Pershing Square, Ackman and CP Rail: A Case of Successful "Activism"?

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Pershing Square, an activist hedge fund owned and managed by William Ackman, began hostile maneuvers against the board of CP Rail in September 2011 and ended its association with CP in August 2016, having netted a profit of $2.6 billion for his fund. This Canadian saga, in many ways, an archetype of what hedge fund activism is all about, illustrates the dynamics of these campaigns and the reasons why this particular intervention turned out to be a spectacular success… thus far.

Governance at CP Rail

In 2009, the Chairman of the board of CP Rail asserted that the company had put in place the best practices of corporate governance; that year, CP was awarded the Governance Gavel Award for Director Disclosure by the Canadian Coalition for Good Governance. Then, in 2011, CP ranked 4th out of some 250 Canadian companies in the Globe & Mail Corporate Governance Ranking[1]. Yet, this stellar corporate governance was no insurance policy against shareholder discontent.

Indeed, during the summer of 2011, a group of 20 portfolio managers were gathered in a New York City bistro to discuss opportunities in the transportation sector. During pre-diner cocktail, one of the investors spoke critically about the governance of CP. "He was exasperated that the company's board had not thrown out the chief executive, Fred Green."[2]

That investor admitted that the previous winter had been grueling for rail transportation, but blaming the weather to justify CP's poor results was, according to him, just another lame excuse made by Fred Green to avoid taking responsibility. His views were shared by many other portfolio managers who turned belligerent about CP's Board and wondered why no activist fund had yet spotted the opportunity offered by CP. A phone call was made to Paul Hilal, an associate at Pershing Square Capital

Management (Pershing Square), an activist hedge fund. That phone call triggered the most highly mediatized proxy contests in Canada. Thou shalt never (henceforth?) underestimate the power of discontented shareholders.

Ackman attacks

Pershing Square began purchasing shares of CP on September 23, 2011. They filed a 13D form on October 28th showing a stock holding of 12.2%; by December 12, 2011, their holding had reached 14.2% of CP voting shares, thus making PS the largest shareholder of the company.

A few weeks after Pershing Square disclosed its acquisition of CP shares, Ackman asked to meet the Chairman of the Board of CP, John Cleghorn. A meeting was scheduled on November 2, 2011 at the Montreal airport. Ackman reminisced: "Although I'd said we wanted to talk about a management change, he and Fred Green were there. After three of us made a presentation, Mr. Cleghorn said, 'I've spoken to the board and want to let you know we're 100 percent behind Fred.' I couldn't believe the board made its decision before hearing our case."[3]

On December 15, 2011, CP issued a press release announcing the appointment (effective immediately) of Tony L. Ingram and Edmond L. Harris as directors on CP's Board. "Both Tony and Ed have extensive and valuable railway experience. I am confident that Canadian Pacific will benefit from their operational expertise and sound business knowledge." said John Cleghorn.[4]

These appointments were a form of concession to Ackman.[5] Tony L. Ingram was the former COO of the CSX,[6] while Edmond L. Harris held the same position at the CP for 11 months before retiring. The latter was well respected by the financial analysts and by the industry in general; his (surprise) departure from the CP raised numerous questions at the time since he was closely associated with the potential successful execution of the multi-year plan[7] (CP's strategic plan). These appointments were well received by Ackman, who nonetheless judged them as being too little, too late, and the proxy contest was officially launched.

In the Chairman's letter to shareholders from the 2011 annual report (signed on March 5, 2012), John Cleghorn wrote that:

> […] Even through a challenging operating environment in 2011, CP has made great strides in the areas of governance, management and operations. The Board believes that Pershing Square's demand for management change would put at severe risk the significant forward momentum the Company is making on the Multi-Year Plan.
>
> On behalf of the Board, I would like to extend our appreciation to Fred Green and his management team for aggressively and successfully implementing our Multi-Year plan and creating superior value for our shareholders and customers.

Ackman responded by inviting all shareholders and other interested parties to a public Town Hall Meeting (held on February 6, 2012) and, with Hunter S. Harrison (retired CEO of CN and his candidate for CEO of CP, his side) made a fact-based presentation about the shortcomings and failings of the CP board and management. Harrison and Ackman stated that their goal for CP was to achieve an operating ratio of 65 for 2015 (down from 81.3 in 2011).

The Board and Fred Green Respond to Ackman... and Harrison

The Board formally responded to the allegations of Ackman in its Management Proxy Circular of March 22, 2012 and Fred Green used the occasion of an investor presentation, on March 27, 2012, to make his case.

The Board qualified Harrison's (and Ackman's) targets of "shot in the dark," showing a lack of research and a profound misunderstanding of CP's reality. Green mentioned that Hunter Harrison was a wrong choice as a potential successor since Harrison's reputation precedes him in Canada and several of CP's customers have said they would consider moving their business elsewhere if Mr. Harrison were appointed CEO[8] of CP.

Relying on an independent consultant report (Oliver Wyman Group), Green mentioned that Harrison's target for CP's operating ratio was not achievable since CP's network was characterized by steeper grades and greater curvature thus adding close to 6.7% to the operating ratio compared to its competitors.[9]

The independent consultant's report was used to buttress several arguments:[10]

"In its report, Oliver Wyman concluded that the Multi-Year Plan (as of October 31, 2011) was both reasonable and achievable in the overall context of expected market conditions, the competitive environment and the action plans supporting major productivity initiatives.

Oliver Wyman also concluded that an operating ratio of 65 for 2015 was neither realistic nor achievable. This conclusion was based on industry experience with respect to the time needed by the other five largest Class I railroads to achieve a 1300 basis point operating improvement from a starting point of 78.

[…] In its assessment of the reasonableness of the assertion that an operating ratio of 65 could be achieved for 2015, Oliver Wyman identified important inherent structural differences between Canadian Pacific and CN franchises that support its conclusions. Principal among these is the significant difference between main line grades and severity of curvature on comparable routes. Canadian Pacific has a more limiting track structure as a result of routes determined when Canadian Pacific and CN were originally constructed. Oliver Wyman's comprehensive and in-depth review of track charts, timetables and traffic flows has determined that Canadian Pacific must operate an additional 203 main line AC locomotives to compensate for its steeper grades and more severe degree of track curvature relative to CN. This requirement to operate with this greater number of locomotives results in higher expenses for fuel, equipment maintenance and depreciation."

The Board also made the following claims:[11]

- "the Board has significant breadth and depth of expertise and experience, including in the railroad and complementary industries, with a recognized commitment to the highest standards of corporate governance; the Other Pershing Square Nominees have no evident railroad industry experience and add no other complementary industry experience;

- the Board has engaged with Mr. Ackman and maintains an open invitation for him to join the Board, an invitation which Mr. Ackman has so far declined. Instead, Pershing Square has launched an unnecessary and costly proxy contest;
- Pershing Square has disclosed no specific plan to achieve its stated operating ratio targets (the Board points out that Hunter Harrison, in an interview with Business News Network, when asked to provide a concrete example of how he would reduce CP's operating ratio, he answered "Well, I think we would first of all, first of all we would build a team and a plan");
- the only stated goal of Pershing Square is to install Mr. Harrison as President and CEO, who the Board believes is not the right leader for Canadian Pacific;
- Pershing Square proposal is ill-conceived and introduces unwarranted risk to shareholder value. Pershing Square has demonstrated a lack of understanding of Canadian Pacific's business.

The Board asserted that Pershing Square had, on numerous occasions, made fallacious statements to support its demand that Fred Green be replaced by Hunter Harrison. For example, Pershing Square "claimed that Canadian Pacific's mobile assets (rail cars and locomotives) were poorly utilized and cited this as a 'big deficiency' on the basis of comparative operating metrics from 2010". In fact, according to CP's Board, "Pershing Square ignored the marked improvements Canadian Pacific has achieved in 2011. Through February 2012, Canadian Pacific has achieved a level of rail car utilization surpassing that reported by CN for the fourth quarter of 2011."[12]

To be fair to Fred Green, his actions as CEO as outlined in Appendix I, do have merit even if eventually he failed to achieve the goals he targeted.

Ackman's retort

These arguments did not sway or deter Ackman. On April 4th 2012, he came out swinging in a scathing letter to CP shareholders disparaging CP's Board of directors in general, and its CEO, Fred Green, in particular. According to M. Ackman, "under the direction of the Board and Mr. Green, CP's total return to shareholders from the inception of Mr. Green's CEO tenure to the day prior to Pershing Square's investment was negative 18% while the other Class I North American railways delivered strong positive total returns to shareholders of 22% to 93%."[13] Thus, according to him, "Fred Green's and the Board's poor decisions, ineffective leadership and inadequate stewardship have destroyed shareholder value."[14]

Ackman demanded that the Board be restructured and the CEO replaced by a leader able to "transform its 'culture of excuses' into one of performance and accountability."[15]

Ackman's letter contained some damning statistics on CP's performance, particularly with respect to all important "operating ratio," showing that CP's performance is the worst of the 6 largest rail operators in North America (and CN the best by a wide margin).

Again, Ackman reiterated that their goal was to achieve an operating ratio of 65 for 2015 (down from 81.3 in 2011).

He lobbied investment funds to support his slate of nominees for the board, as well as the hiring of Hunter S. Harrison (the recently retired CEO of CN) as CEO for CP.

Ackman's letter makes a forceful case for hiring Harrison:

"Hunter Harrison is a seasoned chief executive with a proven, unrivaled track record of operational and cultural transformation. He is a change agent with deep railroad operating experience and a thorough familiarity with all aspects of the Canadian rail industry, including its customers, freight flows, terminal operators, unions (and union leaders), suppliers, regulations, terrain, and weather patterns."

