining volume levels. Said another way, CP was able to improve its locomotive productivity by 40% in three years by removing older units from circulation and running heavier/longer trains. Another aspect of Precision Railroad involves the replacement of hump yards with flat-switching. This change helped CP improve its average terminal dwell (the time a train spends at a terminal) by 19% and average network speed by 40% since 2011. We expect continued improvement in margins as CP benefits from strong operating leverage to volume growth.



Balance Sheet & Cash Flow overview

As of Q3 2017, CP's net debt totaled C\$7.9bn (excluding C\$288 million of off-balance sheet debt) and its net debt/ebitda ratio was 2.4x. Historically, CP's net debt/ebitda has averaged 2.5x and remained within a range of 1.6-3.2x (hitting 3.2x in 2009 and 2011). This is modestly higher than its Class I peers under our coverage universe which typically run a leverage ratio around 2.0x. Management targets a long-term leverage ratio of 2-2.5x. In the figure below we depict CP's gross and net debt balances as well as its leverage ratio since 2005.