The Stock Picker’s Guide to Canadian Pacific Railways in 2014

Description

Canadian Pacific Railway (TSX: CP)(NYSE:CP) is one of the major recovery stories of the past 18 months, with a share price that has already more than doubled since industry veteran Hunter Harrison took over as CEO in June 2012. His business strategy was simple – improve asset utilisation and operating efficiency and reduce costs.

The improvements have been dramatic – a considerable increase in the operating profit margin, a doubling of the net profit margin and an increase in the adjusted 2013 earnings per share of 49% compared to 2012.

Does the story have more legs?

The actions taken by the new CEO since mid-2012 (some are still work in progress) included a substantial reduction in the workforce, the installation of longer sidings to improve asset utilisation, the relocation of the corporate headquarters to a railway yard, the reduction of the active locomotive fleet and railway cars and the identification and intended sale of surplus real estate.

All the key railcar operating measures, including train weight, train length, car velocity and terminal dwell, improved during this period. Also of significant note is that operating expenses including the major expense items of compensation and purchased services declined by 2% during 2013, indicating the considerable focus on cost control.

Moreover, the cost-cutting did not negatively impact freight revenue generation, which moved ahead by 8% during 2013. Top performing categories were grain, fertilisers and industrial and consumer products. In this regard, carloads were flat for the year but revenues per carload went up by 7%, indicating a higher level of profitability per carload. The all-important operating ratio (the percentage of revenue required to pay for operational expenses) improved from 82.5% in June 2012 to a best-in-class comparable level of 65.9% in the fourth quarter of 2013.

Some would argue that the easy part is over now and that it will become increasingly difficult to drive further operating efficiencies and cost reductions. Based on a comparison of the latest financial results from Canadian Pacific with other industry-leading Class 1 North American railroad operators, it would seem that the company still has some room to improve the operating ratio, profit margins, cash flow generation and return on invested capital. However, the gap has now already narrowed to a level where it would seem that Canadian Pacific will be able to match best in class performance measures in 2014 or latest 2015.

During the coming year, the investor focus will shift from operational efficiency improvements to the ability of the company to grow revenue based on a more efficient operating cost structure and the optimal use of the balance sheet, including higher dividend payments and share buybacks.

Foolish bottom line

As admirable as the 2013 performance was, the share is priced for the good news to continue, trading on an expected 2014 price to earnings ratio of 20 times. This is not cheap compared to other Class 1 railroad companies or to the overall market. The CEO indicated on the recent analysts' conference call that he still sees considerable scope to improve the business performance in the years ahead. Any indication that the plan is not progressing as expected may be met with disappointment.

However, this is a company with a strong franchise, a much improved operating performance and more good news to come that I would like to own for the long run. However, I'll wait for a more attractive pricing point to invest.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CP (Canadian Pacific Railway)
2. TSX:CP (Canadian Pacific Railway)

Category

1. Investing

Date
2025/08/23
Date Created
2014/01/31
Author
deonvernooy