Of course, in Ackman's world (and apparently in Harrison's too), no moral or ethical qualms are triggered by the hiring of a recently retired executive from the direct competitor of CP, a man who had signed a binding non-compete agreement on leaving CN and who has been lavishly paid for his services at CN.

Appendix II presents large excerpts from Ackman's letter to shareholders outlining his criticism of CP's management and board as well as his proposed plan of action.

The parties were now on a path towards a full-blown confrontation in the form of a proxy fight around nominees for the board of directors.

Structural differences between CP and other railway companies

Whether shareholders sided with one party or the other would hinge in part on the issue of structural impediments to the performance of CP. Clearly, as stated on multiple occasions, an unquestioned premise of the CP management was that significant structural differences between the CP and the other railway companies imposed higher operating costs on CP. That premise was unquestioned and accepted as a fact by the CP management and its Board as well as by financial analysts and other members of the railroad industry. The magnitude of the operating disadvantage that CP had to endure was estimated at some 6.7% by Green as well as by Oliver Wyman, the consulting firm hired by the Board of CP. This structural impact on costs was, it seems, exacerbated in periods of extreme weather conditions.

Harrison, the putative CEO for CP, would not have any of this, made light of these "impediments" to CP's performance. During the Town Hall Meeting held by Pershing Square, Ackman asked Harrison to share his thoughts on the notorious structural differences at the CP[16]:

"I didn't hear anything about structural differences when they were on top [the CP]. The Rockies, they've always been there. They always will be there. I know it's gonna be difficult to justify a capital investment to get that grade down (laughs). It kind of depends on where you are. I remember coming to Montreal at first and kind of reading back in the files.

I looked at the files after the IPO and one of the things that CN was talking about then was the improvement they were gonna make in their performance, in their operating performance, but they cautioned everyone to 'Please don't think we gonna get to US types standards, it's just not structurally possible, it's not in the cards'. Now, as we went flying past, over the performance in the US, guess what the US carriers said? Don't ever expect us to beat the Canadian standards; it's just not in the cards. They get their healthcare paid for. Our fringes are 40%, theirs are only 15 or 20%, so it's kind of where you are.

Look, every railroad has structural… Every business has structural issues. That's what management's paid to deal with. There's no perfect franchise that I know of. So, you spend your time and energy fixing those things not making excuses about them because guess what happens, you start believing your excuses and then the team starts believing we can't get that thing done because we've got structural issues

So, look… It snows everywhere. It snows on CN, it snows on CP. Some winters are rougher than others but, we need to be prepared for them. So, I'm not a big believer in… that there are structural hardships that this franchise cannot overcome."

As shown in Appendix III, the gap in operating ratio between CP and CN had not always been as wide. In fact, CP had a lower operating ratio than CN during a period of time in the 1990s (Of course, CN was a Crown corporation at that time). The gap eventually widened, reaching unprecedented levels during Fred Green's tenure (the last full year of operating ratios attributable to Green was in 2011).

A Proxy Advisor Invites Itself to the Debate

Just a few weeks before the annual meeting of shareholders where the board candidates proposed by PS were challenging the nominees of management, ISS (Institutional Shareholder Services) – the largest proxy advisory firm – published a report which strongly supported Pershing Square's position "because the dissidents have demonstrated a compelling case that poor board oversight has allowed the company's performance to drift further and further below both its peers and its potential over at least half a decade, it seems clear that change on the board is needed."[17] The CP now had to defend itself against a new and influential party. The company issued a press release to respond to ISS[18]:

- "ISS operates from a false premise and maintains a double standard with respect to CP's Multi-Year Plan and Pershing Square's failure to provide any strategic or operational plan,
- ISS fails to take into account the development and aggressive and successful execution of the Company's Multi-Year Plan,
- ISS has failed to recognize the risk to shareholder value and the delay to the continued execution of the Multi-Year Plan related to Pershing Square's proposal to replace CP's current CEO, Fred Green, with Hunter Harrison,
- ISS attacks the Board's decision to commission the Oliver Wyman report in response to Pershing Square's CEO ultimatum and unrealistic OR target of 65 by 2015, while overlooking the flaws in Pershing Square's thesis,
- ISS's flawed justifications for recommending the Pershing Square nominees are based on incorrect and incomplete information and reflect a lack of objectivity,
- The ISS report contains a number of errors,
- Having failed to present to CP shareholders a balanced analysis of the opportunities and risks before the Company, ISS puts forward spurious reasons to vote against CP's directors, and
- The dissemination of the ISS report to the media prior to receipt by the company and certain ISS subscribers reflects poorly on ISS's professionalism and, by extension, on the recommendation put forward by ISS."

The Ontario Teachers' Pension Plan also publicly confirmed its intention to support Pershing Square's proposed candidates for the board. This public support from a large and respected institutional fund was another strike against the CP. Then, a survey of institutional investors representing 45% of CP's outstanding shares showed that 94% of them would vote for the board nominees proposed by Ackman.[19]

Two other proxy advisory firms, Egan-Jones Proxy Services and Glass Lewis & Co., also endorsed Ackman's position on Canadian Pacific Railway.[20] The perspective looked decidedly gloomy for CP's Board and CEO at the upcoming annual meeting of shareholders.

Annual Meeting of Shareholders Held on May 17, 2012, and Changes to CP's Board

A few hours before the annual meeting, CP issued a press release in which it stated that Fred Green had resigned as CEO, and that five other directors, including the Chairman of the Board, John Cleghorn, would not stand for re-election at the company's shareholder meeting.

Pershing Square had won the proxy fight; all the nominees proposed by Ackman were elected. Quickly thereafter on June 28, just a little more than a month after the shareholders' meeting, Hunter Harrison was appointed CEO. Meanwhile, two other directors (member of the pre-Pershing CP's Board) announced that they were stepping down. Only a few days after Harrison took over as chief executive, Tony Ingram, another director appointed under the older management, also resigned on July 5. Thus, with the addition of Hunter Harrison recently appointed to the Board and the resignation of a third director, the Pershing group now had the majority on the board with 8 of the 14 board members.

Canadian Pacific Railway under E. Hunter Harrison

"Harrison has been making his way across Canada and the northern United States since taking on the job June 29, and he keeps asking: Why do we do this? What do we do with that? When he gets unsatisfactory answers, red tape gets cut, rules are changed, trains are operated differently, and the like."[21] Within just a few weeks, he made several changes that had an immediate impact on the operations. For example:

- A CP intermodal train changes crews 13 times between Montreal and Vancouver. Harrison asked, 'why are these supposed hotshots scheduled to dwell in places like Ignace and Chapleau, Ont., for 20 minutes or longer when a step off-step on crew change takes more like five minutes?.' So schedules are being tightened. Harrison figures that limiting crew changes of intermodal trains to a brisk 5 minutes will take six hours out of the cross-country trip.

- Harrison wondered why so many intermodal trains are stopping along the way to pick up or set off just a few containers at the smaller ramps in Calgary, Regina, and Winnipeg. Try doing this in winter and then timing how long it takes to get a train's air back up in -35 degree Fahrenheit weather. The result was that Vancouver-Toronto trains 110-111 (train numbers assigned to a specific route) were abolished and in their places trains 100-101 were created with no work en route and high priority (green light during traffic controls, and other trains on the tracks have to take the siding to let them pass in priority). The first 101 arrived in Vancouver 17 hours earlier than 111 would have gotten there under the old schedule.

After some 18 months at the helm of CP, Harrison rationalized the operations as well as resources, human and material. The newcomer CEO took a series of measures to transform CP[22]:

- New executive leadership team, including a new Senior Operations lead team (also recruited from CN!) with a mandate for centralized planning and decentralized execution, to eliminate bureaucracy and have service decisions made faster and closer to the customer;
- Revamped intermodal and merchandise train service resulting in faster transit times for customers;
- Closure of hump-switching yards in Toronto, Winnipeg, Calgary and Chicago - producing significant cost savings and more efficient operating practices. A hump-switching yard is an artificially elevated area within a classification yard where the force of gravity is used to move rail cars along a network of marshalling tracks. Those humps were from the 1950s and 1960s; at that time, 80 to 85% percent of the cars that the CP handled had to be sorted, classified or switched. Harrison mentions that "the nature of our business has changed. Bulk and intermodal, which compromises over 70 percent of our business, is all handled in unit trains. We certainly didn't need classification yards. We're going to a more flat switching mode of operation."[23]
- Closure of intermodal terminals in Milwaukee, Obico (Toronto), and Schiller Park (Chicago) - reducing footprint and operating expenses while also facilitating efficient operating practices and reduced end-to-end transit times;
- Improved train service and network velocity resulting in the need for 195 fewer locomotives and 3,200 fewer leased rail cars; this reduced company-controlled railcars and locomotives by 35 percent and 43 percent, respectively.[24] The reduction has been possible through gains in efficiency everywhere on the network. For example, by initiating change in the intermodal markets, the CP took a day out of service from Vancouver to Toronto, and Vancouver to Chicago, both ways (the service is now offered in four days instead of five). By taking a day out of the transit time, "it reduces the overall requirements for locomotives on the system by about 40 locomotives."[25] In some cases the transit time was reduced by even more than a day.
- 4,550 positions have been eliminated,[26] thus decreasing the workforce by 27 percent.[27] Most of these positions were eliminated by attrition, and the majority of the reduction came from the operations, as Harrison would put it in its own style: "If you take 500 locomotives out and 10,000 cars out, obviously you don't need as many mechanics."[28] Part of the reduction also came from the customer service department in Winnipeg (about 75% of the 800 employees)[29] – the new approach puts the responsibility of the customer service (keeping the customer happy) on the person actually delivering the service.
- Relocated CP's corporate headquarters from downtown Calgary to new office space at CP-owned Ogden Yard, "a move that cut costs but also keeps Canadian Pacific's focus on freight operations front and center for corporate employees."[30] Harrison says: 'It's going to save us about $17 million or $18 million annually, and I think over time, it's a better environment for the employees. […]It's a way to take those people out of headquarters and kind of let them be out there and see what the business is all about. It's not about downtown bank buildings and glass towers. It's about railroading."[31]
- New longer sidings program to improve asset utilization and increase train length and velocity. A siding is a low-speed track section distinct from a running line that may be used for marshalling, stabling, storing, loading and unloading vehicles. CP had short sidings (5,000-6,000 feet) and the new program foresees the building of 12,000-15,000 feet sidings to eliminate bottlenecks that will allow the CP "to run longer trains more effectively without adversely affecting speed and velocity."[32]

Harrison communicates non-stop about the importance of his *Five Foundations* to railroad success, which serves as a guide for the change he wishes to instill to CP: 1° provide service; 2° control cost; 3° optimize assets; 4° operate safely and 5° develop people.

