



## CN Keeps Chugging Along

### Description

I wonder how many times some derivation of this title has been used as an intro for this railroad king? Another year is in the books for **CN Rail** (TSX:CNR,NYSE:CNI) and the company has produced yet another round of outstanding results.

Q4 and 2012 broke records for CNR in terms of carloads, revenues, and revenue ton-miles. The company generated \$1 billion in free cash flow in 2012 and is rewarding shareholders with a 15% bump to the quarterly dividend. Adjusted earnings per share for the full year were \$5.61, and CN management expects to grow this figure in the high single digits in 2013. The company expects the transport of energy-related products to be a primary driver of earnings growth, as North American pipeline capacity remains constrained.

That's all positive news as far as I can tell. Of course, the stock was down 1% or so on the day!

### Cream of the crop

Pure and simple, this is one of Canada's finest companies and based on its operating ratio, CN is the best run railroad in North America. If his friend Bill Gates didn't already own 10% of CN, would this have been the railroad that Warren Buffet chose to invest in, instead of Burlington Northern?

For the full year 2012, CN's operating ratio, which compares operating expenses to revenues (lower is better), checked in at 62.9%, an improvement of 0.6% from the year before. According to figures derived from Capital IQ, U.S. peers Union Pacific came in at 68.1%, CSX managed 70.4%, and Norfolk Southern posted 71.3%. The gap is even larger when compared to CN's chief Canadian rival, **CP Rail** (TSX:CP,NYSE:CP) and its 78.1% ratio.

Over the past year, however, this operating gap over its rival has not translated to better stock performance. CN's stock price has generated a 19% return for investors since January 2012, while CP has increased by 53%. CP was all over the financial headlines throughout 2012, as famed investor Bill Ackman renovated the company's executive suite and parachuted in retired CN CEO Hunter Harrison to help close the operating gap between the two companies. The market smiled upon this move, and CP's stock reacted accordingly.

## What's done is done

As investors, we must be aware of these past events, but always looking to the future. Yes, CP was the better stock in 2012. But what about 2013, and more importantly, beyond? The table below outlines a range of possible one-year expected prices for CN's stock. I am taking the company's management at its word and assuming high single-digit EPS growth for next year. In addition, the range of possible multiples are based on historical levels.

		P/E Multiple Range			
EPS Growth	EPS	15	16	17	18
7.0%	\$6.00	\$90.04	\$96.04	\$102.05	\$108.05
8.0%	\$6.06	\$90.88	\$96.94	\$103.00	\$109.06
9.0%	\$6.11	\$91.72	\$97.84	\$103.95	\$110.07

We arrive at a high of \$110 and low of \$90, or upside of 19% and downside of 2%, when the 1.8% yield is factored in. Let's assign a 50-50 probability to both outcomes, and therefore target a 2013 total return for CN of 8.5%.

Now, that doesn't look like much, but CN is not necessarily built to perform over one-year periods. With a tremendous track record of blowing the doors off the competition, this is a company you buy and hold, and hold, and hold – just like Buffet will do with Burlington Northern. In some years, CN's stock will provide a return of 19%, and in some years it will go down 2%. But if it is able to generate a CAGR of 8.5%, investors could double their money every nine years by owning this stock.

## Priced in

As for CP, the outlook is far less certain. I have the utmost respect for the two principal players – Harrison and Ackman. I've had the pleasure of meeting Harrison, and a more passionate and capable executive you will not find. His track record in bringing CN to where it is today speaks for itself. I admire Ackman so much that I went out and bought (and am underwater on) a small slice of JC Penney – his U.S. department-store turnaround idea.

However, after its tremendous run over the past 12 months, CP now trades with an earnings multiple of 27 – compared to CN's at just a little more than 16. Given that CP's operating ratio hasn't even begun to approach the peer group's, let alone CN's, one has to believe that the stock's value already reflects Harrison's and Ackman's capabilities.

### **Bet on the turtle**

This time next year, and for years to come, I expect a very similar report from CN's management, and a very favourable, risk-adjusted return for CN's investors. I don't have the same degree of confidence that CP offers the same scenario.

At this point in the race, I feel far more comfortable predicting an 8.5% CAGR over the next five to 10 years for CN than I do for CP.

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*Fool contributor Iain Butler owns shares and is short put options in JC Penney. David Gardner owns shares of Canadian National Railway.*

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1. Investing

### **TICKERS GLOBAL**

1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:CP (Canadian Pacific Railway)
3. TSX:CNR (Canadian National Railway Company)
4. TSX:CP (Canadian Pacific Railway)

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### **Date**

2025/08/23

### **Date Created**

2013/01/22

### **Author**

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