Which Railroad Belongs in Your Portfolio?

Description

It's a shame that the Canadian stock market doesn't give you many choices. Financial services, energy, and materials dominate our major indices, which creates a problem for investors looking for safety. After all, those three industries can suffer badly when the economy is not doing well.

One place where investors can count on steady earnings is the railroads. It's an industry with only two players in Canada, and insurmountable barriers to entry. As long as we need large quantities of goods moved (i.e., forever), the rails will continue to churn out cash flow and dividends for their investors.

But which one should you hold? Below, we take a look at each.

Canadian National Railway

Recent years have been very good for **Canadian National Railway** (TSX: CNR)(NYSE: CNI) and its shareholders. Over the past five years, its shares have returned nearly 24% per year, as improving economic conditions and the growth of crude by rail have helped the company grow revenue and earnings.

In 2013 alone, Canadian National earned just over $3 per share, not a lot for a company with a stock price north of $60. But even this $3 number may be overstating its earnings power. A railroad requires substantial capital investment just to maintain its fleet and track network. And since most of those costs are counted as investments rather than expenses, it can make the numbers look better than they really are. Last year Canadian National earned only $1.86 per share in free cash flow.

So Canadian National is clearly an expensive stock, but still may be worth the price. It has arguably the best track network of any railroad in North America, as it's the only one that reaches all three coasts (West Coast, East Coast, and Gulf Coast). And it has been the best-in-class operator for many years now. It's no wonder that so many top dividend funds count Canadian National as one of their largest holdings.

Canadian Pacific

If the last five years have been good to Canadian National, they've been even better for shareholders of **Canadian Pacific** (TSX: CP)(NYSE: CP). Over the past five years, Canadian Pacific's shares have returned nearly 35% per year. Over the past three years, it's been 45% per year.

The key event, of course, was activist investor Bill Ackman's involvement with the company, which led to the appointment of Hunter Harrison as CEO. Mr. Harrison has managed to bring Canadian Pacific's bloated cost structure under control, and investors have him to thank.

So how expensive are the company's shares? Well, in 2013 it made about $5 per share in earnings per share, and $4 in free cash flow per share. This is a very small amount for a $180 stock, and based on these measures, Canadian Pacific's shares are much more expensive than Canadian National's.

Investors are clearly hoping that Mr. Harrison can wring more cost savings out of Canadian Pacific, but he has already come a long way, and is close to meeting his promise for a 65% operating ratio. It's hard to see how much more he can do.

What should you do?

At this point, Canadian National has a cheaper stock and a better track record (no pun intended). So It looks like the better option for safety-focused investors.

CATEGORY

1. Investing

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

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