In the first edition of a new magazine for employees (now called *Canadian Pacific Magazine*, replacing the former publication *Momentum*), Harrison observed "If you look at the recent history of CP, it's been an operating company run by marketing people. There are a lot of good railroaders here, a lot of talent to build on. I've sensed some excitement, with people saying, 'Oh, these guys want to railroad again.' So we're letting people know that we're getting back to the basics."

Unlike his predecessor, who was quite discreet in employee publications, Harrison uses this communication tool to impart his vision and strategic orientations, to unveil upcoming major capital expenditures, and to promulgate the results obtained since the leadership change (and give a positive connotation to the word "change"). The magazine is now targeting a readership of railroad people, with topics like the Spike-Driving Championships, interviews with employees working on railroad specialties sharing their passion for what they do, and numerous photographs of locomotives and hump yards. The aim is to create and consolidate a winning culture through the sharing of accomplishments and operational achievements.

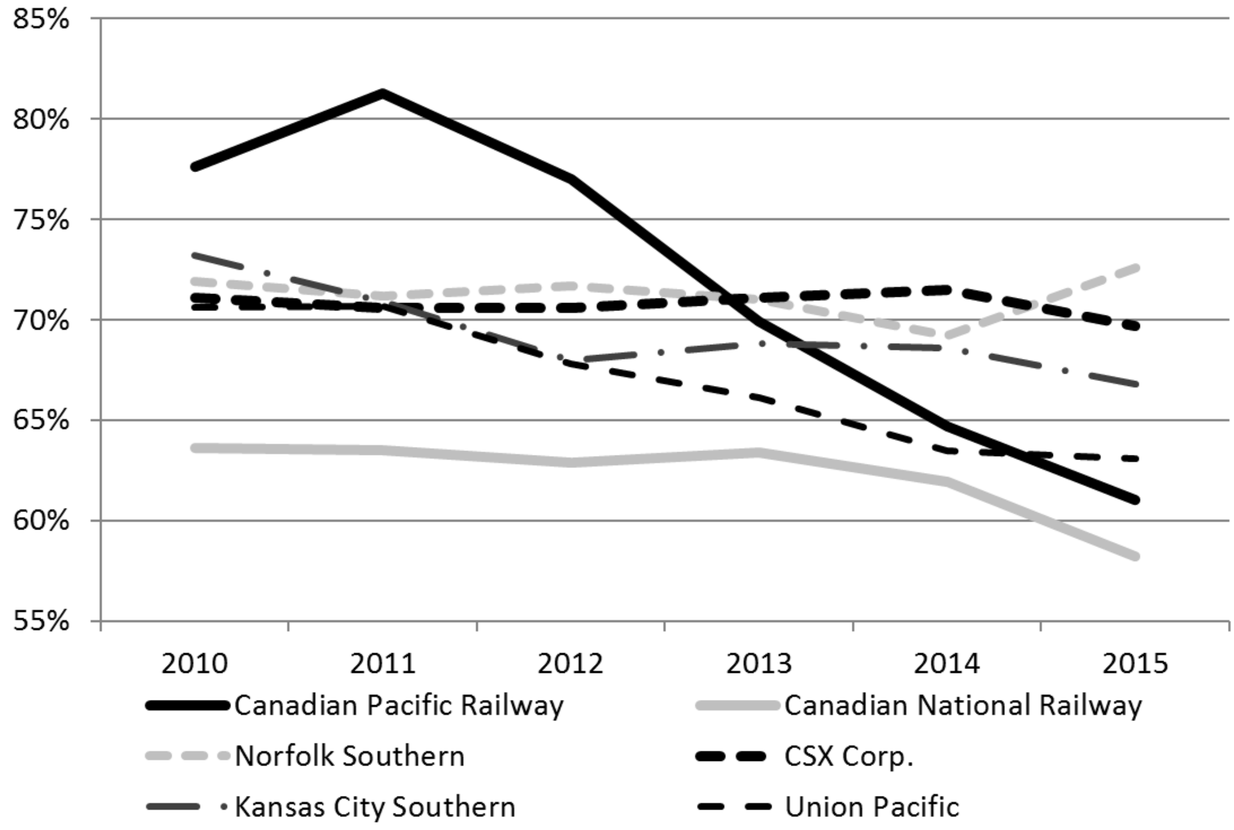


Exhibit 1: Operating ratio, compared to other Class 1 railroad companies

According to Harrison, the rhythm of transformation deployed by the CP exceeds largely all expectations. All the targets set when he arrived have been attained and even exceeded. The decrease in the work force and all the changes made were completed without apparently harming customer service.[33] When the CP unveiled its 2013 results, everything seemed to indicate that Pershing Square was right to request the change.

Under Harrison's leadership, CP's operating ratio improved dramatically (see Figure 2), challenging CN for performance leadership and shattering forever the *"structural difference" argument*.

Appendix IV presents other key performance indicators in the railroad industry and their evolution since 2010. **Appendix V** maps out the evolution of different ratios and indicators during Green and Harrison's respective tenure (first years of Harrison's tenure, showing the quick change), with some comparisons to the CN.

Despite the drastic measures undertaken by Harrison, revenues increased by 7.7% in 2013. Most interestingly, all the key performance indicators, financial and operational (except for AT who remained stable) swiveled in the opposite direction of the enduring trend from the previous years as shown in **Appendix VI**.

The financial markets did, of course, reward handsomely these operating performances. As the shown in Exhibit 2, CP's shares now trade at more than 4 times their price when Pershing Square first started buying shares of CP. In **Appendix VII**, this graph is included and displays the major events and their impact on CP's stock price.

CP's saga became the epitome of how a hedge fund can create value for shareholders by changing board members, management and thus strategies.

Ackman exits CP

During 2015, CP tried – unsuccessfully – to acquire Norfolk Southern Rail, a disappointing outcome. Yet, the drive for more efficiency at CP was relentless. By the end of 2015, CP was the second best among Class I railroads in North America in terms of operational ratio, as shown in Figure 3. CP is now vying with CN for first place.

Almost exactly five years after first buying shares of CP, Ackman confirmed in August 2016 that Pershing Square would sell its remaining shares of CP, thus formally exiting the "target." Harrison was still CEO, and Keith Creel was officially named to succeed him starting on July 1, 2017. In his usual style, Harrison declared:[34] "The board said, 'Look, we've got the opportunity to have two pretty good railroaders during a transition period and that's not the worst thing in the world,'" The succession should assure continuity in the way Harrison has led CP.

Over those five years, CP has generated a compounded annualized total shareholder return of 45.39% (between September 21, 2011 and August 31, 2016), a performance well above the CN and the S&P/TSX 60 index (see Exhibit 2 and Appendix VII). Pershing Square pocketed **some $2.6 billion in profits for its venture into CP**.[35]

With massive reductions in the workforce, a transformation of the operations and a radical change of the CP's organizational culture, CP is undoubtedly a different company from what it was before the proxy fight. In early September 2016, Bill Ackman resigned from CP's Board.

Hunter Harrison's declaration about Ackman's resignation[36] provides a fitting conclusion to this whole episode: "He [Ackman] saw an opportunity at CP, worked hard to bring me in to the fold, and delivered for shareholders and the board. Over the last four years we have built a better CP and that model remains in place to continue to deliver not just for shareholders, but for customers and employees. We thank Bill for everything he has done and wish him well in the future."

Analysis: why was Pershing Square so successful in this case?

Why was the CP intervention such an apparent success, when, in several other instances, Pershing's brand of activism was far less successful? Mr. Ackman's forays into J.C. Penney, Target, and Borders gave results ranging from mediocre to abysmal.

In an article published in the Financial Post, a number of critical features of this saga are singled out to explain the particular success of this intervention:[37]

1. A rare case of perfectly transferable talent

The recently retired CEO of Canadian National Railways (CN), the best performing railroad company in North America, was soon to be freed from the legal (if not the ethical) constraints on his joining a direct competitor. This man, Hunter Harrison, is acknowledged as a highly skilled and innovative railroader… and he was ready and willing to take over as CEO of CP.

In the Canadian context, such behaviour is not quite gentlemanly. Imagine the high performing CEO of the Royal Bank of Canada who, soon after retirement, would join the Bank of Montreal as CEO. But both Ackman and Harrison are Americans who could not care less about the mores and values of the Canadian business world.

