The Problem With Canadian Pacific Railway Limited’s Valuation

Description

Canadian Pacific Railway Limited (TSX: CP)(NYSE: CP) has performed spectacularly well since Hunter Harrison was appointed CEO in mid-2012. In fact, the stock has left its major public market competitors, including **Canadian National Railway Company** (TSX: CNR)(NYSE: CNI) in its wake over this time period.

The operating ratio for the company, which measures operating expenses as a portion of revenues, has improved from 81.3% in 2011 to 65.1% by mid-year 2014. This improvement was the result of solid growth in revenue between 2011 and 2014, combined with only marginal growth in operating expenses. It has thus gone from being the worst among the North American Class I railroad operators to now approaching a leading position, as measured by this key ratio.

This operating level performance also translated into significant progress in net profit, profit per share, and cash flow over the period. For example, adjusted earnings per share improved from $3.15 per share in 2011 to an expected $8.44 per share in 2014 — an increase of 168%.

Stronger growth but a questionable forward valuation

At its recent investor’s day, management set more ambitious goals until 2018. Most importantly, the company expects to double earnings per share based on revenue growth of 10% per year and an operating ratio moving down to around 60%. Considerable growth in crude oil transported by rail is expected to provide the major boost to the expected growth in revenue. Further operational efficiencies will be derived from increases in average train speed, train weight, and fuel efficiencies.

CP Rail has an excellent track record in terms of delivering on operational and financial predictions. Shortly after Harrison took the helm, he predicted that the operating ratio would reach the mid-60% level and that cash flow before dividends would exceed $900 million by 2016. These objectives will, in all likelihood, be reached in the 2014 financial year, two years ahead of target.

The company has without a doubt performed well over the past few years and has an operational infrastructure that is almost impossible to replicate. Combined with a positive longer-term profit outlook, it deserves a premium valuation.

However, the forward valuation of CP Rail is rather extreme. Based on consensus forecasts, the price-to-earnings ratio for the full financial year 2014 is 28 times and 22 times for 2015 and 17 times for 2016. For the 2015 valuation, this represents a premium of more than 30% to the other Class 1-listed North American railroad operators and a 50% premium to its own valuation history.

EV/EBITDA, another key railroad valuation measure, indicates a ratio of 15.7 times for 2014 and 13.5 times for 2015. Again, this is high in absolute terms, much higher than the company’s own historical valuation and represents a steep premium over its peers. Other relevant valuation measures such as price-to-cash flow or price-to-book value ratio deliver similar results.

High entry price = poor long-term investment performance

Canadian Pacific Railway is a stock that would fit well in the portfolios of long-term investors. However, the current price fully reflects the quality of the company and its long-term prospects, leaving very little room for error. Investors would do well to wait for better entry levels.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
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