MADISON'S TIMBER PREVIEW

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Now that the ugly proxy battle and disagreement over board membership at Canadian Pacific Railway are all but over, newly installed CEO Hunter Harrison, retired from Canadian National Railway, is wasting no time making changes with the company.

Please refer to the July 27, 2012 issue of your *Madison's Timber Preview* for details on the movements of activist investor William Ackerman, of Pershing Square Capital, on CP Rail.

Prior to the drama, CP Rail was in the second year of an impressive ten-year plan to purchase more powerful locomotives to provide for increased train lengths and to haul double-decker rail cars. Its difficult to see Harrison taking credit for increasing CP's capacity by 30 per cent when the company was well on the way to doing that back in July 2009.

At the time of the proxy battle, agitators claimed that while it was a good plan, the company had taken too long to move on it and was bogged down by other problems and inefficiencies.

This week Harrison and CP Rail released the first round of their plans to improve the company's bottom line.

The company is still targeting capital expenditures of around $1.1 billion a year. But it will try to stretch those dollars, for example, using materials from underused sidings — which allow trains to pass each other — to build new ones in key areas for 60 per cent lower cost.

Broadly speaking, Harrison will be centralizing the railroad's planning under his command but also aiming to empower frontline workers to react more quickly to operational challenges and improve relations with its customers.

Please see the November 12, 2011 issue of your *Madison's Lumber Reporter* for details on Canada's Rail Freight Service Review, which started because customers were so fed up with the service provided by the two national rail monopolies.

Harrison hopes to achieve an operating ratio in the mid-60s by midyear 2016. CP's operating ratio was an industry worst in 2011, at 81 per cent. Fifteen years prior it had been one of the best in North America.

CP also wants to generate up to $1.4-billion in free cash flow annually by 2016 as revenue grows and costs come down.

One example of inefficiencies the new board has found was in Winnipeg, after a review of the rail yard there determined that only 200 of the 1,000 rail cars arriving actually needed to be at the yard, opening up an opportunity for change. As a result, CP has closed four of its hump yards, three intermodal terminals, and consolidated its Montreal, QC, operations, allowing for $40 million in annual savings.

The company announced last week plans to move its headquarters from downtown Calgary to its Ogden rail yard, about 12 kilometres southeast of the city, in the first quarter of 2014. That transition will save the company $15 million a year, and integrate the headquarters with the railway's operations.

The management team has also taken a hard look at the railway's network itself, and decided to shelve the option it held to build into the Powder River Basin. That project was once heralded as the crown jewel in the railway's 2007 acquisition of the Dakota, Minnesota and Eastern Railroad (DM&E) from

Electra Private Equity, for US$1.48 billion and future payments of over US$1 billion contingent on commencement of construction on the Powder River extension. That rail line services grain, ethanol and merchandise shipments, while Powder River Basin is the largest US coal reserve but is suffering due to slowing demand.

DM&E had plans at the time of the CP purchase to add 260 miles of track around the southern end of the Black Hills to the Wyoming coal fields. The multi-bilion dollar project, by some estimates $5 billion, would have competed with UP and BNSF, which in 2006 carried about 450 million tons of coal from the basin.

Wyoming's in-house state fiscal analysts in October projected coal production in the state would decline 8.7 per cent, or about 40 million tons, in 2012.

CP will also seek expressions of interest on 660 miles of track in the western portion of the DM&E, which Harrison said has been “dead cash” since it was purchased. The line runs from Tracy, MD, west into South Dakota, Nebraska, and Wyoming. Harrison described this portion of the CP network as 'an attractive and highly viable opportunity for a low-cost operator' interested in the area's grain, ethanol, clay, and merchandise customers.

CP currently runs two to four trains every 24 hours through Rochester, MN, which carry mixed freight -- mostly grain or steel -- but not coal. Some trains have started to haul silica sand. Rochester officials and Mayo Clinic leaders have long expressed safety concerns about that proposed rail project, which could have brought coal trains near the Mayo headquarters.

Prior to CP's acquisition, DM&E had become one of the largest regional (Class II) railroads in the United States, with over 2,500 miles of track.

The company will take a $180 million charge to abandon its option to build the 260-mile extension. Less than a year after that acquisition, in its 3Q 2008 results, CP announced plans to chop its capital spending in its operations, and those of its recently acquired Dakota Minnesota & Eastern Railroad.

CP Rail’s net income for 3Q 2008 was $173 million, down from $219 million the previous year. A 40 per cent profit plunge in 2Q results sparked a concerted campaign to cut fat at the company, which in July named Kathryn McQuade the new Executive Vice-President and Chief Financial Officer. On October 20. 2008 CP Rail celebrated the first day of operational control of recently acquired Dakota, Minnesota & Eastern Railroad Corporation and its subsidiaries: Iowa, Chicago & Eastern Railroad and Cedar American Rail Holdings

CP will also be examining at the Delaware and Hudson Railroad, which operates in the US Northeast. It was purchased by CP 1991 and, Harrison argues, has not earned a dollar since.

In trading Wednesday, CP’s shares hit $98.04 before falling back to close at $96.82, a gain of $3.82, or 4.11 per cent, and a 52-week high. Volume was two million shares, four times the three-month average. The stock has climbed about 23 per cent since Harrison was appointed CEO in late June.

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