How Will Moody's Upgraded Outlook for Railroads Affect Investors?

Description

Growing global energy demand, increasing Canadian and U.S. crude production, and pipeline transportation constraints have created a need for alternate transportation so that oil producers can access key refining markets. This has seen railroads step in to fill the gap, despite crude transportation by rail proving to be around $4-$8 more costly per barrel than pipelines.

Over the last five years, crude transportation by rail across North America has grown exponentially, with volume growing almost 300-fold between 2009 and 2013 in Canada and 400-fold in the U.S. This is proving to be a boon for North American railroads.

Why the outlook is growing increasingly positive?

Canada's two largest transcontinental rail networks, **Canadian National Railway** (TSX: CNR)(NYSE: CNI) and **Canadian Pacific Railway** (TSX: CP)(NYSE: CP), are already benefiting from greater demand for crude by rail transportation.

Both have seen the portion of their revenues generated through transporting crude surge since 2009, and this is contributing to a firmer bottom line. For the first quarter of 2014, Canadian National's earnings per share shot up 15% compared to the same quarter in 2013, and Canadian Pacific's spiked a healthy 17% for the same period.

With better-than-expected U.S. economic growth forecast for the second half of 2014, the demand for crude and other bulk freight transportation is expected rise significantly. According to Moody's, the fastest-growing segment of the major freight categories will be oil. This is obvious when the current pipeline crunch is considered in conjunction with Canadian crude production forecast to grow 36% over the next five years.

The growing importance of rail as a means of transporting crude is highlighted by **TransCanada's** (TSX: TRP)(NYSE: TRP) announcement that it is considering transporting crude by rail to fill the capacity gap created by delays in the approval of its controversial Keystone pipeline in order to meet customer demand.

According to Moody’s, all of these factors will cause freight volumes to grow 2%-3% over the next year in conjunction with pricing increases of 1%-2%. This translates into industry-wide revenue growth of 3%-5%, leading to higher cash flow and growing bottom lines for both Canadian National and Canadian Pacific.

What impact will this have on the patch?

However, the downside for players in the patch is that shipping crude by rail is more expensive than by pipeline at around $4-$5 more per barrel, while shipping heavy crude and bitumen by rail from the Canadian oil sands in Alberta to the U.S. Gulf Coast is estimated to be $7-$8 more expensive per barrel.

These additional transportation costs will eat into the margins, and ultimately the bottom lines, of players in the patch, with the worst affected being heavy oil and bitumen producers.

This is because Canadian light oil trades at a far lower discount to West Texas Intermediate than Canadian heavy crude and is far cheaper to transport, allowing light oil producers to generate higher margins, or netbacks per barrel. Currently light oil, or Edmonton Par, trades at an 8% discount to West Texas Intermediate, whereas heavy oil trades at a 16% discount, translating into lower netbacks for heavy oil producers.

This allows pure light and medium crude producers, including **Crescent Point Energy** (TSX: CPG)(NYSE: CPG) and **Lightstream Resources** (TSX: LTS) to generate impressive netbacks of over $50 per barrel. For the first quarter of 2014, they reported netbacks per barrel of crude produced of $52.65 and $56.11 respectively. This allows them to more easily absorb the higher transportation costs associated with transporting crude by rail.

In contrast, those players with the majority of their crude production weighted to heavy oil are generating significantly lower netbacks. For the first quarter of 2014, **Baytex Energy** (TSX: BTE)(NYSE: BTE), which has 76% of its production weighted to heavy oil, reported a netback of $36.55 per barrel. **Husky Energy** (TSX: HSE), with 23% of its total production weighted to heavy oil, reported a netback of $44.81 for its total production and oil sands production only generating a netback of $35.99 per barrel.

These figures highlight the thinner margins that heavy crude and oil sands producers are able to generate and the significant impact higher transportation costs associated with transporting heavy crude by rail will have on them. Even more concerning is that a number of industry analysts are expecting the price differential between Canadian heavy crude and West Texas Intermediate to widen as the impact of the pipeline crunch continues to affect pricing. This will see margins fall even lower when coupled with higher transportation costs.

What does this mean for investors?

Clearly, this upgraded outlook from Moody’s bodes well for the financial performance of Canada’s two major transcontinental railways. However, the increasing reliance on crude by rail bodes ill for the profit margins of heavy oil producers, with heavy oil’s higher transportation costs.

With Canadian crude production set to grow strongly, now is the time to consider investing in either of

Canada’s major rail companies. Both are set to see revenue, cash flow, and profits grow as demand for crude by rail transportation explodes.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:BTE (Baytex Energy Corp.)
2. TSX:CNR (Canadian National Railway Company)
3. TSX:CP (Canadian Pacific Railway)
4. TSX:VRN (Veren Inc.)

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