Is It Too Late to Buy Canadian National Railway Company?

Description

Over the past five years, shareholders of **Canadian National Railway Company** (TSX: CNR)(NYSE: CNI) have been on a wonderful ride – during this time, the shares are up 166%, including 38% just in the past 12 months. The North American economic recovery and the growth of crude-by-rail have helped considerably.

So that leaves the all-important question: is it too late to buy the shares? Below we take a look at the arguments for and against, in an attempt to reach a verdict.

A powerful franchise

There is perhaps no industry more secure than railroads. For one, there are a limited number of competitors, with only six major carriers in North America. Better yet, these six railways generally cover different geographies, further reducing industry rivalries. And this is not going to change – the barriers to entry are far too high for a new competitor to enter. Finally, railways offer an essential service, one that we will need for decades if not centuries.

CN Rail is especially well-positioned, with arguably the best track network of any of the major carriers. It's the only network that reaches the West Coast, East Coast, and Gulf Coast. This allows CN to ship goods to many destinations without the costly delay of switching rail cars onto other carriers' networks (this is especially important in the growing crude-by-rail market, which is facing a shortage of tank cars).

Best of all, CN has been the most efficient railroad for many years. To illustrate, over the last three years, its operating ratio (operating expenses divided by revenue) has averaged just over 63%, which is lower than each of the other railroads.

So as CN continues to expand its services, you can be sure that its investment dollars will generate a solid return for a long time. As an investor, what more can you ask for?

An expensive stock

At this point, there is really only one major argument for staying away from CN Rail: the stock price.

Last year, CN made $3.09 per share in net income, and only $1.86 in free cash flow, yet the shares still trade north of $70. As a result, the shares only yield 1.4%, even though the company pays out a majority of its free cash flow in dividends.

There are other (more minor) drawbacks. One is the capital intensive nature of railroads. Or, in plain English, railroads are very costly to maintain. So much of a railway's investment dollars do not contribute to growth; rather, they go towards simply maintaining the current state. This limits the extent to which railroads can grow earnings and dividends.

Railroads are also subject to heavy regulation. So they cannot simply set whatever prices they want. And this regulatory burden increased in recent months. In fact just last Friday new federal measures require CN to ship 536,250 tonnes of grain through the fall harvest season. CEO Claude Mongeau called the mandate a "burdensome and ill-advised regulatory intervention."

No home runs

If you're looking for a solid franchise to hold for a long time, CN Rail is a great candidate. But for the rest of us, there is limited upside in holding the shares. Your best bet may be to wait for a better opportunity.

CATEGORY

1. Investing

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