Canadian National Railway Company (TSX:CNR)

Industrials Coverage

04-Mar-2016

"Making a play in consistency and elevated shareholder returns"

Initiating coverage – BUY Report

Target Price: C$92.00, **representing 19.5% upside**

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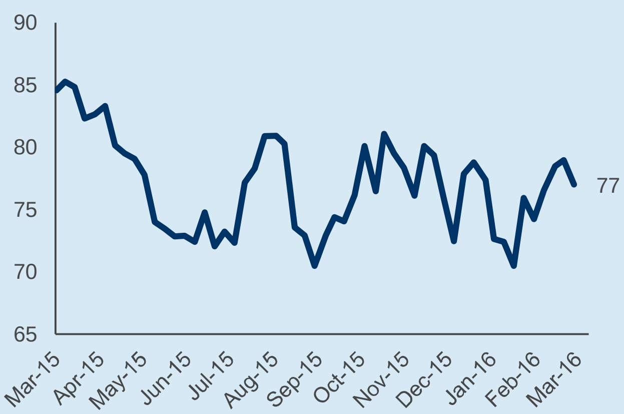
Capitalization table

Price (04-Mar-2016)	C$77.00
FD Shares outstanding (m)	785.0
Equity value (C$m)	$60,445.0
(+) Debt	10,427.0
(-) Cash & equiv.	(153.0)
Enterprise value (C$m)	$70,719.0

Key data

FY	2015A	2016F	2017F
Sales (C$m)	12,902.0	14,555.0	15,095.3
EBITDA (C$m)	6,476.9	7,132.6	7,566.2
EPS (C$)	4.43	4.93	5.40
EV / EBITDA (x)	10.9x	9.9x	9.3x
P / E (x)	17.4x	15.6x	14.3x

LTM price chart (C$)



Company overview

Canadian National Railway (CN) is a Canadian Class I railway company headquartered in Montreal, Quebec, serving Canada and Midwestern and Southern United States through a network that spans 32 thousand Kilometers. CN is the largest railway in Canada, in terms of both revenue and the physical size of its rail network, and is Canada's only transcontinental railway company.

Investment thesis

Our Investment thesis is based upon the fact that Canadian National is best positioned to capitalize on the impact of volume stabilization amongst its peers. Mainly due to its:

- Strong industry fundamentals and diversified operations
- Sound Capital allocation
- Operational and service excellence

Catalyst

- Short-Term: Lag between an adjustment in fuel surcharges and the realized pricing of fuel
- Mid-Term: Limited supply of rails across North America
- Long-Term: Increased efficiency of railway companies, leading to a less impact of Chicago's bottleneck

Valuation

- Our price target is based a blended DCF and comparable companies analysis and attributing a 16.2x P / 2017F EPS multiple

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Executive summary

Thesis and catalysts

Strong industry fundamentals and diversified operations

The industry's natural high barriers to entry result in limited and rational competition, allowing CN's management team to make long-term capital decisions without having to consider an industry disruptor. Simultaneously, the well-diversified revenue streams of CN allows it to minimize its risks and weather fluctuations in 7 commodity groups as no individual commodity group accounted for more than 23% of total revenues in recent years.

Capital allocation

Consistent track records along with the industry nature of high barriers to entry allows CN to increase prices with inflation and increase margins due to efficiency without having to worry about cutting prices to remain competitive.

Operational and service excellence

The railroad is run based on a disciplined operating methodology, executing with a sense of urgency, passion and accountability. . The company never accepts the status quo and believes in continuing to strive for operational excellence by raising the bar at every opportunity.

Valuation

Premium company warranting a premium multiple

CN is a top operator and capital allocator with a unique positioning versus its peers. It is one of two transcontinental Class I rails in North America and has the top margins in the industry, justifying a top percentile multiple. Valuation is based on a blended DCF and comparable companies analysis , giving it a target price of $92 with an associated upside of 19.5% in the next year without including its growing dividend yield.

Financial overview

In C$m, unless noted otherwise

Profit model	2013	2014	2015E	2016E	2017E
Freight revenue	9,951	11,455	11,914	12,347	13,034
Fuel surcharge, FX and other	624	679	988	2,208	2,061
Total revenue	**10,575**	**12,134**	**12,902**	**14,555**	**15,095**
(-) Labor and fringe benefits	(2,182)	(2,319)	(2,408)	(2,483)	(2,625)
(-) Purchased services, materials	(1,351)	(1,598)	(1,711)	(1,835)	(1,807)
(-) Fuel	(1,619)	(1,846)	(1,311)	(1,387)	(1,497)
(-) Depreciation & amortization	(980)	(1,050)	(1,175)	(1,275)	(1,339)
(-) Equipment rents	(275)	(329)	(360)	(373)	(395)
(-) Casualty and other	(295)	(368)	(414)	(372)	(383)
(-) Currency adjustment	--	--	(222)	(973)	(822)
(-) Operating expenses	**(6,702)**	**(7,510)**	**(7,600)**	**(8,698)**	**(8,868)**
EBIT	**3,873**	**4,624**	**5,302**	**5,857**	**6,227**
(-) Interest	(357)	(371)	(435)	(511)	(536)
(+) Other income	5	27	43	--	--
Pretax income	**3,521**	**4,280**	**4,910**	**5,346**	**5,691**
(-) Tax	(938)	(1,185)	(1,344)	(1,497)	(1,594)
Net income	**2,583**	**3,095**	**3,565**	**3,849**	**4,098**
(/) FD shares outstanding (m)	846	824	805	780	759
EPS (C$ / share)	**$3.05**	**$3.76**	**$4.43**	**$4.93**	**$5.40**
EBIT	**3,873**	**4,624**	**5,302**	**5,857**	**6,227**
(-) Depreciation & amortization	980	1,050	1,175	1,275	1,339
EBITDA	**4,853**	**5,674**	**6,477**	**7,133**	**7,566**

Growth and margins	2013	2014	2015E	2016E	2017E
Sales growth (%)	*6.6%*	*14.7%*	*6.3%*	*12.8%*	*3.7%*
EBITDA growth (%)	*5.3%*	*16.9%*	*14.1%*	*10.1%*	*6.1%*
EBIT growth (%)	*5.1%*	*19.4%*	*14.7%*	*10.5%*	*6.3%*
EPS growth (%)	*8.8%*	*23.1%*	*17.9%*	*11.3%*	*9.5%*
EBITDA margin (%)	*45.9%*	*46.8%*	*50.2%*	*49.0%*	*50.1%*
EBIT margin (%)	*36.6%*	*38.1%*	*41.1%*	*40.2%*	*41.3%*
Net income margin (%)	*24.4%*	*25.5%*	*27.6%*	*26.4%*	*27.1%*

Freight revenue / carload (C$)	2013	2014	2015E	2016E	2017E
Petroleum and chemicals	3,195	3,594	3,819	3,931	4,069
Metals and minerals	1,183	1,396	1,548	1,594	1,649
Forest products	3,193	3,517	3,842	3,958	4,097
Coal	1,714	1,426	1,368	1,410	1,459
Grain and fertilizers	2,864	3,103	3,296	3,279	3,395
Intermodal	1,295	1,317	1,308	1,347	1,394
Automotive	2,500	2,707	2,959	3,048	3,155

Balance sheet	2013	2014	2015E	2016E	2017E
Cash	214	52	964	1,102	354
A/R	815	928	938	938	938
PP&E	26,227	28,514	32,015	33,579	35,165
Other	2,907	2,298	2,662	2,662	2,662
Total assets	**30,163**	**31,792**	**36,580**	**38,282**	**39,120**
A/P	1,477	1,657	1,757	1,757	1,757
Current debt	1,021	544	1,305	1,305	1,305
LT debt	6,819	7,865	9,681	10,581	10,731
Deferred income taxes	6,537	6,902	7,754	7,754	7,754
Other	1,356	1,354	1,359	1,359	1,359
Total liabilities	**17,210**	**18,322**	**21,856**	**22,756**	**22,906**
Stockholders Equity	**12,953**	**13,470**	**14,724**	**15,526**	**16,214**

Cash flow	2013	2014	2015E	2016E	2017E
CFO					
(+) Net income from ops.	2,612	3,167	3,523	3,849	4,098
(+) Non-cash expenses	1,242	1,386	1,538	1,275	1,339
(-) Change in NWC	(238)	(105)	89	-	-
(-) Other	(68)	(67)	(70)	-	-
(+) CFO	**3,548**	**4,381**	**5,080**	**5,124**	**5,437**
CFI					
(-) CAPEX	(1,973)	(2,297)	(2,700)	(2,840)	(2,925)
(-) Other	(603)	(697)	(1,099)	(1,211)	(1,353)
(-) CFI	**(2,576)**	**(2,994)**	**(3,799)**	**(4,050)**	**(4,278)**
(-) CFF	**(913)**	**(1,549)**	**(369)**	**(936)**	**(1,907)**
Net impact on cash	**59**	**(162)**	**913**	**138**	**(748)**

Ratio overview	2013	2014	2015E	2016E	2017E
Net debt / Total capitalization	*37.1%*	*38.3%*	*40.5%*	*41.0%*	*41.9%*
Current ratio	*0.8x*	*0.9x*	*1.0x*	*1.1x*	*0.8x*
Net debt / LTM EBITDA	*1.6x*	*1.5x*	*1.5x*	*1.5x*	*1.5x*
EBITDA / Interest	*13.6x*	*15.3x*	*14.9x*	*14.0x*	*14.1x*
Return on average equity	*22.0%*	*23.1%*	*25.1%*	*25.4%*	*25.8%*

Carload ('000)	2013	2014	2015E	2016E	2017E
Petroleum and chemicals	611	655	636	637	650
Metals and minerals	1,048	1,063	960	972	991
Forest products	446	433	446	457	466
Coal	416	519	460	469	479
Grain and fertilizers	572	640	619	602	614
Intermodal	1,875	2,086	2,222	2,310	2,357
Automotive	222	229	240	242	247

Industry review & emerging themes

The North American railroad industry

The overarching North American railroad industry can be split into three main duopolies, the West (BNSF and Union Pacific dominate), the East (Norfolk and CSX dominate), and the North (CP and CN) [KCS is the smallest and operates in the South]. The industry is driven heavily by economic indicators and the railroads remain under pressure from their end market drivers; the strong US dollar, deteriorating global commodity demand, and a weak energy market. The end of 2015 marked a year of weak volumes, with coal and metals volumes falling 26% and 27% YoY for the last 4 weeks of 2015. Volume stabilization will provide a strong vector for all industry players to improve their current depressed valuation, and CN is best positioned to capitalize on this impact as the best-in-class player.

