Do Canadian National and Canadian Pacific Belong in Your Portfolio?

Description

The U.S. oil revolution of the last few years has not only benefited the oil exploration and production companies. Crude by rail — the transport of crude oil by train — has caused a surging demand for railcars, and the supply cannot keep up. That doesn't mean that our Canadian railways are good investments. Here are three reasons why I think neither company is a secure investment at these costs.

Expensive valuation

Both **Canadian National Railway** (TSX: CNR)(NYSE: CNI) and **Canadian Pacific** (TSX: CP)(NYSE: CP) are expensive on a valuation basis trading at price-to-earnings ratios of 22.45 and 38.14 respectively. High valuations are warranted considering that the rail business has high barriers of entry because of the massive capital investments that are needed to build a network and the regulations in place.

Nevertheless, with P/Es over 20, both companies are overvalued in my opinion. With such high metrics, it goes without saying that the dividend is abysmal considering that this is essentially a duopoly in Canada. Canadian National has a 1.4% yield while Canadian Pacific's dividend yields 0.7%.

Capital intensive

The rail transport sector is one where capital expenditure just for maintenance is extremely high. For example, in 2013 Canadian Pacific spent $1.2 billion on capital expenditures while making $1.9 billion in operating cash flows. It's also worth noting that we are in an environment where demand is extremely high for railcars. Average operating cash flows in the last four years were about $1.07 billion, while CAPEX have always been around $1.05 billion. So while the current environment is positive for both companies, once demand starts to slow down there might be less cash going into the coffers of both companies.

Competition for crude by rail

Right now transporting oil by rail is the cheapest and fastest way in North America. Mostly because the pipeline network currently in place is not built for the increases in production that the shale oil revolution brought. Pipeline companies are busy building their network to accommodate the added supply and when completed, it will take a lot of the demand away from rail cars. Pipelines might be less versatile in where they can move oil, but they are much cheaper and safer than using conventional rail cars. I do not think that the current level of revenues and profit from both companies is sustainable in the mid to long term. I would not invest under the assumption that revenues will not drop with the added competition entering the market.

Heavy regulation in the aftermath of the latest tragedy

The tragedy at Lac-Megantic in Quebec in 2013 raised concerns over the transportation of oil by railcars that often travel straight through densely populated areas. Residents of many cities went to their representatives and asked for more severe regulations concerning safety. This civil concern added even more pressure to companies in this sector to invest more capital in their equipment given the severity of accidents, and we can assume increased capital expenditures in the coming years.

The last few years have been kind to rail operators thanks to the shale oil revolution in the United States and the lack of pipelines available. Fools should remember that being a long-term investor does not force you to buy at any valuation, far from it. Sometimes it is better to let the train pass you by.

CATEGORY

1. Investing

TICKERS GLOBAL

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

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