One Railroad Stock to Buy and One to Avoid

Description

After a severe winter that presented unparalleled operational challenges, the railways appear to be regaining lost momentum.

Despite record-breaking temperatures that affected much of Canada and the U.S. in December and January, the first quarter results for most of North America's leading railroads exceeded expectations. It should be pointed out, however, that forecasts were lowered somewhat as analysts factored in the impact of cold weather on railroad operations.

When it's extremely cold for extended periods of time, railways aren't terribly efficient. They need to run shorter trains, use more locomotives, and spend more money on fuel and labour. But with spring in the air, and summer just around the corner, freight is moving with greater speed and efficiency along the rails.

Despite the temporary, weather-related challenges, long-term railroad investors have done very well. Over the past five years, the Dow Jones U.S. Railroads Index is up approximately 220% compared to a gain of just over 100% for the S&P 500.

As long-term investors, we seek companies that offer the best opportunity to achieve market-beating returns. So, with this in mind, here are a few thoughts on one railroad you should consider buying, and one that you should avoid.

The case for Canadian National

Canadian National Railway (TSX: CNR)(NYSE: CNI) is North America's second-largest railroad, and its most efficient.

Canadian National achieved railroad supremacy by relentlessly focusing on its operations. Its operating ratio, the percentage of revenue consumed by operations, has declined from the high 90s in 1993 to 89% in 1995, and now sits at 69.6% for the first quarter of 2014. A low operating ratio allows more revenue to flow to the bottom line as profit, and provides added flexibility to use price strategically towin new business.

And then there is Chicago. If you travel by air frequently, you likely avoid connecting through Chicago during the winter if at all possible. Railroad operators feel the same way.

With the 2008 purchase of Elgin, Joliet, & Eastern Railway Company, Canadian National became North America's only transcontinental railway. It established a bypass around the western side of the heavily congested Chicago-area rail hub, alleviating substantial bottlenecks for both regional and continental rail traffic entering and exiting Chicago freight yards.

The benefit of that purchase was evident in Canadian National's first quarter. Unlike competitor **Canadian Pacific** (TSX: CP)(NYSE: CP), which moved 5% fewer revenue-ton-miles during the quarter, Canadian National actually moved 5% more RTM.

In terms of valuation, Canadian National is not the least expensive railroad stock, but it is definitely of the highest quality. Steady and consistent revenue growth; modest improvements in its operating ratio, strong cash flow, a growing dividend; and an effective management team make for a compelling investment thesis.

The case against Canadian Pacific

There is no debate — Canadian Pacific has enjoyed an incredible run since Hunter Harrison was appointed its Chief Executive Officer in June 2012. Over the past two years, Canadian Pacific stock has appreciated nearly 130% compared to a much more modest gain of 29% for the **S&P/TSX Composite Index** (TSX: ^OSPTX).

Today, Canadian Pacific is priced more like a technology growth stock than a railroad. Its trailing and forward price-to-earnings ratios trade at significant premiums to their five-year averages. With a price-to-earnings ratio of 36, Canadian Pacific is the most expensive Class 1 railroad by a wide margin. For comparison, competitors **Union Pacific** (NYSE: UNP) and Canadian National have P/E ratios of 20 and 21 respectively.

It appears that Canadian Pacific's largest shareholder has noticed the lofty heights reached by its stock. According to INK Research, Bill Ackman of Pershing Square Capital recently sold 3.2 million shares of its stake in Canadian Pacific for $533 million.

Priced to perfection is the best way to characterize Canadian Pacific's stock. If the management team is unable to deliver, and possibly surpass, expectations for earnings-per-share growth exceeding 30% in 2014, the stock is guaranteed to disappoint investors.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:CP (Canadian Pacific Railway)
3. NYSE:UNP (Union Pacific)
4. TSX:CNR (Canadian National Railway Company)
5. TSX:CP (Canadian Pacific Railway)

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