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PALOS

Weekly Commentary

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CONTENTS

By Charles Marleau CIM® and William Mitchell CIM®

Canadian Pacific Railway – Covering the Continent

Canadian Pacific Railway Ltd. (TSX/NYSE: CP) was formed and incorporated in 1881 with the goal to physically unite Canadians from coast to coast. The building of the railway is regarded as one of Canada's greatest feats of engineering. Over the last fourteen decades, CP's businesses have diversified to include hotels, airlines, mining, energy, logistics and communications. Headquartered in Calgary, CP carries a market cap of CAD$ 60 billion and has a dividend yield of roughly 3%.

On March 21, CP announced plans to merge with **Kansas City Southern** (NYSE: KSU) in a transaction supported by both boards. The transaction implies an approximate 23% premium being paid by CP. Holders of KSU would receive US$ 90/share and 0.489 shares of the newly merged company, which is to be named **Canadian Pacific Kansas City** or CPKC. To cover the costs of the deal CP will raise US$ 8.6 billion through the issuance of new debt and shares. Current CEO Keith Creel will remain at the helm and the head office will stay in Calgary. Regional offices will be maintained in key operational jurisdictions.

The proposed merger of the two smallest Class I railroads will create a unified network that connects Canada's existing coast to coast network (Vancouver/Prairies/Ontario & Quebec/ and the Maritimes) with the U.S Midwest (Minnesota to the Gulf Coast), and Mexico's industrial heartland and ports on both Mexican coasts. The new company will be the only railway with a truly continent-wide footprint. For 2020, CP's revenues were overwhelmingly generated through the transport of grains, commodities (energy, chemicals, plastics) and an intermodal logistics and transportation business. By comparison, KSU revenues were predominantly generated in chemicals & petroleum, industrial & consumer goods, agriculture and intermodal.

There is some speculation that the Surface Transportation Board (STB) in the U.S. may elect to roadblock the deal given CP's previously unsuccessful attempt to acquire **Norfolk Southern** (NYSE: NSC) in 2015. The difference this time is that management of both companies are supportive of the merger. Further, the combined entities will remain as the smallest of the Class I railways and this should relieve regulatory concern that the merger will harm competition. In fact, with virtually no pre-existing overlap the expanded network should create greater overall price competition and be welcomed by customers.

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Although some analysts are viewing the deal as a large price to pay, the merger matches complementary networks, diversifies revenue streams, and offers the opportunity for cost synergies. Bottom line, over the long-term the combining the smallest Class I railroads should allow them to compete with the larger players – in our view a smart business move. Not to be overlooked is the opportunity to capitalize on the growth potential related to the 2020 renewal of the USMCA trade agreement between the three countries, particularly in the automotive parts and vehicle production industries.

The **Palos Equity Income Fund** and the **Palos Income Fund LP** have held shares in CP Rail since January of 2017. We consider CP to be a blue-chip company. CP is a core holding in our funds that is characterized by its reliable and sustainable dividend growth. We believe the merger will create a mega cap company (over US$ 70 billion) with the potential for significant future growth guided by improved competitiveness in the North American rail industry.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$9.57	9.43%
Palos Equity Income Fund - RRSP	PAL101	$6.97	9.24%
Palos Merchant Fund L.P. (Dec 31, 2020) [2]	PAL500	$1.35	-21.15%
Palos WP Growth Fund - RRSP	PAL210	$23.42	46.73%
Palos-Mitchell Alpha Fund [3]	PAL300	$12.86	8.08%
S&P TSX Composite (Total Return with dividends reinvested)			8.26%
S&P 500 (Total Return with dividends reinvested)			6.19%
S&P TSX Venture (Total Return with dividends reinvested)			7.79%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			1.68%
Canadian Government 10-Year			1.50%
Crude Oil Spot			US $60.97
Gold Spot			US $1732.30
US Gov't10-Year/Moody BAA Corp. Spread			211 bps
USD/CAD Exchange Rate Spot			US $0.7952

[1] *Period ending March 26, 2021. Data extracted from Bloomberg*
[2] *Fund is priced annually*
[3] *Fund is priced weekly on Tuesdays*

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