Investors Cheer Canadian Pacific's Recent Announcement: Should You Buy, Too?

Description

On Wednesday, the board of **Canadian Pacific Railway** (TSX: CP)(NYSE: CP) announced that Chief Executive Officer Hunter Harrison agreed to a contract extension with the railway for an additional year.

Investors cheered the news, sending Canadian Pacific stock up nearly 1.5%. Harrison joined Canadian Pacific in June, 2012 with an agreement for four years, plus an option for an additional year. With this extension, Hunter Harrison will be with the railroad until 2017.

A playbook for operational excellence

Harrison has successful brought his playbook for improved operational and financial performance to Canadian Pacific from his time leading rival **Canadian National** (TSX: CNR)(NYSE: CNI). Mr. Harrison served as its Executive Vice President and Chief Operating Officer from 1998 to 2002, and President and Chief Executive Officer from 2003 until 2009.

The plan to improve operational efficiency at Canadian Pacific has focused on reducing employee counts, running longer and faster trains, making better use of assets, and adopting new technologies to use less fuel and make workers more productive.

The plan has come together as advertised, and the result has been significantly higher earnings, cash flow, and impressive returns for Canadian Pacific shareholders.

A railroad's operating ratio, its operating expenses as a percentage of revenue, is the ultimate indicator of efficiency and management effectiveness. A low operating ratio means more revenue flows to the bottom line as profit, and gives the company added flexibility to lower prices and gain market share.

At the end of 2012, Canadian Pacific's operating ratio was 77%. The company's goal is to reduce that figure to 65% by next year. Hunter Harrison took 12 years to accomplish a similar task at Canadian National, reducing its operating ratio from 77% in 1997 to 66% in 2009. But it appears that Hunter Harrison is on track to achieving Canadian Pacific's operating ratio target one year ahead of schedule, and significantly faster than what he accomplished at Canadian National.

Record first-quarter performance

The contract extension for Hunter Harrison follows Canadian Pacific's impressive first-quarter results announced April 22. According to most measures, it was a record performance.

For the first quarter, total revenues increased just 1% to $1.5 billion, but operating income increased 17% to $423 million. And net income of $254 million, or $1.44 per diluted share, was an improvement of 16% from the same period a year earlier.

The most impressive figure achieved by Canadian Pacific during the quarter was its operating ratio of 72%, a 380 basis point improvement from the first quarter of 2013. The weather posed significant operational challenges for all railroads, and an improvement of this magnitude is impressive.

Priced for perfection

Despite the slower than expected start to 2014, Hunter Harrison reaffirmed his confidence in meeting expectations for revenue growth of between 6% and 7%, a full-year operating ratio of 65% or better, and earnings-per-share growth of greater than 30%.

At current valuations, including a price to earnings ratio exceeding 33, Canadian Pacific stock is priced for perfection. However, Mr. Harrison is well on his way to achieving the operating ratio target of 65% one year ahead of schedule.

CATEGORY

1. Investing

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