Of course, recruiting Harrison came at a price, some $44M in 2012. Harrison then turned around and recruited Keith Creel (then executive vice-president and chief operating officer at CN) to follow him as CP's President and Chief Operating Officer (and most probably Harrison's successor).

This sort of opportunity to recruit the recently retired CEO of the company's best performing competitor is rare in practice. Ackman has learned that lesson when as the largest shareholder of J.C. Penney (a chain of department stores), he pressured its board of directors to replace the CEO by Ackman's choice: Ron Johnson, at the time president of Apple retail. That turned out to be a disastrous choice. Johnson was let go 17 months later to be replaced by the very CEO he had replaced.

So, an "activist" hedge fund unhappy with the performance of the current CEO of a targeted company calls on the recently retired CEO of a direct competitor who happens to be ready to jump ship and hit the ground running. How rare is that?

2. A simple, well-defined industry

The North American Railroad Industry is extremely well defined. The same companies have been serving this market for decades; their networks are well-established. Performance measures are standard across the industry, which makes for easy comparability across firms. Thus, it is a simple task for management, the board

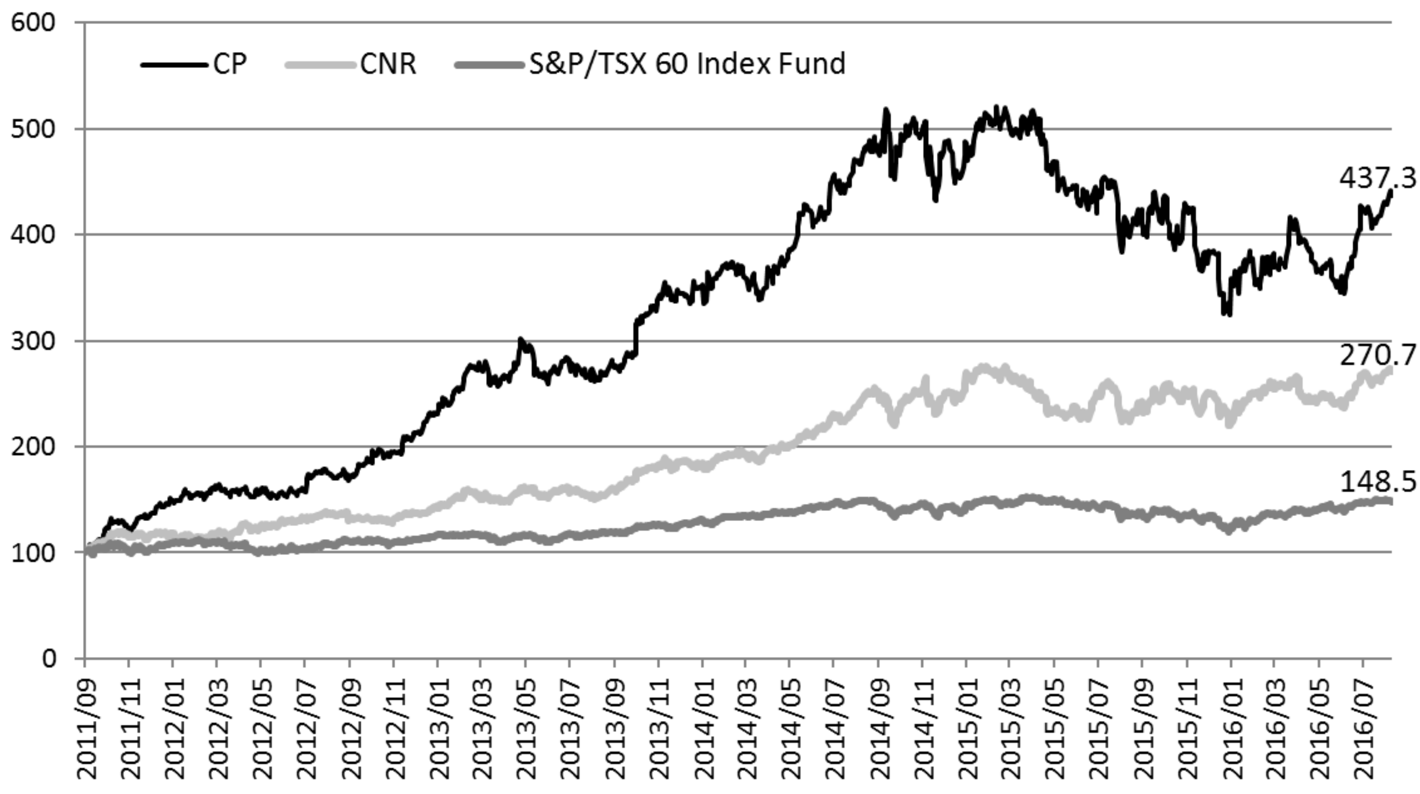


Exhibit 2: Evolution of CP's stock price compared to CN and S&P/TSX 60 index (basis 100).

of directors and investors to benchmark any company against its peers. Unfortunately for CP, its score was substantially lower than its peer group and the gap was widening year after year. But, it was widely accepted (including by financial analysts following the industry) that there were structural factors which explained a good part of this inferior performance. As for the part under the control of management, vigorous action plans were being implemented to bring CP's performance much closer to its peers within five years. That was certainly the firm conviction of the CP board.

3. A prestigious and experienced Canadian board of directors

The board of CP had a nec plus ultra membership drawn from the Canadian business elite, the "royalty of Canadian directors:" former CEOs of the Royal Bank, Cargill, Ipsco, Shell Canada, and Corby Distilleries; current CEOs, scions of old families, a former minister in the Government of Canada. These people had a wealth of business experience and were proud to serve on the board of an iconic corporation whose history is enmeshed with the very history of Canada.

They surely did not lack confidence in their ability to govern the corporation. Indeed, their collective wisdom and governance skills had been recognized repeatedly by various agencies making a business of rating the governance of corporations.

Here comes an upstart "hedge fund" manager from New York who has the gall to criticize their stewardship and to pretend he knows what CP should do to improve its performance. His "bright" insight involves, first of all, the disgraceful suggestion that the CP board chairman go and try to persuade the former CEO of a rival Canadian company to jump ship and join CP!

Here there is more than a whiff of cultural clash between American and Canadian business practices. The differences in values between Americans and Canadians have been well documented,[38] and the cultural clash between Ackman and CP's incumbent board offers yet another example. Indeed, the proposal to hire the former CEO of a competitor must have been viewed as heretic and nonsensical to CP's directors. Such underhand maneuver is just not done in the Canadian business world in general and at CP in particular. CP's culture has been shaped over a hundred years; it is based on the company nurturing its executives, promoting them from within whenever possible.

Not only was Ackman arguing for CP to drop this policy of strict "promotion from within" but was urging CP to hire someone from a direct competitor. Ackman was not inhibited by this Canadian culture (nor was Harrison, an American citizen); he just saw an opportunity.

CP's board could have hired Harrison and gotten all the benefits without the pain of a proxy fight and the humiliation of being rejected by shareholders; but it was, to them an unthinkable breach of the CP culture. In many ways, Pershing Square was merely instrumental to the dramatic operational turnaround undertaken at the CP.

Of course, it is also plausible that a prestigious board, a board made up of experienced former or current executives would be more likely to reject out of hand any suggestion coming from a "financial" sort of player.

4. Massive support from institutional shareholders and other parties

Yet, indifferent to these considerations, large Canadian institutional investors supported Pershing Square's attack on the board of CP. Perhaps tired of CP's stagnating stock price under the leadership of Green, they saw in the hedge fund a vehicle to channel their frustration.

But many other parties also saw the need for change at CP. Indeed, the large proxy advisory firms, the largest Canadian pension funds, eminent and influential experts of the industry, and even the president of Teamsters Canada Rail Conference - Maintenance of Way Employees Division (union representing more than 10% of CP's employees), all supported Ackman in his quest. This is a very rare case where an activist hedge fund enjoyed support that extended beyond the short-term shareholders.

These four features of the CP saga, taken together, are rather unique. Yet, the proof is in the pudding! Under a new leadership, CP has quickly and remarkably improved its performance. What did not seem achievable was achieved. Structural impediments to CP's performance seem to have vanished.

How come the CP board at the time, presumably savvy and experienced, did not spot the mediocre performance of CP, did not challenge the common assertion that structural factors explained CP's poor results? How come no one seemed to notice that the CP performance had been deteriorating? Why were they satisfied with the level and rate of progress proposed by management? Why did they not challenge management about the reasons for CP trailing all other North American railroads.

After all, the critics formulated by Pershing Square were all based on publicly available data. Why could the CP board not see what outsider Pershing Square could spot in a few weeks? The initiatives that Harrison was able to implement swiftly after taking over as CEO constitute a damning indictment of the board (and management) of CP at the time.

Conclusion

Costs and benefits

Let's summarize the benefits and costs of this instance of hedge fund activism. The stock market just loved what was happening at CP and rewarded the company with a booming stock price.

But it should be factored in that over 6,000 CP employees lost their job and the new management exerted unrelenting pressure on the remaining workers to increase productivity. The company claims that it treated fairly those who lost their jobs, that most just took early retirement, etc.

Still, it could be argued that the financial success of CP under Ackman and Harrison was a sort of wealth transfer from workers to shareholders.

Uniqueness of the CP case

The case identified four factors that are rarely present in other cases of activism, a fact which explains why few of these interventions achieve the level of success of the CP case. Indeed, many interventions actually fail and others achieve only moderate success. In fact, a study[39] by Allaire and Dauphin analyzed 259 firms targeted by activist hedge funds, and not a single case showed any similarity with the CP's case and the perfect alignment of the four factors mentioned above.

