2 Reasons to Avoid Canadian Pacific Railway Limited, and 1 Stock to Buy Instead

Description

Over the past couple of years, few stocks have done as well as **Canadian Pacific** (TSX: CP)(NYSE: CP). Since the beginning of 2013, the stock has more than doubled.

Part of this is due to a much-improved environment for railroads. But most of the credit should go to Hunter Harrison, who was brought on as CEO thanks to a proxy fight led by activist investor Bill Ackman. Mr. Harrison has proved very adept at cutting costs and increasing efficiency — something he's done at other railroads before.

That being said, there are reasons to avoid shares of CP, and two are shown below. Then we highlight one stock you should buy instead.

1. A couple of headwinds

It's true that Canadian Pacific has done very well lately. To illustrate, it has lowered its operating ratio (which measures expenses as a percentage of revenue) from over 80% to less than 70% under Mr. Harrison's leadership. But there are a couple of things to watch out for: One is government regulation. And this has come to light in recent months, thanks to the Canadian government's mandates regarding the transportation of grain. Most recently, CP has been ordered to transport over 500,000 tons of grain per week through November 29 or face stiff fines. While this alone is little more than an annoyance, it does highlight just how vulnerable the rails are to the government's whim.

The other is a limited track network, which is not as extensive as that of rival **Canadian National Railway** (TSX: CNR)(NYSE: CNI). To illustrate, CP's network extends from Vancouver toward the East Coast — but not all the way — and as far south as Kansas City. Meanwhile, CN's network reaches the West Coast, East Coast, and Gulf Coast. So CN can more effectively serve its customers, which puts CP under constant pressure.

2. Price

CP trades at a very lofty valuation by almost any standard. According to Morningstar, it trades at over 21 times forward earnings. Suddenly, CN, at 19.4 times forward earnings, doesn't look so expensive.

The shares are also trading well above Mr. Ackman's projections when making the case for Mr. Harrison in early 2012. And those projections seemed optimistic at the time. So to no one's surprise, Mr. Ackman has sold down his CP stake.

1 stock to buy instead: CAE

CAE (TSX: CAE)(NYSE: CAE) is in the business of simulation-based products and services, which are used around the world by airlines and militaries.

Unlike the rails, CAE is not constrained by geography, and thus has far more room to grow. Most promising is growth from emerging markets such as China, where increased air travel is placing greater need for both planes and simulators. There's also a looming pilot shortage, which places even greater need on CAE's services.

Better yet, CAE only trades at 15 times forward earnings. So there seems to be much more of a runway (no pun intended) with this company than with the rails, especially CP. The choice should be clear.

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