Carload category volume impact

At 2015 year end, all carload categories, with the exception of automotive, have fallen into negative territory. As rail companies manage volume declines heading into 2016, the industry's next year will be heavily marked once again by oil and gas prices, US dollar strength, and demand from the automotive sector.

With that in mind we have covered a view on the primary carload categories heading into 2016:

Intermodal

Positive US GDP growth (Exhibit 1, F1) will be slightly offset by increased competition from truckers in the current low fuel-price environment

Coal

Low natural gas prices environment will cause shift in power generation in favor of natural gas away from US coal production (Exhibit 1, F2)

Chemical and petroleum

Crude rail traffic remains volatile, as spreads decrease (Exhibit 1, F3). However when oil supply reaches peak, rail demand increased due to a pipeline bottleneck. Additionally, chemical baseload provides relatively stable demand throughout economic cycles

Agriculture

US grain prices (Exhibit 1, F4) negatively impacted by global oversupply and strong US dollar and volatile grain prices equal volatile rail volumes

Metals and minerals

Headwinds from declining frac sands market (high profitability) and aluminium production offset by strong auto steel demand (Exhibit 1, F5)

Automotive

Expansion of new auto sales and demand for parts and equipment provides strong rail segment (Exhibit 1, F5)

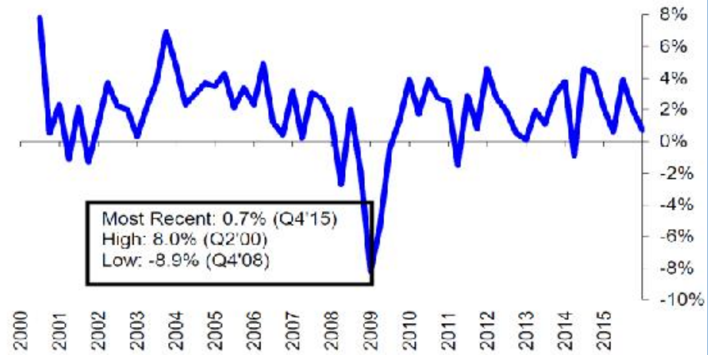
Forest products

Significant upside if single family units continue to recover (Exhibit 1, F6)

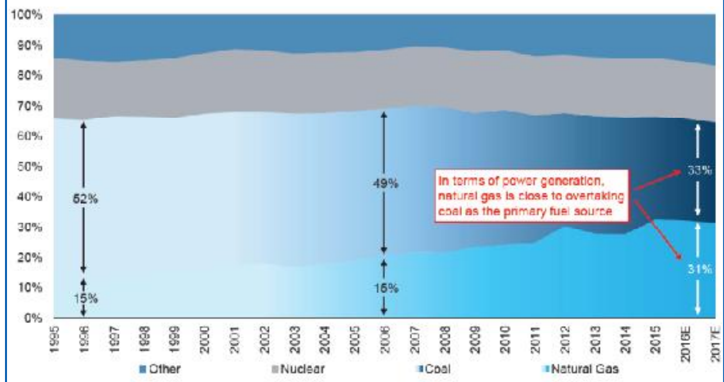
Industry review & emerging themes

Exhibit 1 – Cartload impacted economic dashboard

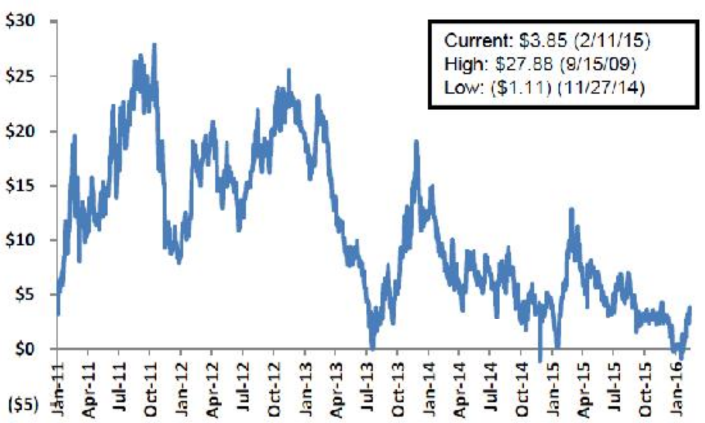
F1: Quarterly GDP growth[1]



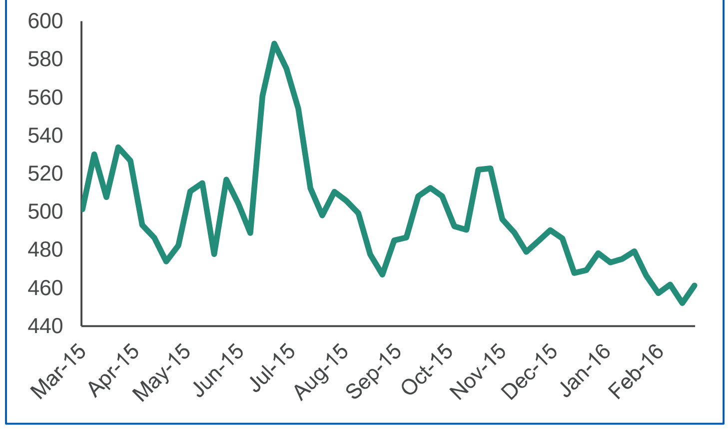
F2: US power generation by fuel source[2]



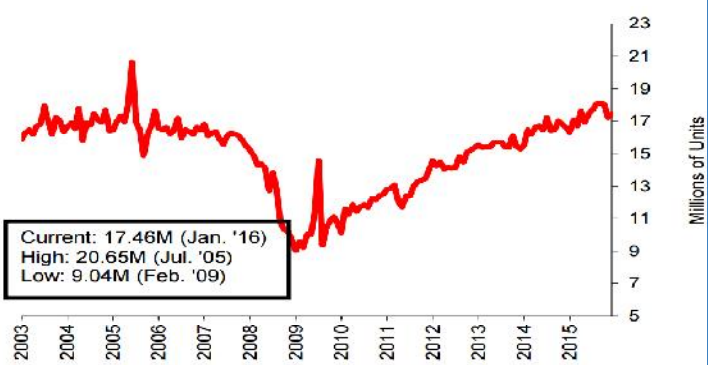
F3: Brent / WTI spread[3]



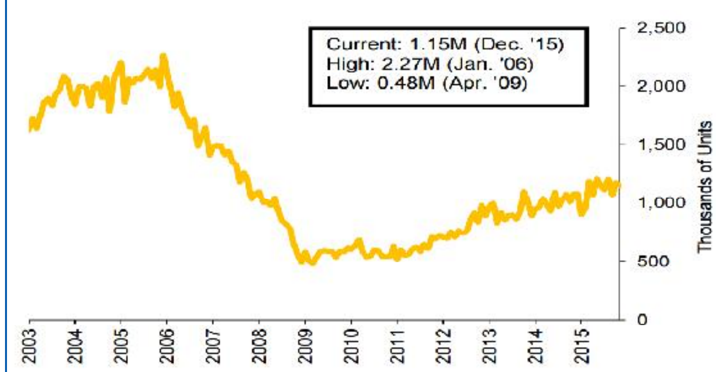
F4: US wheat prices (US$)[3]



F5: US auto sales total SAAR[5]



F6: US new single unit housing starts total SAAR[6]



1 Source: Bloomberg, U.S. Department of Commerce
2 Source: EIA, Barclays Research
3 Source: Bloomberg
4 Source: Bloomberg
5 Source: Bloomberg
6 Source: Bloomberg, U.S. Census Bureau

