



## Why Canadian Pacific Railway Limited Should Be in Every Investor's Portfolio

### Description

In **Canadian Pacific Railway Limited's** ([TSX: CP](#))([NYSE: CP](#)) recent history, it fell so deep into complacency that it found itself on a fast track to nowhere. And it is this history of being the most inefficient railroader in North America that attracted CEO Hunter Harrison, known for bringing **Canadian National Railway Company** ([TSX: CNR](#))([NYSE: CNI](#)) to its glory days.

Even more recently, Canadian Pacific Railway has been in the midst of a very successful turnaround that has shown productivity on the rise and returns to shareholders chugging along very nicely. A quick SWOT analysis of key variables reveals important facts about the company that have left me optimistic about the stock.

### Strengths

Once the biggest weakness at CP, its operating efficiency (or lack thereof) has quickly become one of its biggest strengths. By this, I mean the level of progress in this metric, which signifies the improvement in efficiency, has been mind-blowing. The company's operating ratio (operating expenses divided by revenue) has declined to just over 65%, versus the high of 81% in 2011. Variables such as train length, train velocity, and terminal dwell were all improved. Trains have more cars, are going faster, and spend less hours parked at terminals, all driving up efficiencies. Let's go back to see how this dramatic change came about.

At the helm of the transformation is Harrison, who is also well known for his 11-year tenure at Canadian National Railway, during which he transformed it from an inefficient mess in 1998 to one of the best-run — if not the best — railway companies in North America. He was brought in two years ago and has since added many old CN employees who were involved in CN's turnaround. Needless to say, these executives have a good track record, and they are cleaning up house by applying similar strategies they employed in CN's successful transformation.

### Weaknesses

A weakness that CP has is again related to its operating ratio. While the improvements have been impressive, the company is still behind CN, which has an operating ratio of closer to 63%. It is still one

of the most inefficient railroad companies in its peers group. However, this weakness is fast being eliminated.

## **Opportunity**

The opportunity lies in the fact that the company's operating ratio has a lot of room to go lower, and its current management has done it before, so investors can have confidence in the results.

Furthermore, there is plenty of opportunity to return cash flow to shareholders due to ballooning cash flows. Free cash flow at CP has increased dramatically in the last two years. In 2013, it increased almost 200% to \$500 million. And in the latest quarter (Q2 2013), free cash flow increased another 45% year over year.

With these increases in cash flow, management has stepped up its share repurchase plan. It was announced late Monday that the share repurchase plan would be more than doubled to about 12.7 million shares from the current 5.3 million. Furthermore, with a current dividend yield of 0.60% versus 1.26% over at CN, I think that investors can reasonably expect a dividend hike as well.

## **Threats**

CN has the more extensive U.S. network. There is therefore the risk that CP will be left behind in its growth south of the border.

A threat or risk for investors is in the fact that the stock is expensive. It trades at a trailing P/E of 39 times versus CN at 24 times. On a forward basis, CP trades at a P/E of 27 times with an expected earnings growth rate of 32%, while CN trades at a forward P/E of 21.6 times with an expected earnings growth rate of 19.6%. But the gap is not unreasonable considering the difference in growth rates at both companies.

## **Bottom line**

CP's investor day will be held tomorrow. Investors can expect more details as to how the company will drive revenue growth going forward, share buybacks, dividend plans, and the opportunity for further efficiency improvements.

## **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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**Author**

karenjennifer

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