How You Can Profit From the Patch's Pipeline Crunch

Description

A growing lack of pipeline capacity is becoming a glaring headache for players in the patch and a major stumbling block for oil producers looking to increase production. Pipeline constraints are a key driver of the price differential between Canadian crude blends and West Texas Intermediate because they are preventing oil producers from getting their crude to key refining markets.

These constraints also affect the profitability of many oil producers in the patch, forcing them to use higher-cost rail transportation to get their crude to key markets. This is causing their operating netback per barrel of crude produced, which is a key measure of operational profitability, to drop.

However, this shouldn't prevent *investors* from profiting from Canada's growing crude production.

How can investors profit?

With **TransCanada's** (TSX: TRP)(NYSE: TRP) Keystone pipeline mired in political controversy, delaying approval of the critical southern leg, and other smaller pipelines awaiting regulatory approval, dependence on crude by rail continues to grow. Even TransCanada, Canada's second-largest midstream company has stated it is considering transporting crude by rail as a means of expanding its own crude transportation capacity.

This dependence on rail transportation can only grow exponentially, with Canadian crude production expected to expand by a massive 83% over the next 17 years to 6.4 million barrels daily. Even over the short term, crude production in the patch is expected to explode, with the Canadian Association of Petroleum Producers estimating that crude production will grow by 14% between now and 2016 to 4.2 million barrels daily.

Such a significant growth in crude production, coupled with a lack of pipeline capacity, will cause the volume of crude transported by rail to grow exponentially.

This has seen the CAPP forecast the volume of crude transported by rail to grow 2.5 times over the next two years to 700,000 barrels daily, representing a quarter of total forecast crude production.

What does this mean for investors?

This will be a boon for Canada's two key rail networks, **Canadian National Railway** (TSX: CNR)(NYSE: CNI) and **Canadian Pacific Railway** (TSX: CP)(NYSE: CP). Both have significant transcontinental rail networks, making them important players in the patch as they step in to fill the transportation gap left by the lack of pipeline capacity.

Both railway networks have dramatically increased their crude transportation capacity, with Canadian National's volume of crude transported by rail in 2013 almost doubling compared to 2012 . Canadian Pacific's volume of crude transported by rail for the same period shot up 60%.

For the first quarter of 2014, Canadian National's revenue from transporting petroleum products jumped 23% compared to the same period in 2013. Canadian Pacific's revenue from shipping industrial and consumer products, which includes crude, spiked 11% for the same period.

Canadian Pacific has also projected that revenue from shipping crude and other petroleum products will double to be 10% of the company's total revenue over the next two to three years.

This indicates that revenue, cash flow, and ultimately the bottom lines for both companies are set to grow, unlocking value for shareholders.

Canadian National appears to be the best value for investors, as it is seeing stronger revenue growth from crude transportation and is also more attractively priced than its rival. It has an enterprise value of 13 times EBITDA compared to Canadian Pacific's 16 times, and is trading with a price-to-earnings multiple of 16 times.

By investing in Canada's largest rail transport provider, investors will benefit from the growing demand for crude by rail and also diversify away from the patch. Both rail operators, while key providers of crude transportation capacity, receive considerable proportions of their revenue from freight, grain, and consumer products transportation, thus mitigating some of the investment risks associated solely with investing in crude production.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:CP (Canadian Pacific Railway)
3. NYSE:TRP (Tc Energy)
4. TSX:CNR (Canadian National Railway Company)
5. TSX:CP (Canadian Pacific Railway)
6. TSX:TRP (TC Energy Corporation)

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