Is Now the Time to Buy Canada's Railway Companies?

Description

The past few years have been very good to Canada's railway companies and their shareholders. To illustrate, shares of **Canadian National Railway Company** (TSX: CNR)(NYSE: CNI) shares have tripled in the past five years, and **Canadian Pacific Railway Ltd** (TSX: CP)(NYSE: CP) shares have quadrupled in less than three years.

And the companies' prospects have never looked better. They are both operating very efficiently, and growth in industries like crude-by-rail holds plenty of promise.

But there are still reasons why this is the wrong time to buy the rails. Below we take a look at three.

1. Limited growth

Many people are very excited by growth prospects for the rails, especially in crude-by-rail. But one must remember a very important thing about this industry: growth is expensive. It requires upgrading tracks, buying new locomotives, and other capital expenditures that take a real bite out of cash flow.

To illustrate, let's take a look at Canadian National. From 2007 to 2013, its total volume, measured in revenue-ton-miles, increased by 2.2% per year. And during the past five years, the company has spent a total of $8.7 billion on capital expenditures and acquisitions – about three-quarters of its net income over this time.

There's a moral to this story: the rails can only grow so fast, no matter how much demand increases.

2. Government regulation

There is one other major impediment to growth: the actions of governments in Canada and the United States. Two headwinds in particular are worth highlighting.

One is the Canadian government's mandate regarding grain rail cars. In early August, both Canadian National and Canadian Pacific were ordered to transport at least 500,000 ton of grain per week until late November or face a fine. It was not the first such mandate delivered this year. And last week *The Wall Street Journal* reported that CN is having trouble meeting the minimum standard.

Another is regulation of crude by rail. In July, the Obama administration tightened standards in the wake of numerous rail car derailments, including one in Lac-Mégantic that killed 42 people. Among other measures, the new rules call for the phase out of DOT-111 tank cars over two years. Environmental groups had been calling for even tougher measures.

There’s a moral to this story as well: cracking down on the rails is not bad politics. And that spells bad news for CN and CP in the years ahead.

3. Price

This is the biggest reason to avoid the rails. Thanks to their price run-ups, CN and CP trade at 23.6 and 38.3 times earnings respectively. For companies with high capital requirements, modest growth prospects, and regulatory headwinds, that is too high a price to pay.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:CP (Canadian Pacific Railway)
3. TSX:CNR (Canadian National Railway Company)
4. TSX:CP (Canadian Pacific Railway)

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