The ABCs of Investing in Railroads: Canadian Pacific vs. Canadian National

Description

By Christine Conway

"The success or failure of a railroad is not based on the economy. It's based on how you control the costs." — E. Hunter Harrison

E. Hunter Harrison became CEO of **Canadian Pacific Railway** (TSX:CP, NYSE:CP) in July 2012; previous to that, he served as the chief executive of **Canadian National Railway** (TSX: CNR, NYSE:CNI) through 2009. Few people know the railways better.

In December 2012, Harrison told *The Globe & Mail*, "Canada, within 18 months, will have two of the most successful railways in the world." It's been about eight months since he made that statement, and we can start to measure the progress that's been made. Let's take a look at both Canadian Pacific and Canadian National to see how they're managing the cost of operations and dealing with the changing price of fuel and safety costs.

Measuring efficiency
It's an obvious point, but in the rail industry, there are a number of things out of each company's control, including the cost of fuel, the Canadian dollar, changes in industry regulations, and so on. In order to be successful, these costs must be very carefully watched. We can get a quick measure of how well the railroads are doing by looking at the operating ratio, which is a good gauge to find which companies are most efficient and productive.

The operating ratio takes a look at how much of the money coming in from sales is used in operations. The less it costs to get the job done, the better. This quarter, Canadian Pacific's operating ratio was 71.9%; Canadian National's was 60.9%. Canadian National is the more efficient operator, but Canadian Pacific is improving: in the second quarter of 2012, its operating ratio was 82.5%.

Controlling costs
Controlling costs is about managing big-ticket items — those that eat up most of the budget and therefore eat into profits. These items include the standard expenses of compensation & benefits, materials, and equipment rentals. However, the rail industry has specific challenges like managing the

cost of fuel and safety.

To offset fluctuations in fuel charges, the rail companies have fuel cost recovery systems in place, which allow them to pass some of the fluctuation to the shippers of the goods through contracts and fees.

Companies can also mitigate larger fuel price movements through the use of futures contracts. In March 2013, Canadian Pacific settled its outstanding diesel futures contracts, and in its second-quarter report it said it had exited its hedging program. By June 30, there were no diesel futures contracts remaining.

The ability to move goods safely is both a corporate responsibility and a huge cost. When tragic events like the accident that took place in Lac-Mégantic hit the news, companies have to show that they are doing all that they can to keep safety a priority. For Canadian National, between 18%-20% of revenues is invested in capital program focused on safety. These programs involve training staff and using technology to monitor the tracks and keep them clear.

Where the railroad companies stand right now
Canadian Pacific pays a lower dividend and has had lower growth over the past three years. But it's improving. Steadily and surely. Analysts are forecasting growth of 27% next year, versus 13% for Canadian National. CP has to be viewed for what it is — a company in transition. But as you can see from the P/E ratios below, the stock's valuation has priced in a lot of the upside from that transition.

Metric	**Canadian Pacific**	**Canadian National**
Current Price	$125.83	$98.36
Market Cap	$21.9 billion	$42.0 billion
Earnings Per Share	$3.24	$5.60
P/E	38.80	17.60
Forward P/E	15.83	14.64
Yield	1.1%	1.7%
Revenue growth, 2009-2012	8.8%	10.2%

Source: GlobeInvestorGold

With a lifetime of railroading under his belt, CEO Hunter Harrison has a track record to suggest that he can complete the turnaround and make CP an efficient railroad.

He's at an age when most of his colleagues would be out enjoying retirement. When he joined the firm, he made it clear that his role is a temporary one. With his named successor Keith Creel already being groomed, it remains to be seen if the changes will stick and if CP will be able to reward shareholders and not just contracts to move goods.

Canada's rail companies are no doubt 2 of the best businesses that this country has to offer. For a glimpse at 3 of the best that our neighbors to the south can muster, **click here now** and download "**3 U.S. Stocks That Every Canadian Should Own**". It's **FREE!**

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Fool contributor Christine Conway doesn't own shares in any of the companies mentioned at this time. David Gardner owns shares of CN Rail. The Motley Fool doesn't own shares in any of the companies mentioned.

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