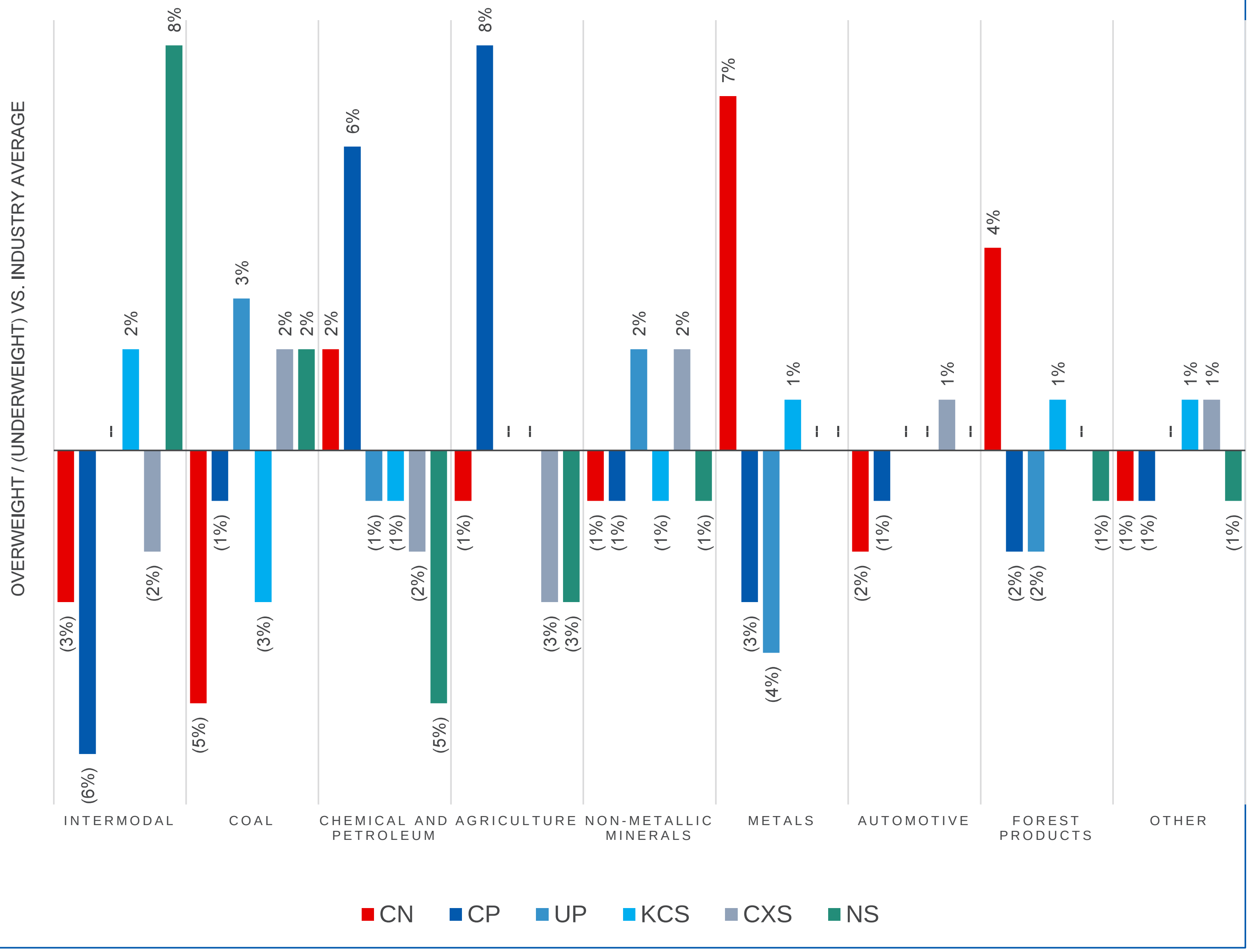
Industry review & emerging themes

Volume mix management

Diversified end-markets and their impact the rail transportation puts management decision making of volume mix at the forefront of industry positioning (Exhibit 2).

Exhibit 2

Company-specific volume mix vs. industry volume mix per carload category[1]



CN has a heavy positioning in metals and forest products at the expense of intermodal, coal. However the company can justify their positioning away from certain strong business lines when evaluating their operating ratio, which distinguishes them as the best of bread operator (Exhibit 3 & 4). Their operations are driven by strict cost controls and prompt resource alignment (more focused on intermodal than their Canadian counterpart).

1 Source: Company fillings

Industry review & emerging themes

Exhibit 3

2015 industry operating ratio[1,2]

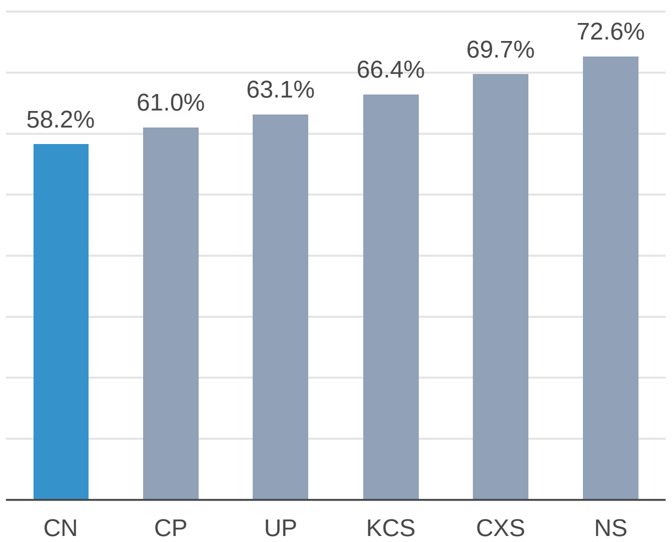
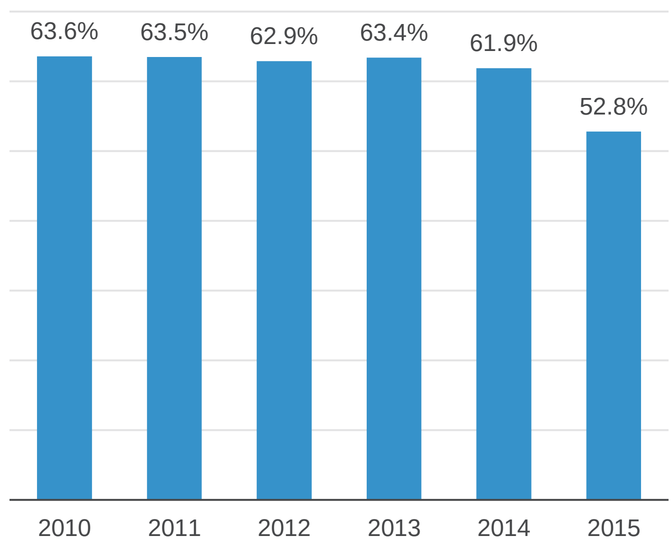


Exhibit 4

CN historic operating ratio[1,2]



Counter implication of volume declines: decreased congestion

Despite the downside of declined volumes, upside remains at an efficiency level on rail tracks as networks become less congested. Companies are utilizing this to increase train prices by providing faster train speed, simplified network fluidity, and improved service. This decrease in usage also results in a decreased depletion on rail networks, which ultimately alleviates rail infrastructure capex deployment.

Capital allocation planning

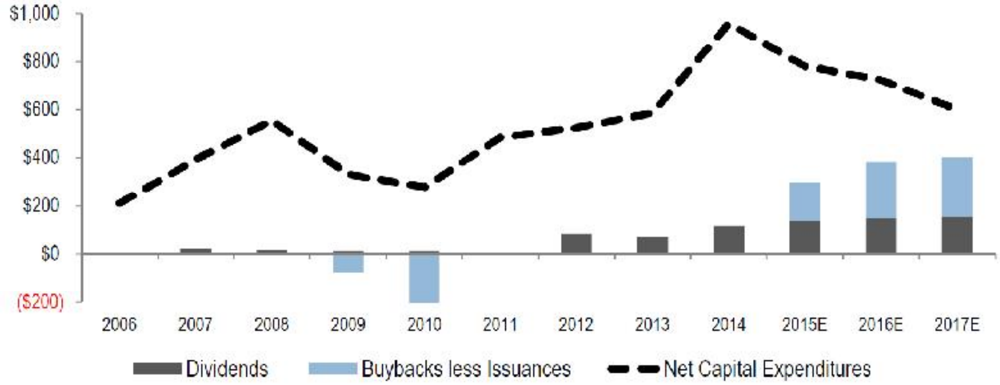
A major theme in declining volume environment is the capital allocation plan employed by each company. Investors will prioritize direct capital returns and leading capex management to ensure a sustainable flow of future free cash flows (Exhibit 5).

CN remains a industry vanguard in direct capital returns having consistent dividend growth and buybacks in the last 5 years, despite the demand backdrop. On capex management, the majority of RailCos are engaging in cutting capex, while CN is leveraging their best-of-breed operating model to deploy C$2.9bn (7% higher y-o-y) in capex in 2016. The rationale is to capitalize on low infrastructure costs this year (industry-wide cost cutting is decrease rail infrastructure demand) and impede fewer train schedules (there is lower traffic from decreased volumes this year, implying a lower opportunity cost during the instalment period).

