Why Canadian National Railway Company Should Be in Your Portfolio

Description

The U.S. oil revolution has caused a tremendous increase in demand for the rail business. Indeed, the transport of oil by rail has caused a surging demand for railcars, and the supply cannot keep up. High barriers to entry and long delays on pipeline projects are two of many reasons why I think **Canadian National Railway Company** (TSX: CNR)(NYSE: CNI) is a strong long-term investment.

Capital intensive

The rail transport sector is one where capital expenditure just for maintenance is extremely high. For example, last quarter Canadian National spent $442 million on capital expenditures while making $1.16 billion in operating cash flows.

Considering that we are in an environment where demand is extremely high for railcars—the company has added five hundred locomotives since the back end of the recession—we can expect capital expenditures to be in the high range of management guidance of 18% to 20% of revenues. This is good news for the consumers of that service, and it keeps on adding to the barriers of entry of the sector.

Few competitors

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. The price-to-earnings ratio for Canadian National is at 23 as of today, and while it is not cheap on that metric, it is much cheaper than competitor **Canadian Pacific Railway Limited** (TSX: CP)(NYSE: CP) whose P/E ratio is over 33.

We have to remember that an industry with high barriers of entry will warrant a higher P/E ratio. I doubt we'll see both companies trading at a P/E in the low teens anytime soon. Given such high valuation, both dividend yield for the moment is minuscule with Canadian National at 1.4% yield while Canadian Pacific's dividend yields 0.7%.

Competition for crude by rail

Right now transporting oil by rail is the cheapest and fastest way in North America. The pipeline network currently in place is not built for the increases in production that the shale oil revolution brought. That being said, pipeline companies like **Enbridge Inc.** (TSX: ENB)(NYSE: ENB) and **TransCanada Corporation** (TSX: TRP)(NYSE: TRP) 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. That is because pipelines, while being less versatile in where they can move oil, are much cheaper and much safer than using conventional rail cars.

A positive note with the added capacity of pipeline companies is that it will free up railcars for the agriculture industry, which at the moment is being left behind due to the high demand for oil. I do not think that both our railroad companies will have any trouble finding clients for their railcars in the future. At the end of the day, moving products using rails is one the cheapest methods for long cross country trips.

Dividend hike or additional share buyback?

On the last conference call, when asked about potential M&A, management reiterated that its plan is to grow the business organically. While this might be meaningless at first, with free cash flow estimated to be at $2 billion for 2014, organic growth will be easily paid for with that cash, leaving the company executives with significant cash on the balance sheet.

Considering that mergers and acquisitions are not in the works, we can anticipate either an increase in the dividend or a more aggressive completion of the share buyback program. Either way, shareholders will be rewarded.

CATEGORY

1. Investing

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1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:CP (Canadian Pacific Railway)
3. NYSE:ENB (Enbridge Inc.)
4. NYSE:TRP (Tc Energy)
5. TSX:CNR (Canadian National Railway Company)
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