CN Rail and CP Rail Offer a Diversified Play on Canada's Oil Patch

Description

It's fast becoming clear that a lack of transportation infrastructure, particularly oil pipelines, is acting as a significant constraint on the development of Canada's oil industry. The industry has become a critical driver of economic growth in Canada and is now one of the most important components of GDP by industry.

The scale of the problem caused by insufficient transportation infrastructure is illustrated by a Canadian Chamber of Commerce report released in September 2013. The report estimated it was costing the Canadian economy as much as $50 million a day.

Clearly with **TransCanada's** (TSX:TRP) (NYSE:TRP) Keystone Pipeline effectively on ice, other means of transportation are desperately needed to fill the gap. Otherwise Canada's economic growth will slow and it will cause significant damage to the industry. High volume bitumen and heavy oil producers **Suncor** (TSX:SU)(NYSE:SU), **Imperial Oil** (TSX:IMO)(NYSE:IMO) and **Canadian Natural Resources** (TSX:CNQ)(NYSE:CNQ) will see margins and profitability deteriorate.

How can the infrastructure gap be filled?

Canada's rail industry is stepping in to fill the gap as quickly as commercially possible. Already over the last five years the amount of crude transported by rail exploded by a whopping 28,000%. Boosting the profitability of Canada's main rail companies **Canadian National Railway Company** (TSX:CNR) (NYSE:CNI) and **Canadian Pacific Railway** (TSX:CP) (NYSE:CP). Both have significant transcontinental rail networks and the ability to readily transport considerable amounts of bitumen and heavy crude.

The scale of the forecast growth in the transportation of bitumen and heavy oil by rail becomes apparent with the Railway Association of Canada expecting up to 140,000 carloads of crude or the equivalent of 230,000 barrel per day. This is significantly higher than the 500 carloads transported in 2009.

Despite rail transportation of bitumen and crude being more costly than pipeline transportation, by around $10 to 15 per barrel, it does have one advantage over pipelines. The bitumen and heavy crude transported by rail does not require costly diluents in order to transport it – because it' transported in specially heated railcars – reducing production costs. This creates an incentive for bitumen and heavy crude producers to consider rail in preference to pipelines.

As such, the rail industry expects the volume of bitumen and crude to continue growing exponentially, boding well for the growth of the bottom-line of Canada's two largest rail companies.

Feeling the flow

The positive financial impact of the growth in crude transported by rail can be seen in both CNR's and CP's third quarter 2013 financial results. For that period CN reported an eight percent year-over-year increase in revenue and a six percent increase in net income.

For the same period, CP reported an eight percent increase in revenue and 45% in its bottom-line.

But do they appear attractively valued?

But the question that arises is just how cheap are CN and CP in comparison to the oil majors and the pipeline companies TransCanada and **Enbridge** (TSX:ENB)(NYSE:ENB).

Now let's takes a closer look at the valuation ratios of these companies to see just how cheap Canada's two major rail companies appear.

Company	Enterprise Value	EV-to–EBITDA	Price-to-Earnings	Price-to-Boo
CN Rail	$54 billion	12	18	4
CP Rail	$30 billion	14	31	4
Enbridge	$59 billion	21	40	5
TransCanada	$55 billion	16	20	2
Suncor	$58 billion	5	18	1
Imperial Oil	$43 billion	9	13	2
Cdn Natural Resources	$44 billion	7	15	1
Cenovus	$27 billion	7	36	2

Husky Energy	$32billion	6	14	2

Source: Company Financial Filings, Yahoo Finance and Y Charts.

On the basis of these the ratios in the table it Canadian National appears to be far better value than Canadian Pacific. But it still appears expensive in comparison to major integrated oil companies such as Suncor, Canadian Natural Resources and **Husky Energy** (TSX:HSE).

However, both rail companies appear more attractively value than oil infrastructure companies Enbridge and TransCanada. Both are facing their own problems with expanding their existing pipeline infrastructure, which is impacting their future growth prospects.

Foolish bottom line

Both rail companies have the capability to fill the gap left by the lack of pipeline infrastructure in Canada. With the oil industry expecting production to continue growing, the volumes transported by rail will only increase, which bodes well for the bottom-line of both companies. I believe making them an attractive and diversified play on Canada's oil patch.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
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