Lessons in corporate governance

In this day and age, the CP case teaches us that no matter its size or the nature of its business, a company is always at risk of being challenged by dissident shareholders, and most particularly by those funds which make a business of these sorts of operations, the activist hedge funds.

Of course, a widely held company with weak financial results and a stagnating stock price will inevitably attract the attention of these funds.

But the puzzling question and it is an unresolved dilemma of corporate governance remains: how come the board did not know earlier what became apparent very quickly after the Ackman/Harrison takeover? Why would the board not call on independent experts to assess management's claim that structural differences made it impossible for CP to achieve a performance similar to that of other railroads? How could the board have known that performances far superior to those targeted by the CEO could be swiftly achieved?

Lurking behind these questions is the fundamental flaw of corporate governance: the asymmetry of information, of knowledge and time invested between the governors and the governed, between the board of directors and management. In CP's case, the directors, as per the norms of "good" fiduciary governance, relied on the information provided by management, believed the plans submitted by management to be adequate and challenging, and based the executives' lavish compensation on the achievement of these plans. The Chairman, on behalf of the Board, did "extend our appreciation to Fred Green and his management team for aggressively and successfully implementing our Multi-Year plan and creating superior value for our shareholders and customers."[40] That form of governance is being challenged by activist investors of all stripes.

Their claim, a demonstrable one in the case of CP, is that with the massive amount of information now accessible about a publicly listed company and its competitors, it is possible for dedicated shareholders to spot poor strategies and call for drastic changes. If push comes to shove, these funds will make their case directly to other shareholders via a proxy contest for board membership.

Corporate boards of the future will have to act as "activists" in their quest for information and their ability to question strategies and performances.

Appendix I

Fred Green's initiatives to improve CP's performance

Green, the CEO of CP from 2006 to 2012, could also argue that he had been a proactive driver of improvements at CP. A few months before officially becoming CP's President and CEO, Fred Green had already started to set the table for important changes. In an internal memo titled "Organizational change for greater success," Green (then as President and COO) wrote in 2006 that "The intent is to build fluidity into all aspects of our business and, by doing so, to improve our operating and financial performance and narrow the operating ratio gap with our direct competitor (Canadian National Railway)." At the time, a source in the industry familiar with the decentralization plan mentioned that "Fred knows that a big part of the problem is nobody is really watching the shop close enough at the field operations level. […] If they pull up their socks, they can equal CN's performance."

However, the operating ratio climbed gradually from 75.4% in 2006 to 78.6% in 2008. Blaming the economic downturn for this mediocre performance, Green launched in 2008 a new campaign titled Execution Excellence for Efficiency (E3) featuring initiatives such as running longer trains and renegotiating fuel contracts with freight customers. CP had also instituted a hiring freeze, trimmed staff travel budgets and restricted discretionary expenses as part of the campaign.

In 2009, the operating ratio stands at 79.1%. In a continuous effort to control costs, Green issued an internal memo to the roughly 3,000 non-union staff across Canada in which he was asking them to burn off vacation days. He was also ending the system in place, which allowed up to 52 weeks of holiday time to be banked. This initiative was put in place to strengthen the balance sheet since "unused vacation is a liability for which the company maintains an accrual."

The initiatives put in place do have an impact, especially over the intermodal train lengths. On average, these trains went from 63 railcars in 2008 to 90 in 2010 . The CP also invested in new technologies for railway optimization.

Even if there was a few notable achievements in 2011, such as the addition and extension of sidings (at the foundation of the train lengthening strategy) that allowed the CP to establish a record year for train weight, the operating ratio went up to 81.3%. The CP adopted a new multi-year plan, built around three key initiatives:

1. driving volume growth;
2. expanding network capacity to safely and efficiently support higher volumes and;
3. cost control.

These initiatives were backed by the following multi-year programs:

- First Mile-Last Mile – this program drives improvements in service, asset velocity and enables low-cost growth by reducing railcars and creating additional terminal capacity.
- Scheduled Bulk – we continue to schedule our bulk train operations as part of our Integrated Operating Plan. In grain, our efforts involve leveraging our grain elevator footprint by scheduling all aspects of our grain shipments, including First Mile-Last Mile switching and bulk unit operations, all centered around a simplified network of origin grain hubs.
- Long Trains – this program is driving increased train lengths; improving service, safety, productivity and efficiency. It includes targeted infrastructure enhancements and the use of proprietary train marshaling software, which maximizes the use of distributed locomotive power.

- Fuel Efficiency – this program targets year-over-year improvements in fuel efficiency and reduced emissions. It consists of the acquisition of new locomotives, the remanufacturing of older locomotives and using new technologies which improve train handling and reduces idling. This program is enhanced by the disciplined execution of the Integrated Operating Plan, improving velocity and driving fleet productivity.
- Locomotive Reliability Centres – we are consolidating the number of major locomotive repair facilities from eight to four highly efficient super shops which will result in improved maintenance capabilities, lower unit costs, reduced overheads and improved locomotive availability and reliability.

To increase track speeds, the CP was to invest approximately $250 million over the next few years to upgrade the network on CP's North Line (which runs from Winnipeg to Edmonton). Once done, these upgrades would reduce route miles for some shipments by between 5% - 10%. The plans' target is to reach an operating ratio between 70% and 72% by 2014, and between 68.5% and 70.5% by 2016.

The last Multi-Year Plan reiterated several elements from the previous plans. However, the arrival of Pershing Square in September of the same year shifted management's time and effort to coping with the challenge of PS, a common and perturbing occurrence when companies are under attack by activist hedge funds.

But the fact remains that for several years preceding the proxy contest by Pershing Square, CP's key financial indicators were inferior to those of comparable competitors. Indeed, the graphs in Appendix II show decreasing ROS, ROA and ROE at CP between 2010 and 2012 (and even since 2009 for the ROS), while all its competitors have improved these indicators over the same period. CP was also at the bottom of the pack on those three performance indicators in 2012. For instance, CP's return on equity of 9.93% in 2012 was dismally low when compared to CN's ROE of 24.70%.

Appendix II

Excerpt from the letter from Ackman to CP shareholders

April 4th 2012

Some of the Board's and Mr. Green's failures are outlined below.

- Mismanagement of Operations – Mr. Green and the Board have mismanaged CP's physical assets and its talented employees, resulting in poor operating performance.
    - o Industry-Worst Operating Performance – CP's key indicator of performance – its operating ratio – highlights the Company's industry-worst operating performance. Notably, CP's closest comparable and competitor – Canadian National Railway Company (CNR) – has the best operating ratio (63.5% in 2011 or a full 17.8 percentage points better than CP's), enabling it to generate nearly twice the profit for each dollar of revenue as CP. Over Mr. Green's tenure, CP's pre-tax operating profit has declined 1% despite the inclusion of profits from a substantial acquisition. Excluding the profits from that acquisition, we estimate that pre-tax operating profits have declined 10% or more.
    - o Over the six years since Mr. Green became CEO, other railroads have substantially improved their performance, but CP's operating ratio deteriorated (i.e., increased) by 3.6 percentage points from the middle of the pack to last place. This deterioration is due to Mr. Green's mismanagement of CP's physical assets and talented employees. The following chart (Figure 1) compares CP's operating ratio versus its competitors during Mr. Green's tenure (CP is in red and lower is better):
- Failure to Serve Customers Has Led to Market Share Losses – Poor management leads to poor service

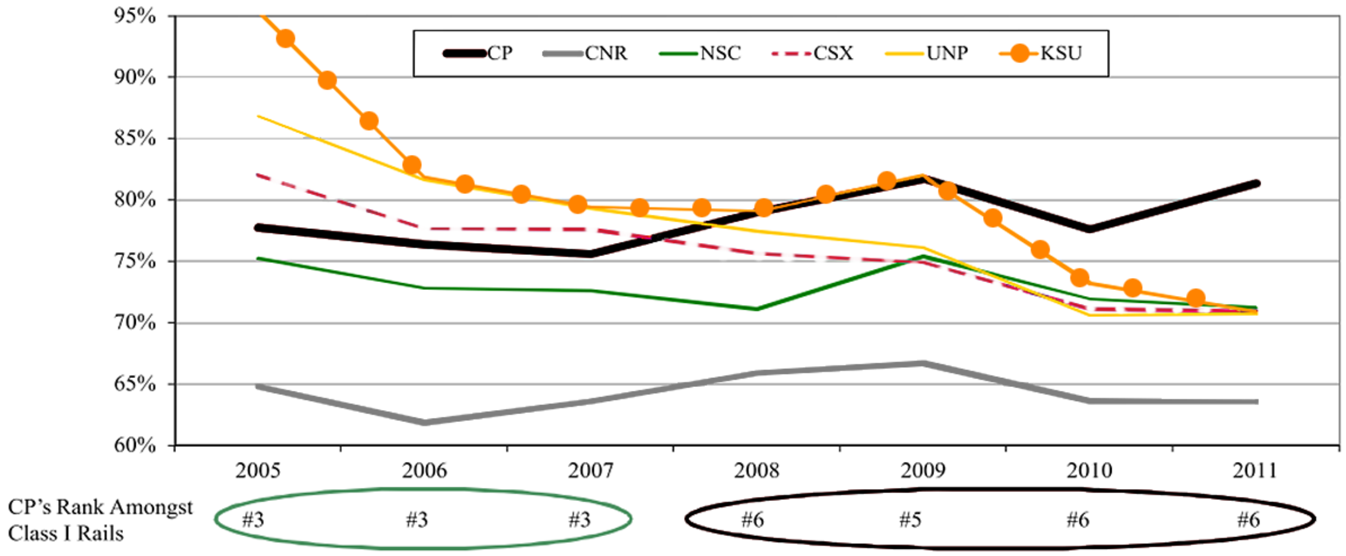


Figure 1: Operating Ratio by Year
As the above chart (Figure 1) illustrates, the operating ratios of every other North American railroad improved (i.e., declined) over Fred Green's tenure, while CP's, uniquely, deteriorated (i.e., increased).

and market share losses. Compared to its principal competitor CNR, CP has longer transit times per mile, less reliable transit times, and less reliable railcar availability. As a result, CP has lost market share to CNR over the last six years, including 7.4 percentage points of intermodal market share, despite CP's completing a substantial acquisition during that period. This underscores the critical and urgent importance of improving service levels because customers vote with their feet.