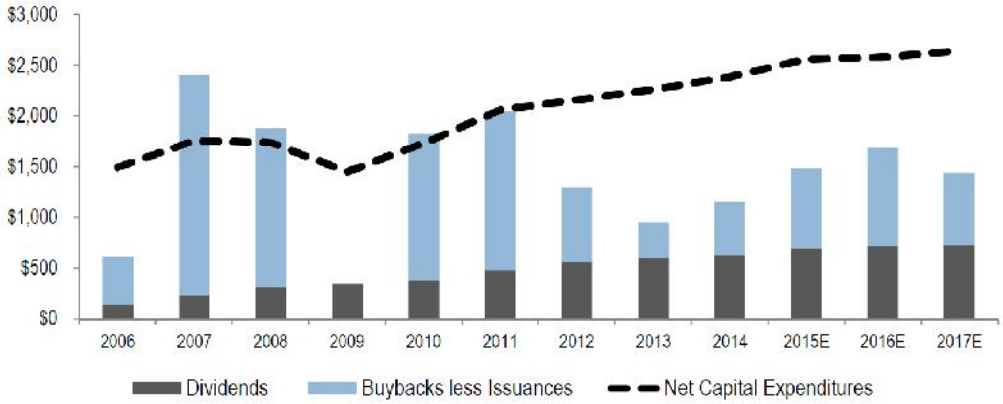
1 Operating Ratio = Expenses / Revenues
2 Source: Company Fillings

Exhibit 5 – Capex and return of shareholder capital[1]

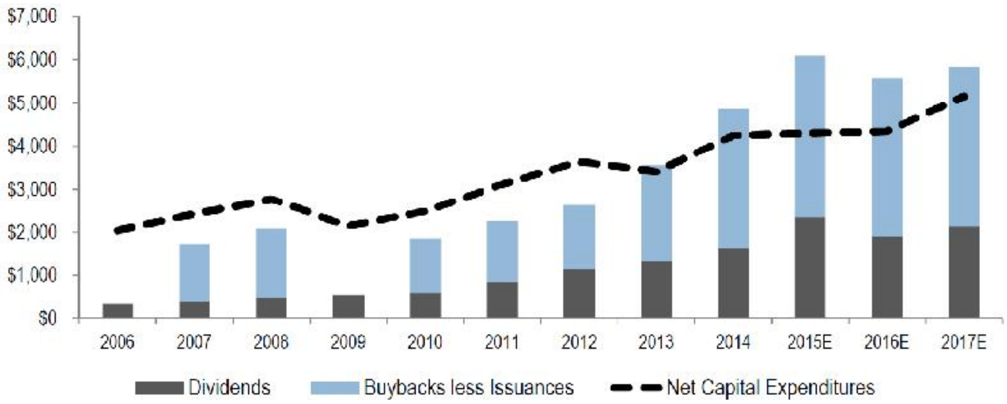
KCS
KCS's capex is the highest of its peer group at over 30% of revenues



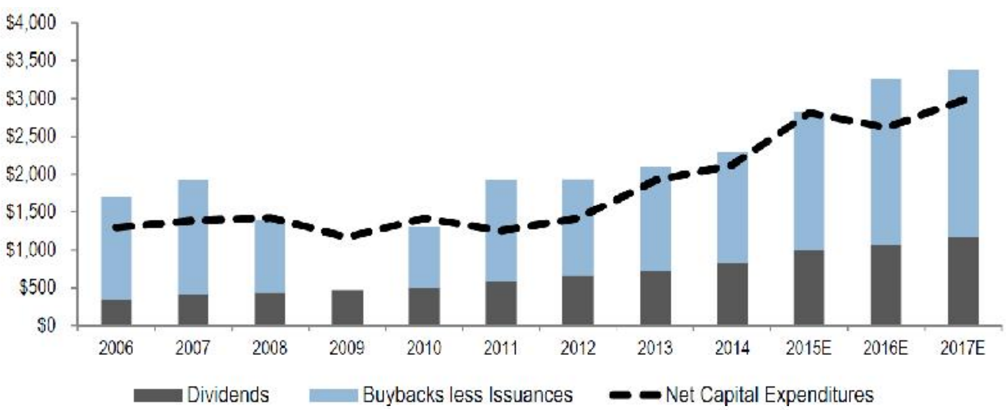
CXS
CSX's capex could moderate in absolute terms if gross ton miles fall in 2016



UP
UP's capex is not expected to moderate through 2017



CN
CN's capex has the potential to moderate along with gross ton miles



1 Source: Company fillings and consensus estimates

Industry review & emerging themes

Case study: Consolidation in the North American rail space?

Context

- Canadian Pacific Railway proposing a merger with Florida-based CSX and acquiring Virginia-based Norfolk Southern. Thus, creating the largest railway company in North America.

Timeline

- Extensive regulatory process due to legislation in the industry. Proposed merger would begin an extensive process that would last anywhere between 18 to 24 months if NFS' shareholders accept CP's deal

Limitations to execution

- Regulations in both Canada and the U.S. where the Surface Transportation Board has put an unofficial freeze on all mergers of Class I railways since 1999 when CN tried to buy BNSF.
- Intense regulatory scrutiny and may not get approval from the U.S. Surface Transportation Board, which requires that rail mergers enhance competition as opposed to merely preserving it.
- Norfolk Southern is yet to show approval of proposed deal. Strong propensity for NFS management to decline the merger as they are new and would lose their jobs in the event of a merger.
- Accepting the merger would mean that NFS would never be able to complete another merger to form a true transcontinental railway

1 Source: Company fillings

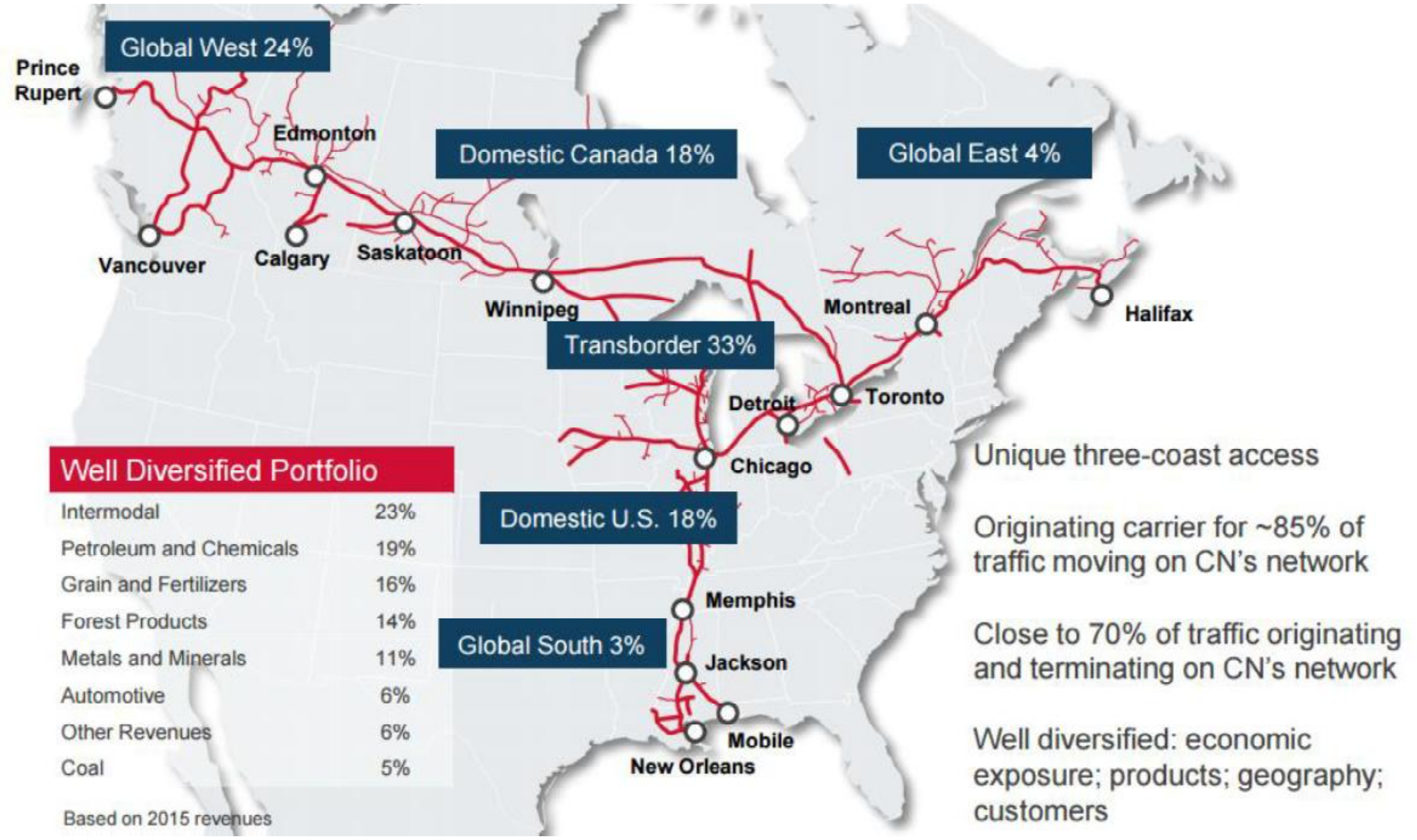
Business model and strategic direction

Canadian National Railway is building for the future

Viewing itself as a true backbone of the economy, CN has maintained its position as Canada's largest transportation company and North Americas only transcontinental railway. Through expansion and acquisitions, CN operates 32,000 Km of track. The company's underlying goals are focused on building for the future, while creating value for its customers and shareholders. Benefiting from a well balanced and diversified portfolio, Canadian National Railways derives its revenue from seven commoditized groups (Exhibit 6).

Exhibit 6

CN revenue and regional diversification[1]



With sound and well diversified revenue streams in place and by balancing operational and service excellence, CN has a stated an objective to grow faster than the overall economy at a low incremental cost.

1 Source: Company fillings

Business model and strategic direction

CN has been able to meet its objective in the recent years due to its business model, which is based on continuous service improvement, a supply chain approach that allows the company to grow for its customers and embracing a culture that encourages nimbleness and the ability to capitalize on opportunities.

Service improvement

Railroaders

CN considers its employees the most important success factor. Investing in its employees has lead ta a seismic shift in its employee base, where it hired 14,000 new employees in a period of 4 years. In the 2014 alone, CN invested approximately $55 million in building training centres in both Canada and the United States. These centres provide employees with hands-on trainings and support. We believe that these training centres will strategically contribute to the effectiveness of the “peoples” body of CN, which will allow it to meet its expectations in building for the future. Having a well trained and equipped personnel who undergoes internal training rather than outsourcing, will grow CN’s potential while simultaneously minimize costs.

