



## Can Canadian Pacific Railway Maintain its Incredible Momentum?

### Description

**Canadian Pacific** ([TSX: CP](#))([NYSE: CP](#)) reported second-quarter results recently, and it appears to be defying gravity and all naysayers. It delivered another record quarter, the best in the company's 133-year history and did so despite continued operational challenges in the U.S. Midwest after a harsh winter.

For the second quarter, total revenues increased an impressive 12% to \$1.68 billion and operating income grew an astounding 40% to \$587 million. Reported net income in the second quarter was \$371 million, or \$2.11 per diluted share, versus \$252 million, or \$1.43 per share, in the second quarter of 2013. This represents a 48% year-over-year improvement in earnings per share, and \$0.01 better than the consensus estimate.

Here are two important takeaways from Canadian Pacific's latest earnings release, and what it means for investors.

### Exceeding expectations

With two quarters in the books, Canadian Pacific is well on its way to surpassing expectations it set for 2014. So far this year, revenue is up 7% and EPS is better by 33%, exceeding guidance on both accounts. And for the all-important operating ratio, Canadian Pacific's first half performance of 68.3%, 560 basis points lower compared to the first half of 2013, demonstrates solid progress towards its full-year objective of 65% or better.

It's important to put this progress, particularly with respect to Canadian Pacific's operating ratio, into perspective. At the end of 2012, Canadian Pacific's operating ratio — how much of its revenue goes toward funding operations — was 77%. The company's goal was to reduce it to 65% by 2015, initially thought impossible by many analysts, appears well in hand. Hunter Harrison, Canadian Pacific's current CEO, took 12 years to accomplish a similar task when he was at **Canadian National Railway** ([TSX: CNR](#))([NYSE: CNI](#)), reducing its operating ratio from 77.3% in 1997 to 66.7% in 2009. The team at Canadian Pacific is on track to a similar achievement in just three years.

It appears that if you've already designed the playbook, implementing it a second time can be

done that much more quickly.

## Going with the grain

If there is one area of concern in Canadian Pacific's second-quarter results, it would be the company's reliance on grain revenue.

The 13% revenue gain achieved during the second quarter was due primarily to the increased movement of Canadian and U.S. grain. For Canadian grain, revenues were up 32% on 28% more carloads and 34% greater revenue ton miles (RTM). And for U.S. grain, revenue was up 26% for the quarter, driven by 5% more carloads and an 11% increase in revenue ton miles (RTM).

Western Canadian farmers harvested a record 80 million tonnes of grain and oilseed last year, a crop 27% above the previous 2008-2009 record and 37% above the five-year average. And in the U.S., the yield was well above its five-year average. After a slow start, that crop is now getting to market in earnest. And given the sizeable backlog, grain transport should provide a considerable tailwind to Canadian Pacific's results for the balance of 2014 and into 2015.

But long-term investors should pay careful attention to how a smaller revenue contribution from U.S. and Canadian grain will affect results near the end of 2015, and into 2016.

## What's a Foolish investor to do?

Canadian Pacific stock has been priced for perfection for well over a year – and for investors, it's delivered. The stock is up 32% YTD, and 62% over the past 12 months. Today, the stock sports a lofty P/E ratio of around 40, the highest among Tier I railroads, along with the lowest dividend yield of 0.70%. Continued strong stock gains will require Canadian Pacific to not only exceed already lofty expectations, but also be supported by a strengthening economy. If either fails to materialize, Canadian Pacific stock may just run out of track.

## CATEGORY

1. Investing

## TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
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3. TSX:CNR (Canadian National Railway Company)
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## Author

jklacey

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