- Mismanagement of Capital – The Board's and Mr. Green's inadequate and imprudent stewardship of shareholder capital over the past six years has further harmed CP and its shareholders.

o Overpayment for the DM&E – In 2008, under Mr. Green's leadership and with the Board's approval, CP purchased the Dakota, Minnesota & Eastern Railroad (DM&E) at a price of approximately 18 times pre-tax operating profit. The consensus among the investment community at the time and since has been that CP grossly overpaid for DM&E, by many accounts by over 30%.

o Excessive Borrowings to Finance the DM&E Purchase, and Poor Share Buyback Decisions, Resulted in Substantial Shareholder Dilution – Having overpaid for the DM&E, the Board and Mr. Green compounded the problem by financing the DM&E acquisition with excessive debt, contributing to an over-leveraging of the Company's balance sheet. As a result, during the depths of the financial crisis in February 2009, CP had to raise equity by selling $511 million of stock at fire-sale prices – at $36.75 per share – when they had previously completed repurchasing $517 million of stock at $63.03, only 14 months earlier, materially diluting shareholder value. At the same time, other railroads, whose balance sheets had been protected by boards and management with more effective and prudent oversight, created substantial shareholder value by repurchasing their shares at extremely attractive prices during the financial crisis.

o Mishandled Capital Investment – CP's balance sheet mismanagement limited CP's capital investment during the recession – a time when materials, third-party labour costs, and the opportunity cost of network disruption are the least costly. Even as the Board and Mr. Green failed to make important fluidity-enhancing capital investments at opportune times, they squandered shareholder capital on excessive locomotive and car stock. For instance, even though CP's locomotive productivity is already demonstrably below that of CNR, CP has announced that it will spend $500 million for new and replacement locomotives. This new capital commitment comes just a year after Ed Harris – CP's then-COO and current Board member – stated in 2010: "[CP] doesn't need more locomotives. [CP] already has one of the best fleets that I've ever seen in my travels whether as a consultant or a prior executive." (CP Analyst Day June 2010)

o Inadequate Returns on Capital – The bottom line report card on the incumbent Board and management's stewardship of shareholder capital is CP's return on invested capital (ROIC). CP's ROIC was only 7.1% for 2011, a full 3.6 percentage points lower than CNR's.

- Mismanagement of Executive Ranks – One of a board's and CEO's critical functions is attracting, retaining, developing, managing and holding accountable a company's executive ranks. Fred Green and the Board have failed to properly manage CP's executive ranks.

o Management Instability – The Board and Mr. Green have presided over a revolving door with five COO changes, and three CFO changes in fewer than six years. This instability has handicapped CP's operations and financial functions.

o Lack of Accountability – Mr. Green has proposed and attempted to implement "detailed plan" after "detailed plan" after "detailed plan" over his tenure (over 10 distinct plans and initiatives in all). Each plan was rolled out with fanfare and promises for substantial improvements. Each was accompanied with claims of impressive progress and improved metrics. Yet, none of these detailed plans reversed CP's deteriorating performance. The Board nevertheless continues to refuse to hold Mr. Green accountable for his failure to execute. Instead, the Board is now embracing yet another "multi-year plan" – much of which is a rebranding of prior initiatives – accompanied by yet another raft of claims of progress and promises.

- Mismanagement of Executive Compensation – Despite Mr. Green's unacceptable performance during his tenure, the Board continues to compensate him as though his performance has been meritorious. This failure to properly manage executive compensation has materially contributed to CP's decline.

o Unacceptably Low Performance Targets – The Board has set Mr. Green's individual performance objectives so low that even though CP has consistently and substantially lagged behind its peers, the Board has deemed Mr. Green to have met all but one of those individual performance objectives during his tenure.

o Excessive CEO Compensation – The Board has paid Mr. Green $32 million from 2006-2011, even though total returns to shareholders were negative 18% over the same period (the date before Pershing Square's initial purchases of CP shares), a period during which every other Class I North American railroad delivered solid returns.

o Excessive Management Compensation – Even as CP's performance has languished, the Board increased the Cost of Management Ratio (named executive officer compensation as a percentage of net income) from 1.2% of net income in 2006 to 2.5% in 2011. Stated simply, income to shareholders has languished while compensation to executive management has increased.

- Weak Ownership Commitment – The Board's current directors (excluding Mr. Green) collectively have an equity stake of less than 0.3% in CP, and nearly all of these equity interests were granted as director compensation.

In summary, poor decisions, ineffective leadership and inadequate stewardship by current CEO Mr. Green and the CP Board, compounded by a deficient corporate culture, have severely degraded CP, Canada's iconic railroad. All stakeholders – customers, employees, and shareholders – and the economy have suffered from this failure.

The Solution: A Restructured Board and the Right New CEO

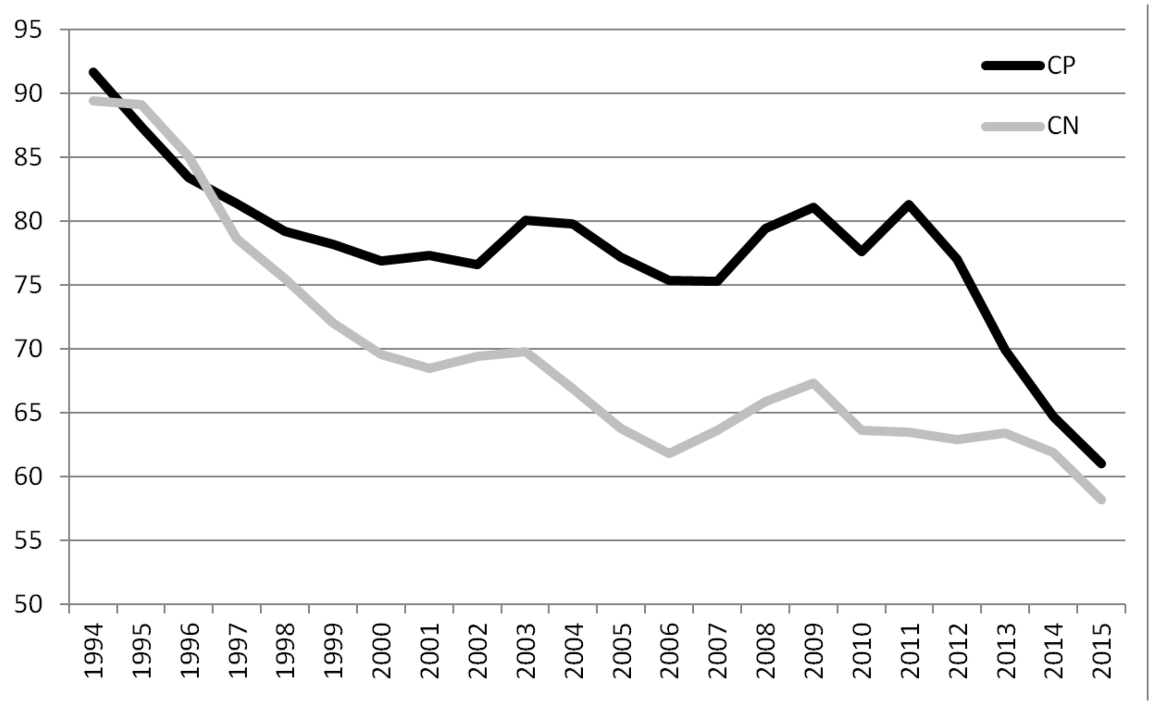
Electing the seven Nominees for Management Change will reset the Board's culture and composition, ensure that shareholders' voices will be heard, and deliver an unequivocal shareholder mandate that will catalyze essential management change.

We believe the Nominees for Management Change are the right directors and Hunter Harrison is the right new CEO for the job. We are confident that upon meeting Hunter and considering the alternatives, the reconstituted Board in its entirety will conclude that Hunter Harrison is the ideal CEO choice.

Why Hunter Harrison?

Hunter Harrison is a seasoned chief executive with a proven, unrivaled track record of operational and cultural transformation. He is a change agent with deep railroad operating experience and a thorough familiarity with all aspects of the Canadian rail industry, including its customers, freight flows, terminal operators, unions (and union leaders), suppliers, regulations, terrain, and weather patterns."