Customer first

Name given to a portfolio of initiatives that addresses customer’s pinch points. CN is yet to fully leverage its latest first mile/last mile initiative (iAdvise), which facilitates customer communications.
CN believes timely, accurate information is key to building customers confidence and firmly believe iAdvise has the potential to build their trust and elevate CN ahead of the competition. In a time where customers are demanding up-to-date information and tracking options, we believe that iAdvise does give CN a strategic position in meeting market demands.

Safety

CN believes that the key to outstanding railroading is safety. From this belief, CN has invested significantly in training, coaching, recognition and employee involvement initiatives. Incorporating this aspect into their culture pushed CN a step further into their goal of becoming North Americas safest railroad. We believe that an increase in safety standards does not only impact CN’s employees, but also creates value for their customers.

Supply chain approach

CN’s numerous Supply Chain Collaboration Agreements with ports, terminal operators and customers leverage key performance metrics that drive efficiencies across the entire supply chain.

Business model and strategic direction

CN's franchise allows it to leverage direct access to six port facilities, 17 automotive distribution facilities, 21 forest products trans load centres, 21 bulk distribution terminals, 16 metals and minerals distribution centres, and 21 intermodal terminals across Canada and the U.S.

Information technology

CN has proved itself when it comes to fuel-efficiency compared to its peer in the industry, consuming close to 15 per cent less fuel per GTM than the industry average.

Along with this social responsibility, CN has incorporated technological advancements and systems to further enhance its fuel-efficiency while minimizing its costs. Some of which are:

- Horsepower Tonnage Analyzer
  - An initiative that matches horsepower to tonnage, CN was able to conserve its fuel consumption without hindering its schedule
- Wi-Tronix
  - A locomotive telemetry system, that standardizes and transmits locomotive event recorder in real time to the CN data centre from anywhere in North America
  - This system contributed to not only fuel conservation, but to safety monitoring and incident investigations as well.

The technological enhancement that CN underwent recently will continue to have its impact in the future as the company expands its utilization and incorporates the recent expenditures towards its goal.

Primary revenue streams

Intermodal

Intermodal transportation accounts for most of CN's revenue (~23% last year). Intermodal growth has been fuelled by CN's increasing share of trade with Asia. We believe that Canadian exports will increase as a result of the depreciating loonie, this in turn will increase the company's share in transportation, especially in the intermodal sector.

Petroleum and chemical

A significant portion of CN's revenue (~19%) are derived from chemicals / plastics, refined petroleum products, natural gas liquids, crude oil and sulfur. Revenues in this group have expanded (mostly as a result of FX), but the decrease in crude oil and a lower applicable fuel surcharge rate are a risk in the near term as oil prices remain depressed.

Business model and strategic direction

Grain and fertilizers

Grain and Fertilizers comprise ~16% of the company's revenue. CN works closely with partner ocean carriers to provide "match-back" of their containers. Match-backs occur when import marine containers, are reloaded with export products such as grain or specialty crops. Match-backs enable ocean carriers to cover the cost of shipping otherwise-empty containers back to their home port, thus improving round-trip economics.

Forest products

As it is strategically positioned to serve the mid-west and southern U.S. forest products end markets, CN has added 1275 new railcars between 2014 and 2015, in preparation to take advantage of the improving U.S. housing market. This provided CN with the capacity to ship increasing volumes of lumber, panels and other housing-related products.

Pairing up the improving housing market in the U.S. with the increased capital expenditure of CN, it will be able to meet the demands of transportation within its share, allowing it to swiftly seize the opportunity.

Business model and strategic direction

Management overview

Claude Mongeau – President and CEO (at CN since 1994)

Mr. Mongeau holds an MBA from McGill, and an undergraduate degree is psychology from UQAM. At CN, he held the positions of Executive Vice-President, CFO, VP Strategic and Financial Planning, and AVP Corporate Development. Prior to Joining CN, he was a partner with Groupe Secor, a management consulting firm providing strategic advice to large Canadian corporations. He also worked in the business development unit of Imasco, a diversified holding company. His career started in Europe with Bain & Company, a leading American consulting firm. He is also a member SNC-Lavalin Group Inc., RAC, and CCCE.

Luc Jobin – Executive Vice-President, CFO (at CN since 2009)

Mr. Jobin earned his Diploma in Public Accountancy from McGill University in 1982. He obtained his Chartered Accountant Accreditation from the Canadian Institute of Chartered Accountants in 1983. Prior to his appointment at CN, Luc Jobin was an Executive Vice-President of Power Corporation of Canada (PCC), an international management and holding company, where he was responsible for PCC's portfolio of diversified investments. Mr. Jobin was President and CEO of Imperial Tobacco when he joined PCC in 2005.

Jim Vena – Executive Vice-President, COO (at CN since 1977)

Mr. Vena is a graduate of the University of Alberta and Athabasca University. He joined CN in 1977, and had held the positions of Senior Vice-President of CN's Southern Region, Senior Vice-President of CN's Western Region, Senior Vice-President of CN's Eastern Region, Operations in CN's Eastern Region, Vice-President of CN's Champlain district.

Russell J. Hiscock – President, CEO of CNID (investments) (at CN since 1987)

Mr. Hiscock holds a Bachelor of Mathematics degree from University of Waterloo, a Master of Arts degree in Economics from University of Western Ontario and an MBA from University of Toronto. He is a Certified Chartered Financial Analyst and a Certified Management Accountant. Mr. Hiscock joined CN Investment Division in 1987 as a Manager in Investments. He is the past Chairman of the Pension Investment Association of Canada (PIAC) and served as a Director of Freehold Resources. Mr. Hiscock still serves as a Director of Rife Resources.

Thesis development and catalysts

Strong industry fundamentals and diversified operations

The North American Class I rail industry is unique for several key specific reasons and allow for CN to grow its annual free cash flow, creating a compounding effect on shareholders returns for years to come.

The industry's natural high barriers to entry result in limited and rational competition. This permits CN's management team to make long-term capital decisions without having to consider an industry disruptor. Given expectation of continued solid freight volumes in years ahead, CN is investing significantly to build for the future, increasing network capacity, resilience and fluidity across its network, including its Edmonton-Winnipeg and Winnipeg-Chicago corridors.

CN's freight revenues are derived from seven commodity groups representing a diversified and balanced portfolio of goods transported between a wide range of origins and destinations. This product and geographic diversity better positions CN to face economic fluctuations and enhances its potential for growth opportunities. In 2014, no individual commodity group accounted for more than 23% of total revenues. From a geographical standpoint, 17% of revenues relate to United States (U.S.) domestic traffic, 33% cross border traffic, 19% Canadian domestic traffic and 31% overseas traffic. CN is the originating carrier for approximately 85% of traffic moving along its network, which allows it both to capitalize on service advantages and build on opportunities to efficiently use assets.

CN continues to reinforce its role as a true backbone of the economy and a key player in fostering the prosperity of the North American markets it serves. The company has long been a dispensable transportation supplier for many key sectors in North America. With some of the best transit times in the industry, and serving ports on both Canadian coasts that are closest to key Asian and European destination, CN helps its customers win in the markets where they compete.

Outlook for 2016

Given our expectation that volumes will remain under pressure in Q1/16, CNR is our preferred name given its 1) network advantage that generates a diversified revenue stream with relatively limited Coal exposure; 2) operational prowess that has generated best-in-class operating and track level metrics; and 3) service excellence model that is resonating with customers to retain market share during a period of volume weakness.

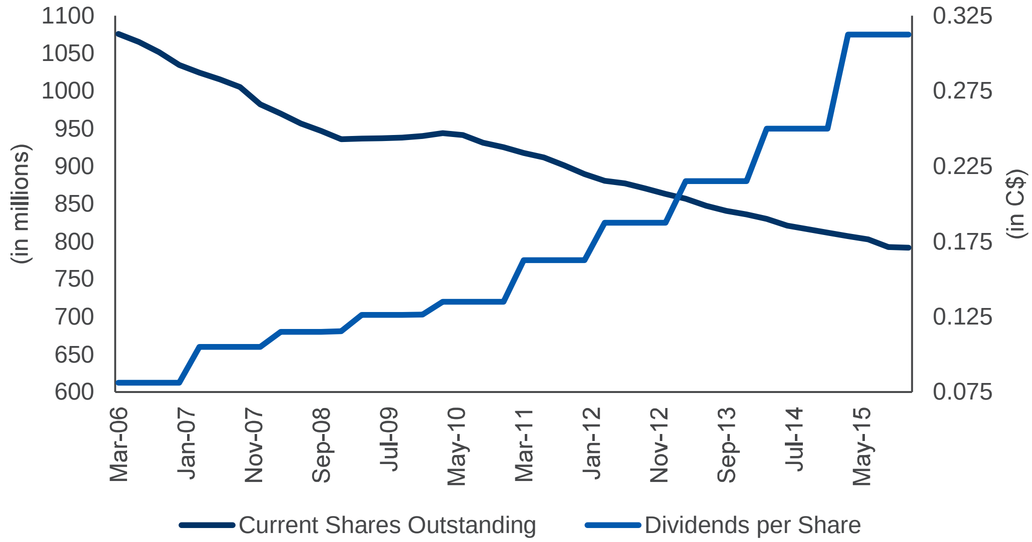
Thesis development and catalysts

Capital allocation

The combination of the buyback and dividend increases have resulted in an investment in CN growing at a CAGR of 13% over the last 10 years compared to the CAGR of 0.87% for the S&P/TSX Index (Exhibit 7). The aforementioned barriers to entry will allow for this trend to continue as the protected market allows CN to increase prices and margins due to efficiency without having to worry about cutting prices to remain competitive.

