Is Canadian Pacific Railway Limited Worth $38 Billion?

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) announced another strong quarterly performance on Tuesday. Despite the results, the question is whether the company is really worth $38 billion and whether investors could realistically expect to be adequately rewarded from this point onward.

The financial performance was particularly good in the third quarter

CP Rail announced profits per share of $2.31 for the third quarter, which was 26% ahead of the comparable quarter last year, although it was somewhat lower than the $2.39 expected by the market consensus forecasts. Revenue was up by 9% driven by higher crude oil and grain volumes.

Expenses increased by only 4% but it is somewhat concerning that the largest components, namely labour and fuel were higher by 7% and 10%, respectively. The fuel bill may decline if energy costs continue to move lower but the labour costs increased despite a decline in the workforce.

The company also continued with its share repurchase program and has bought 5.3 million shares at an average price of $187 so far this financial year. A further increase in the authorization to repurchase an additional 7.4 million shares was announced in late September and will probably be implemented in the months ahead.

… and so was the operational performance

Operationally, the company again reported an improvement in results with key measures such as revenue per ton mile, average train weight, train length, locomotive productivity, fuel efficiency and train speed improving measurably.

The operating ratio, a key performance measure in the railroad environment and which measures operating expenses as a portion of revenues, improved again to 62.8% from 65.9% last year. This ratio was set at 81.3% in 2011 indicating the considerable improvement in the operating performance of the business over this time period.

The company management predicts further strong growth

At the recent investor’s day, the management of the company set further ambitious goals until 2018. Most importantly they expect to double the earnings per share based on revenue growth of 10% per year and an operating ratio moving down to around 60%.

The CEO reiterated in the quarterly report that the current demand environment is “strong,” that CP Rail is on track to finish the year on a high note and ready to meet long-term goals.

… but the valuation is too high

The company has without any doubt performed well over the past few years and has an operational infrastructure which 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 27 times, 20 times for 2015 and 17 times for 2016. For the 2015 valuation, this represents a premium of more than 20% to the other Class 1-listed North American railroad operators and a 45% premium to its own valuation history. On an alternative valuation measure, EV/EBITDA, the premiums are even higher.

A high entry price may lead to poor long-term investment performance

CP Rail is a stock that would fit well in the portfolios of long-term investors. However, the current price fully reflects the quality of the firm and the attractive longer-term prospects as promoted by its management, leaving very little room for error.

Investors who wish to have an exposure to the railroads will find better value among the other highly regarded operators, such as **Canadian National Railway Corporation** (TSX: CNR)(NYSE: CNI) or **CSX Corporation** (NYSE: CSX).

CATEGORY

1. Investing

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