Appendix III



Evolution of the operating ratio (% - left scale) for the CP and CN (1994-2015)

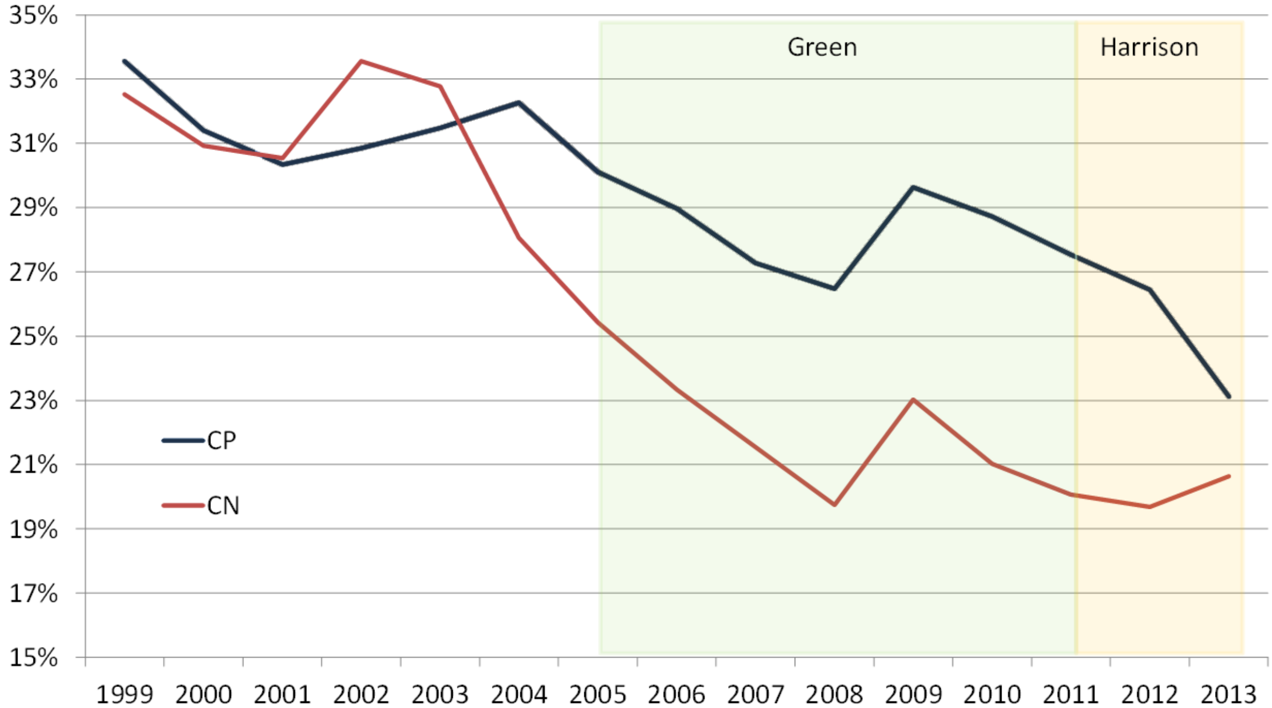
Appendix IV

Key Performance Indicators	2015	2014	2013	2012	2011	2010
Operating Ratio (adjusted)	61.1%	64.7%	69.9%	77.0%	81.3%	77.6%
Freight gross ton-miles ("GTM") (millions)	263,333	272,862	267,629	254,354	247,955	242,757
Train miles (thousands)	34,047	36,252	37,817	40,270	40,145	39,576
Average train weight – excluding local traffic (tons)	8,314	8,076	7,573	6,709	6,593	6,519
Average train length – excluding local traffic (feet)	6,935	6,682	6,530	5,981	5,665	5,660
Fuel efficiency (U.S. gal. of fuel consumed/1,000 GTMs)	0.994	1.035	1.06	1.15	1.18	1.17

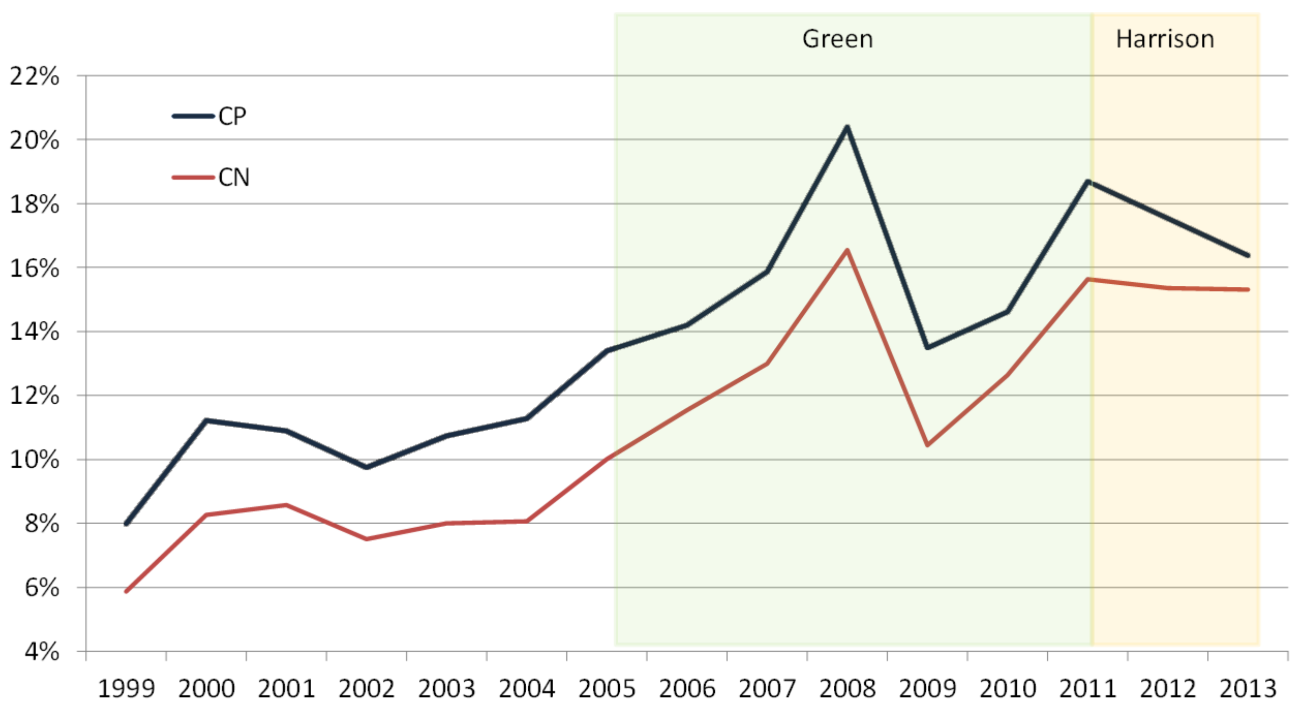
Source of data: CP annual reports.

Appendix V

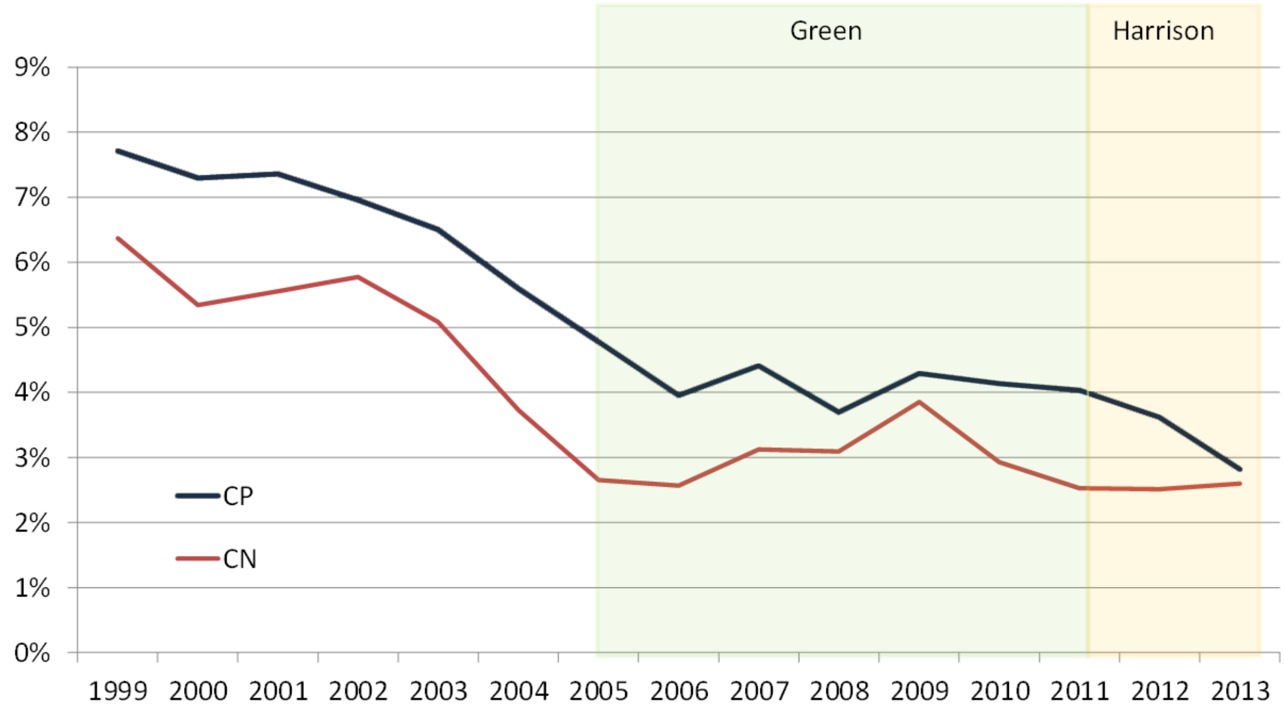
Evolution of ratios and operating statistics