Exhibit 7

Buybacks and dividend growth[1]



CN's management team has demonstrated exceptional capital allocation based on their ROIC, EVA spread, and ROE (Exhibit 8). This exemplary and consistent track record is reason to believe the executives will continue to allocate capital in the best interest of shareholders.

Exhibit 8

Historic return on capital and economic value add spread[1]

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Return on invested capital	*9.5%*	*8.3%*	*7.3%*	*6.0%*	*8.5%*	*9.3%*	*10.1%*	*8.9%*	*10.4%*	*10.0%*
EVA Spread	***2.2%***	***0.0%***	***(0.5%)***	***1.1%***	***(2.7%)***	***(0.7%)***	***2.4%***	***3.5%***	***4.1%***	***1.8%***
Return on average equity	*19.3%*	*17.5%*	*17.3%*	*13.7%*	*17.0%*	*19.4%*	*22.1%*	*22.0%*	*23.1%*	*25.1%*

1 Source: Company fillings, KWPMP analysis

Thesis development and catalysts

Invested capital has resulted in CN having the strongest EBITDA margins and operational efficiency in its peer group, warranting in what we believe should be a premium multiple compared to its competition.

Although first impression may believe that low cash reserves compared to total debt may pose as an operational risk; however, CN's coverage ratio is ~15x and net debt to LTM EBITDA has consistently been in the 1.45x to 1.55x range even throughout the financial crisis of 2008-2010, demonstrating the management teams aptitude at allocating capital.

Operational and service excellence

For many years, CN has operated with a mindset that drives efficiency. The Company maintains that philosophy today and works hard to run more efficient trains, reduce dwell times at terminals and improve overall network velocity. With CN's business model, fewer railcars and locomotives are needed to ship the same amount of freight in a tight, reliable and efficient operation. The railroad is run based on a disciplined operating methodology, executing with a sense of urgency, passion and accountability. Employees across the network embrace this culture.

Operational excellence requires measurement of all aspects of CN's operations. At CN, everything is scheduled, measured, executed, reviewed and repeated. The Company is constantly fixing noise or pinch points and repeating it all over again. Constant improvement is a part of how CN does business. The Company never accepts the status quo and believes in continuing to strive for operational excellence by raising the bar at every opportunity.

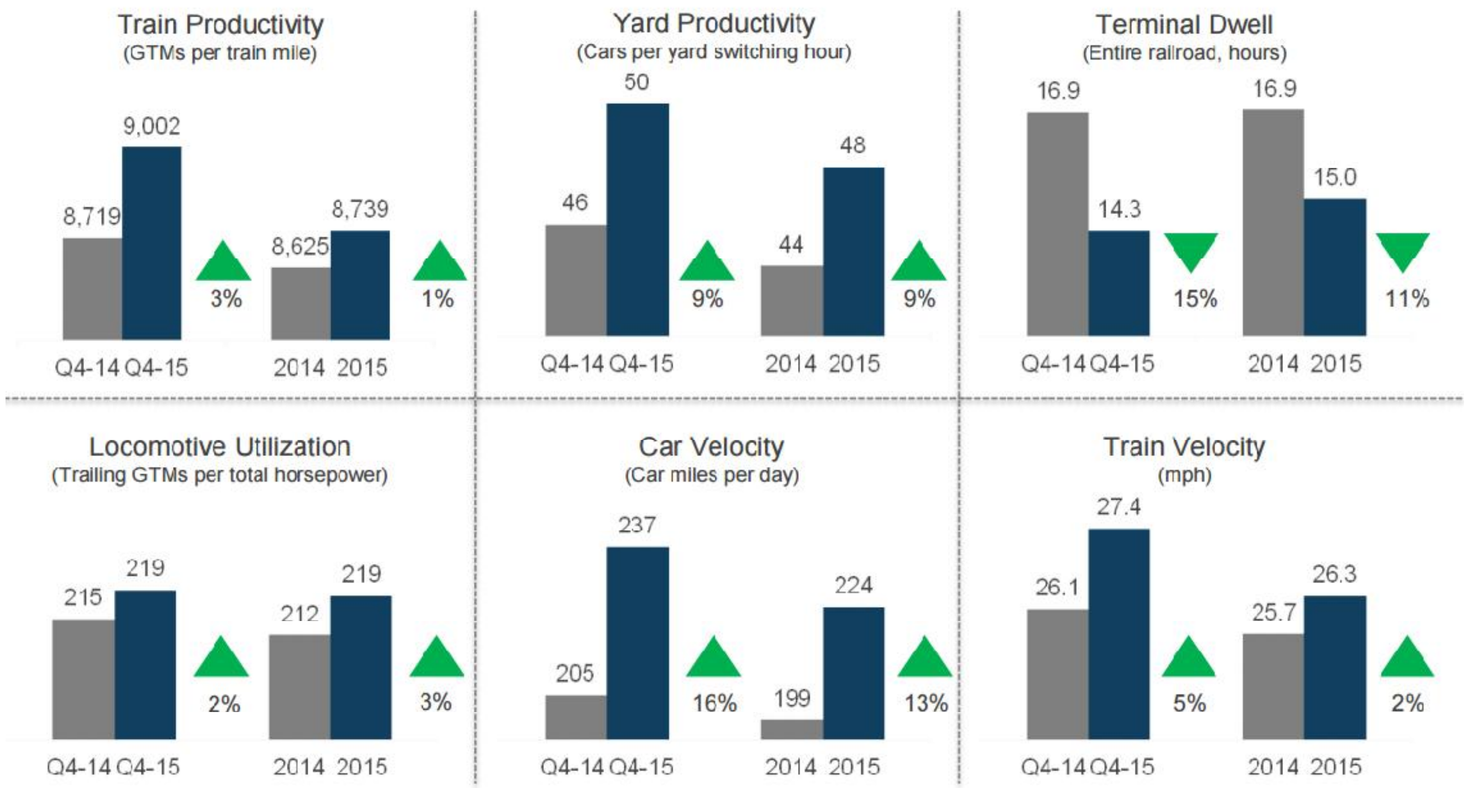
At the same time, CN's broad-based service innovations benefit customers and support the Company's goal to grow the business faster than the overall economy, which can translate into growing car loadings, revenues and earnings. CN understands the importance of being the best operator in the business, and being the best service innovator as well. Service excellence means expanding CN's perspective, working more closely with customers and involving all relevant areas of the Company in the process. CN has broadened its commitment to service excellence through a wide range of continuous-improvement innovations. For example, in bulk markets, the successful CN Scheduled Grain Plan Service has resulted in much improved car-spotting reliability and shows how the Company is driving fundamental innovation in the industry. The Company has also set its sights on becoming a true supply-chain enabler by helping to elevate service performance end to end. CN is pursuing better end-to-end service and greater operating efficiencies while helping customers find their place in global markets. In manufacturing markets, be it in forest products or metals, the

Thesis development and catalysts

Company is focused on better car order fulfillment to gain market share one carload at a time. In Intermodal, CN is taking advantage of supply-chain agreements to open up new gateway markets, building on mutual trust and on the continuous improvements in key performance metrics (Exhibit 9).

Exhibit 9

Best in class performance[1]



In an environment where customer demand for productivity and service will continue to increase over time, CN is well-positioned to services customer needs and allow it to maintain its reputation as top operator in North America, benefitting shareholders for years to come.

