3 Reasons to Avoid Canadian Pacific Railway Limited

Description

Over the last five years, investors in **Canadian Pacific Railway Limited** (TSX: CP)(NYSE: CP) have been a happy group. After a somewhat lacklustre performance between 2009 and 2011, billionaire investor Bill Ackman came in and influenced the company to shake things up. Ackman essentially forced out then-CEO Fred Green, replacing him with former **Canadian National Railway Company** (TSX: CNR)(NYSE: CNI) head E. Hunter Harrison.

Since Harrison took over, the stock has been on a tear. Shares are up nearly 300% based on increased rail traffic used by Alberta's energy patch, as well as increased grain transport. Costs have also been cut, which helped lead the company to great results in 2013, with profit coming in at nearly $5 per share. Based on that, shares have recently broken through $200, resting today at around $207 each.

Considering the company's impressive results, should investors start loading shares into their accounts? Hardly. I'd avoid the stock, especially at these levels. Here are three reasons why.

1. Valuation

Although it's backed by solid results, there's no denying that Canadian Pacific Rail is an expensive stock.

As mentioned, the company earned almost $5 per share in 2013 on revenue growth of approximately 10% year over year. Results so far in 2014 have been good, putting the company's trailing 12-month earnings at $5.84 per share. Based on those earnings, shares trade at more than 35 times earnings.

That's expensive for even a high-growth technology name, and especially so for this company. Earnings are expected to rise to $8.58 per share in 2014, but that's including some very ambitious targets. Both third and fourth quarter earnings will need to rise more than 40% higher than last year just to meet expectations. Even if the company does hit its ambitious price target, it still trades at 24 times forward earnings. That's expensive, no matter how you justify it.

One small earnings stumble could send shares of Canadian Pacific down sharply. That's the nature of stocks that are dealing with such growth.

2. Pipeline capacity

To characterize Canadian Pacific Rail's success as an oil-by-rail story is simplistic, but the fact remains that it has taken advantage of this trend.

For the most part, business looks good. Pipeline capacity is woefully inadequate, and new terminals are popping up everywhere to facilitate the transfer of crude onto rail cars. If you believe the management of both Canadian Pacific and Canadian National, the cost of shipping oil by train isn't much higher than by pipeline.

Of course, pipeline operators know this as well, and are pushing hard to add the pipeline capacity needed to capitalize on this trend. **Enbridge Inc** made headlines earlier this year with the approval of the Northern Gateway pipeline, and **TransCanada Corporation's** Keystone XL pipeline should get approved sometime in 2015. Other players in the sector are also adding pipeline capacity. These projects won't make a huge difference in the short term, but in the long term they could take a big bite out of the oil-by-rail business.

3. Grain transport

Ottawa recently instituted a new law called the Fair Rail for Grain Farmers Act, which stipulates that both Canadian Pacific and Canadian National must dedicate a certain percentage of their fleet toward transporting grain. Farmers were upset over the winter when both railroads didn't bother to transport last year's bounty, since they were too busy with oil. This led to the government stepping in and creating this new law.

In the long run though, the act may prove unnecessary. Crop yields hit record levels in 2013, and were also strong in 2012. This year's crops, however, aren't looking nearly as good. Both Saskatchewan and Manitoba were ravaged by floods, and Alberta has seen its share of nasty weather.

For Canadian Pacific, it's simple. Less harvested grain is bad for business. It won't make a huge difference, but the company needs operations to run smoothly if it's going to meet those ambitious growth targets.

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