Salary and benefits as a % of total revenues



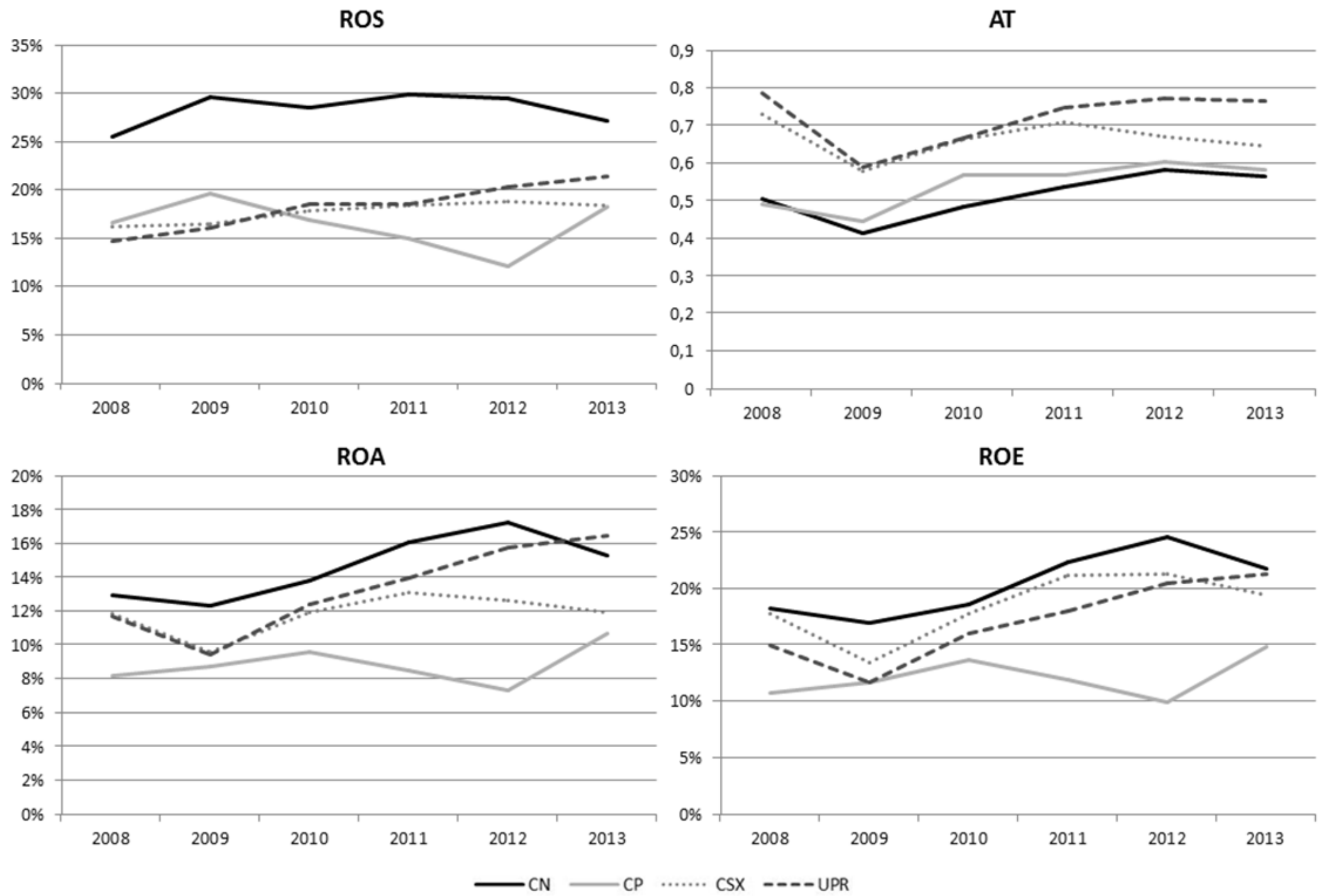
Fuel expenses as a % of total revenues



Fuel expenses as a % of total revenues

Appendix VI

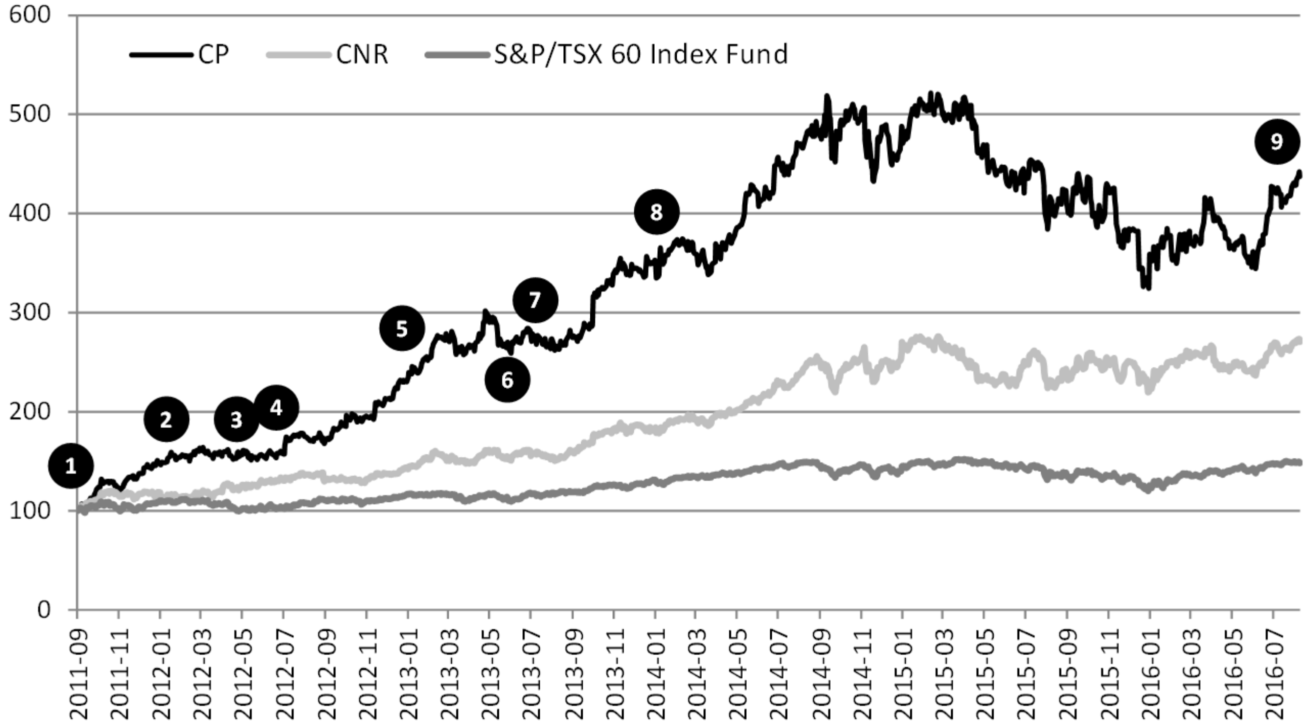
Selection of Performance Indicators



Class 1 Companies, Railroad Industry (2008-2013)

Appendix VII

CP's Share Price* Evolution Comparatively to CN and the S&P/TSX 60 Index, from September 23, 2011, to August 31, 2016 (Basis 100)



**Prices adjusted for dividends and splits. Source of data: http://www.finance.yahoo.com*

1. Beginning of shares purchases by Pershing Square in order to acquire an interest in the CP (September 23, 2011)
2. Public Town Hall Meeting in Toronto held by William Ackman to denounce CP's management and governance, and asking shareholders to vote for a change (February 6, 2012)
3. Annual Meeting of Shareholders, vote in favor of Pershing Square's proposal for change (May 17, 2012)
4. Hunter Harrison is appointed CEO, following his election as Director on CP's Board (June 28, 2012)
5. 2012 Fourth quarter results (January 29, 2013). 6 months after Hunter Harrison's arrival, the operating ratio for the quarter reaches 74.8%, comparatively to 78.5% for the same quarter a year before.
6. Pershing Square announce its intent to sell about 30% of its interest in the CP (June 3, 2013)
7. Disclosure of 2013 first semester results (July 24, 2013). The operating ratio for the period reaches 73.9% comparatively ton81.3% for the same period a year before. These results mark the first year anniversary of Hunter Harrison's tenure.
8. On January 29, 2014, the CP disclosed its 2013 4th quarter results. The operating ratio was reduced to 65.9% for the quarter, and to 69.9% for the year, relatively to 74.8% and 77% for the comparable periods, respectively. Hunter Harrison was named CEO of the year for 2013 by Morningstar and Top Turnaround CEO of the Year by Canadian Business.
9. August 2016, Pershing Square sells the remaining shares of CP and officially exits.

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Professor Yvan Allaire is the Executive Chair of the Institute for Governance of Public and Private Organizations (IGOPP). A professor of strategy for many years, he co-founded the strategy consulting group SÉCOR Inc., and was executive vice-president at Bombardier Inc (1996-2001) and Chairman of Bombardier Capital (1999-2001). Professor Allaire was also Chair of the Global Council on the Role of Business of the World Economic Forum in 2013 and 2014.

Professor Allaire is the author of several IGOPP policy papers, which offer new perspectives on a range of controversial issues including dual-class voting shares, corporate citizenship, the place of women on boards of directors, say-on-pay by shareholders and executive compensation, among others. Prolific author, Professor Allaire has published many award-winning articles on strategy and is the co-author of several books on strategy and governance.

Yvan Allaire holds a B.Sc. Com (Summa cum laude) and an MBA from Université de Sherbrooke, and a Ph.D. from the Massachusetts Institute of Technology (MIT). He is a Fellow of the Royal Society of Canada.

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