1 Source: Company fillings

Financial assessment and valuation overview

Target price

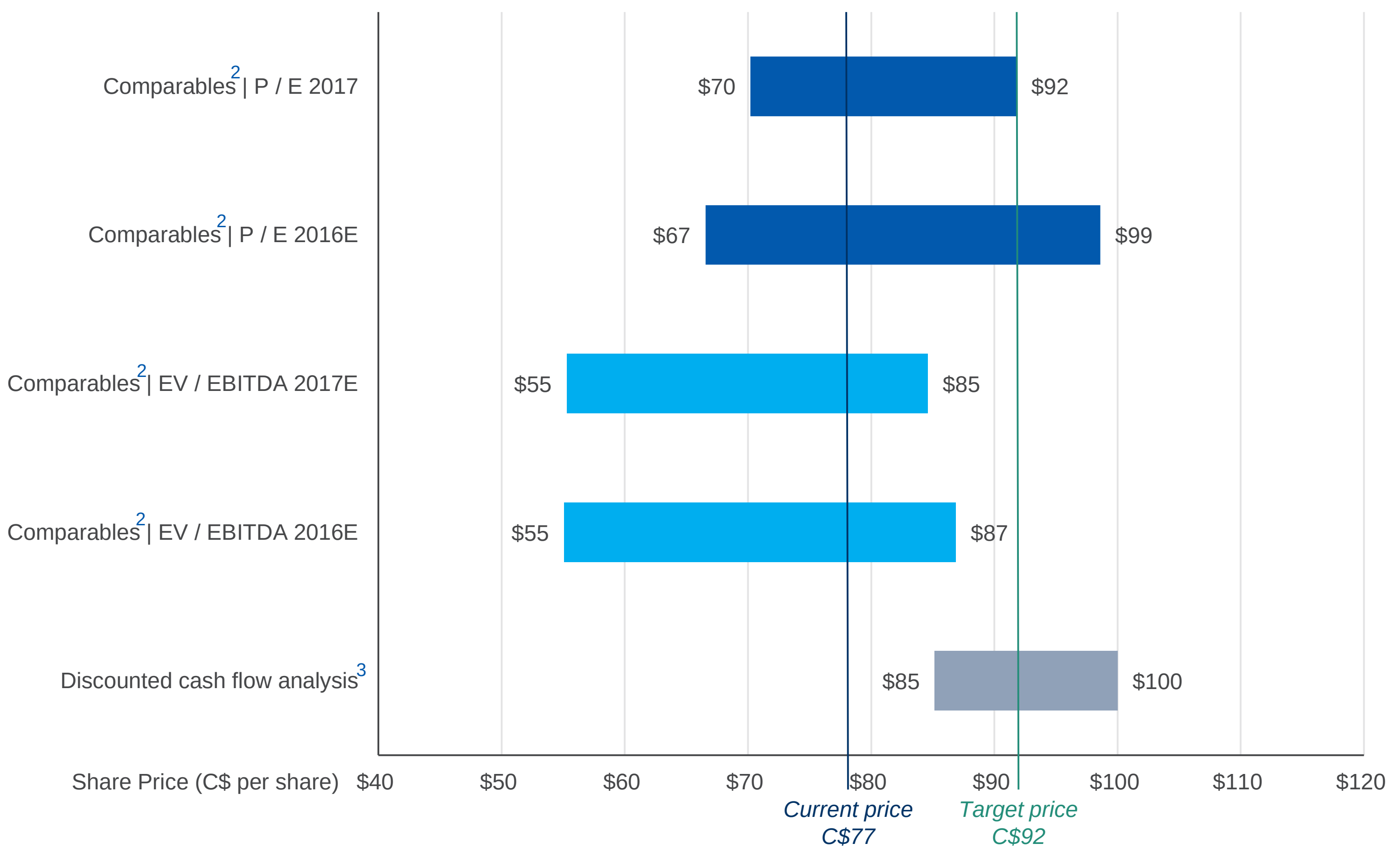
We are initiating a buy on CN with a price target of C$92 (16.2x P / 2017F EPS), representing a 19.5% return to its current price of C$77.

Valuation rationale

CN's superior EBITDA margins, stronger balance sheet compared to the North American industry average, as well as being the only Class I rail with positive projected 2016 EBITDA growth, provides them with adequate backing to merit a superior multiple versus its comparable peer group[2]. This view is supported by the firms consistent free cash flow growth driven by its best-of-breed business model which result in a discounted cash flow analysis target price range of C$85 to C$100 (Exhibit 10). In addition the company provides superior direct capital returns to its investors (strongest dividend growth and share buyback amongst comparable peer group[2]).

Exhibit 10

Illustrative valuation overview[1]



1 Source: Company Fillings, Bloomberg, KWPMP analysis
2 Comparable peer group includes Kansas City Southern. Canadian Pacific, Norfolk Southern, Union Pacific, and CSX
3 Assumes weighted average cost of capital of 8.5% and terminal growth rate from 2020F+ of 2.5%

Financial assessment and valuation overview

Operating model assumptions

Conservative revenue growth was used for 2016 estimates due to a foreseeable decline in grain and fertilizer transportation. Due to the nature of the business, the long term growth rate is moving towards a combination of GDP growth and annual price increases. As a result of increasing operational efficiency, we are confident that Canadian National Rail's operating margin remain flattish at ~41% for the next 5 years. A potential positive catalyst for operating expenses in 2016 will be the lag between an adjustment in fuel surcharges and the realized pricing of fuel for CN as fuel costs have ranged from 17%-25% in recent years and the downturn in oil pricing could result in a positive benefit (Exhibit 11).

Exhibit 11

Profit model[1]

Revenues	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015A	2016F	2017F	2018F	2019F	2020F
Petroleum and chemicals	1,346	1,260	1,322	1,420	1,640	1,952	2,354	2,428	2,504	2,643	2,777	2,918	3,065
Metals and minerals	950	728	861	1,006	1,133	1,240	1,484	1,486	1,549	1,635	1,718	1,805	1,896
Forest products	1,436	1,147	1,183	1,270	1,331	1,424	1,523	1,715	1,808	1,908	2,005	2,106	2,213
Coal	478	464	600	618	712	713	740	629	662	698	734	771	810
Grain and fertilizers	1,382	1,341	1,418	1,523	1,590	1,638	1,986	2,040	1,974	2,084	2,189	2,300	2,417
Intermodal	1,580	1,337	1,576	1,790	1,994	2,429	2,748	2,905	3,113	3,286	3,453	3,627	3,811
Automotive	469	355	457	484	538	555	620	710	738	779	819	860	903
Freight Revenue	**7,641**	**6,632**	**7,417**	**8,111**	**8,938**	**9,951**	**11,455**	**11,914**	**12,347**	**13,034**	**13,694**	**14,387**	**15,116**
Growth (%)	*6.3%*	*(13.2%)*	*11.8%*	*9.4%*	*10.2%*	*11.3%*	*15.1%*	*4.0%*	*3.6%*	*5.6%*	*5.1%*	*5.1%*	*5.1%*
Fuel Surcharge	-	-	-			-	-	(98)	(38)	35	156	156	156
Other items	841	735	880	917	982	624	679	732	690	711	732	754	777
Total Revenue	**8,482**	**7,367**	**8,297**	**9,028**	**9,920**	**10,575**	**12,134**	**12,902**	**14,555**	**15,095**	**15,897**	**16,612**	**17,363**
Growth (%)	*7.4%*	*(13.1%)*	*12.6%*	*8.8%*	*9.9%*	*6.6%*	*14.7%*	*6.3%*	*12.8%*	*3.7%*	*5.3%*	*4.5%*	*4.5%*

Operating expenses	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015A	2016F	2017F	2018F	2019F	2020F
Labor and fringe benefits	1,674	1,696	1,744	1,812	1,952	2,182	2,319	2,408	2,483	2,625	2,756	2,896	3,042
Purchased Services, Materials	1,137	1,027	1,036	1,120	1,248	1,351	1,598	1,711	1,835	1,807	1,912	2,052	2,201
Fuel	1,403	769	1,018	1,412	1,524	1,619	1,846	1,311	1,387	1,497	1,661	1,695	1,729
Depreciation & Amortization	725	790	834	884	924	980	1,050	1,175	1,275	1,339	1,406	1,476	1,550
Equipment rents	262	284	243	228	249	275	329	360	373	395	418	439	460
Casualty and other	387	349	398	276	338	295	368	414	372	383	395	406	419
Currency adjustment						-	-	222	973	822	822	822	822
Operating Expenses	**5,588**	**4,915**	**5,273**	**5,732**	**6,235**	**6,702**	**7,510**	**7,600**	**8,698**	**8,868**	**9,371**	**9,786**	**10,222**
Growth (%)	*11.3%*	*(12.0%)*	*7.3%*	*8.7%*	*8.8%*	*7.5%*	*12.1%*	*1.2%*	*14.4%*	*2.0%*	*5.7%*	*4.4%*	*4.5%*
Operating income	**2,894**	**2,452**	**3,024**	**3,296**	**3,685**	**3,873**	**4,624**	**5,302**	**5,857**	**6,227**	**6,526**	**6,826**	**7,141**
Growth (%)	*0.6%*	*(15.3%)*	*23.3%*	*9.0%*	*11.8%*	*5.1%*	*19.4%*	*14.7%*	*10.5%*	*6.3%*	*4.8%*	*4.6%*	*4.6%*
Incremental Margin	*3.1%*	*nm*	*61.5%*	*37.2%*	*43.6%*	*28.7%*	*48.2%*	*88.3%*	*33.6%*	*68.4%*	*37.3%*	*41.9%*	*42.0%*

1 Source: Company fillings, KWPMP analysis

Financial assessment and valuation overview

Comparable peer group analysis

CN's peer group is comprised of North America's Class I rails, with exception to BNSF (owned by BRK) and represents a sector with closed competition due to the industry's unique barriers to entry. Each rail services a different network or regions; however, only two of the rails are true transcontinental rails, Union Pacific and CN. EBITDA margins and operating ratios are two of the most important metrics in the industry, whereas liquidity ratios are important to track, especially in a depressed economic environment (Exhibit 12).

Exhibit 12

Peer group comparable analysis – valuation[1]

		EV/EBITDA			P/E		
Company Name	Ticker	2015	2016E	2017E	2015	2016E	2017E
Kansas City Southern	KSU	10.7x	9.8x	9.1x	19.2x	16.7x	16.2x
Canadian Pacific	CP.TO	9.8x	9.3x	8.7x	16.8x	13.1x	12.9x
Nortfolk Southern	NSC	7.9x	7.4x	6.9x	15.0x	12.8x	12.3x
Union Pacfic Corp	UNP	8.3x	7.7x	7.4x	15.0x	13.5x	13.0x
CSX Corp	CSX	7.3x	6.9x	6.6x	13.0x	12.5x	11.6x
Maximum		10.7x	9.8x	9.1x	19.2x	16.7x	16.2x
75th Percentile		9.8x	9.3x	8.7x	16.8x	13.5x	13.0x
Median		8.3x	7.7x	7.4x	15.0x	13.1x	12.9x
25th Percentile		7.9x	7.4x	6.9x	15.0x	12.8x	12.3x
Minimum		7.3x	6.9x	6.6x	13.0x	12.5x	11.6x
Canadian National Railway C	**CNR.TO**	**10.7x**	**10.1x**	**9.3x**	**17.9x**	**15.4x**	**13.9x**

Peer group comparable analysis – operational[1]

		EBITDA	Debt /		Operating Ratio		
Company Name	Ticker	Margin	EBITDA	ROE	2015	2016E	2017E
Kansas City Southern	KSU	45.0%	2.1x	14.9%	66.4%	64.3%	63.6%
Canadian Pacific	CP.TO	48.9%	2.5x	32.1%	61.0%	58.7%	57.7%
Nortfolk Southern	NSC	37.5%	2.3x	13.0%	71.7%	70.7%	70.2%
Union Pacfic Corp	UNP	46.1%	1.3x	22.8%	63.1%	63.2%	63.5%
CSX Corp	CSX	40.6%	1.9x	14.9%	69.2%	70.4%	69.9%
Maximum		48.9%	2.5x	32.1%	71.7%	70.7%	70.2%
75th Percentile		46.1%	2.3x	22.8%	69.2%	70.4%	69.9%
Median		45.0%	2.1x	14.9%	66.4%	64.3%	63.6%
25th Percentile		40.6%	1.9x	14.9%	63.1%	63.2%	63.5%
Minimum		37.5%	1.3x	13.0%	61.0%	58.7%	57.7%
Canadian National Railway C	**CNR.TO**	**50.9%**	**1.6x**	**24.5%**	**58.2%**	**57.4%**	**56.6%**

1 Source: Company fillings, KWPMP analysis

Financial assessment and valuation overview

Discounted cash flow analysis

Due to the stability of cash flows as a result of consistent demand in the industry, growth straightforward to project and margins are dependent on operating efficiency. As a result, access to capital markets is easy and are demonstrated in the weighted average cost of capital in the industry. CN's management has confirmed that annual capital expenditures will remain at 18%-20% of revenue, whereas depreciation & amortization is dependent on current PP&E levels. The exit multiple of 11.0x EBITDA was selected as the value of CN's assets will continue to increase over time due to limited supply of rails across North America (Exhibit 13).

Exhibit 13

Discounted cash flow analysis[1]

	2013A	2014A	2015A	2016F	2017F	2018F	2019F	2020F
EBITDA	4,853	5,674	6,477	7,133	7,668	8,243	8,737	9,261
Operating income	3,873	4,624	5,302	5,857	6,227	6,526	6,826	7,141
Taxes (28%)	1,123	1,341	1,485	1,640	1,744	1,827	1,911	1,999
EBIAT	2,750	3,283	3,817	4,217	4,484	4,699	4,914	5,142
(+) D&A	980	1,050	1,175	1,275	1,440	1,716	1,912	2,120
(-) Capex	1,973	2,297	2,322	2,620	2,717	2,861	2,990	3,125
UFCF	1,757	2,036	2,670	2,873	3,207	3,554	3,836	4,137

Sum of PV UFCF's	**13,673**
WACC	*8.50%*
Perpetual growth	*2.50%*
Terminal value (Perp. growth)	68,943
Enterprise value	82,616
(-) Net debt	(10,274)
Equity value	72,342
(/) FD shares outstanding	785
Implied share price (C$)	**$92.16**

Sum of PV UFCF's	**13,673**
WACC	*8.50%*
Exit multiple	*11.0x*
Terminal value (Exit multiple)	67,752
Enterprise value	81,425
(-) Net debt	(10,274)
Equity value	71,151
(/) FD shares outstanding	785
Implied share price (C$)	**$90.64**

1 Source: Company fillings, KWPMP analysis

Financial assessment and valuation overview

Direct capital returns

Operating in an industry with large barriers to entry paired with limited and rational competition has allowed CN to continuously grow free cash flow and this flexibility is permitting management to grow the dividend towards the long-term payout ratio of 35%. The next few years are projected to maintain CN's 3-year dividend growth rate of ~20%, with excess free cash flow used for share repurchases. Demonstrated in Exhibit 14, the combination of share repurchases and dividend increases has resulted in strong shareholder returns.

Exhibit 14

Peer group comparable analysis – valuation[1]

	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015A	2016F	2017F	2018F	2019F	2020F
Operating EPS (fd)	**1.85**	**1.62**	**2.10**	**2.41**	**2.81**	**3.05**	**3.76**	**4.43**	**4.93**	**5.40**	**5.76**	**6.21**	**6.70**
Growth	*9.1%*	*(12.6%)*	*29.6%*	*15.1%*	*16.2%*	*8.8%*	*23.1%*	*17.9%*	*11.3%*	*9.5%*	*6.6%*	*7.8%*	*7.8%*
Payout ratio (TTM)	25%	31%	26%	27%	27%	28%	27%	28%	32%	33%	34%	35%	36%
Common Dividends/Share	0.46	0.50	0.54	0.65	0.75	0.86	1.00	1.25	1.56	1.79	1.97	2.17	2.39
Growth	*9.5%*	*9.5%*	*7.2%*	*20.4%*	*15.4%*	*14.7%*	*16.3%*	*25.0%*	*24.8%*	*15.0%*	*10.0%*	*10.0%*	*10.0%*

1 Source: Company fillings, KWPMP analysis

Risk evaluation

The risks that can impact our valuation lie in:

- The Canadian dollar- US dollar exchange rate. As the year progressed the CAD has been strengthening. A persistent appreciation in the loonie can lead to a reduced cross-border freight activity which in return will impact the valuation negatively

- Significant re-regulation resulting from the ongoing review of the Canada Transportation Act. The Review aims to look forward 20-30 and identify specific priorities and actions that will have an impact on the country's long-term economic well-being. If there are decisions made regarding price regulations in the near-monopolistic Canadian rail environment, it could have a large impact on CN's operations

- Lower consumer confidence, resulting from the current status of the North American economy, potentially impacting volume in CN's key revenue drivers. If the softness persists, consumer demand and industrial production may experience significant weakness and negatively affect CN's business

- Consolidation within the Class I rails in North America (as a result of the proposed merger between Canadian Pacific Rail and Norfolk Southern), may lead to pricing pressure from CP

- Natural disaster impacting CN's assets and creating delays in transportation and possibly losing contracts as a result

Appendix

Appendix 1

Leverage ratios[1]

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015E
Net debt / Total capitalization	35.6%	34.3%	41.5%	35.2%	33.1%	37.7%	38.0%	37.1%	38.3%	40.5%
Net debt / LTM EBITDA	1.47x	1.49x	2.07x	1.88x	1.45x	1.55x	1.46x	1.57x	1.47x	1.55x
EBITDA / Interest	11.8x	10.6x	9.7x	7.9x	10.7x	12.3x	13.5x	13.6x	15.3x	14.9x
EBITDA margin	46.4%	45.0%	42.7%	44.0%	46.5%	46.3%	46.5%	45.9%	46.8%	50.2%
Revenue growth	9.5%	-0.4%	7.4%	-13.1%	12.6%	8.8%	9.9%	6.6%	14.7%	6.3%
Current ratio	0.6x	0.7x	0.9x	1.2x	0.8x	1.1x	0.8x	0.8x	0.9x	1.0x

Appendix 2

Cash flow metrics[1]

	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015A	2016F	2017F	2018F	2019F	2020F
Cash flow from operations	2,031	2,279	2,999	2,976	3,060	3,548	4,381	5,080	5,124	5,437	5,715	5,996	6,288
Cash flow from investing	(1,369)	(1,446)	(1,383)	(1,729)	(1,421)	(1,852)	(2,176)	(2,802)	(2,840)	(2,925)	(3,013)	(3,103)	(3,196)
Change in restricted cash & equiv	--	--	--	(499)	(22)	73	(15)	(60)	--	--	--	--	--
Free cash flow	**662**	**1,206**	**1,616**	**1,746**	**1,661**	**1,623**	**2,220**	**2,338**	**2,285**	**2,512**	**2,702**	**2,893**	**3,091**
Free cash flow per share	$0.69	$1.27	$1.72	$1.92	$1.90	$1.92	$2.70	$2.91	$2.93	$3.31	$3.66	$4.03	$4.43

Appendix 3

Operating metrics[1]

	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015A	2016F	2017F	2018F	2019F	2020F
Operating EPS (fd)	**1.85**	**1.62**	**2.10**	**2.41**	**2.81**	**3.05**	**3.76**	**4.43**	**4.93**	**5.40**	**5.76**	**6.21**	**6.70**
Growth	*9.1%*	*(12.6%)*	*29.6%*	*15.1%*	*16.2%*	*8.8%*	*23.1%*	*17.9%*	*11.3%*	*9.5%*	*6.6%*	*7.8%*	*7.8%*
Payout ratio (TTM)	25%	31%	26%	27%	27%	28%	27%	28%	32%	33%	34%	35%	36%
Common Dividends/Share	0.46	0.50	0.54	0.65	0.75	0.86	1.00	1.25	1.56	1.79	1.97	2.17	2.39
Growth	*9.5%*	*9.5%*	*7.2%*	*20.4%*	*15.4%*	*14.7%*	*16.3%*	*25.0%*	*24.8%*	*15.0%*	*10.0%*	*10.0%*	*10.0%*
EBITDA	**3,619**	**3,242**	**3,858**	**4,180**	**4,609**	**4,853**	**5,674**	**6,477**	**7,133**	**7,566**	**7,932**	**8,302**	**8,691**
Growth	*1.9%*	*(10.4%)*	*19.0%*	*8.3%*	*10.3%*	*5.3%*	*16.9%*	*14.1%*	*10.1%*	*6.1%*	*4.8%*	*4.7%*	*4.7%*

1 Source: Company fillings, KWPMP analysis