



Head-to-Head: Canadian Pacific Railway Limited vs. Canadian National Railway Company

Description

Canadian Pacific Railway Limited ([TSX: CP](#))([NYSE: CP](#)) and **Canadian National Railway Company** ([TSX: CNR](#))([NYSE: CNI](#)) have delivered excellent results so far this year. However, that is now history and investors should consider which company offers the best investment prospects.

Operational performance: CN Rail still has the edge

The operating ratio, which measures operating expenses as a portion of revenues, is a key indicator of how well the railroad company can control its expenses relative to the revenue. CN Rail has an industry-leading operating ratio, which averaged 63% over the past five years.

Under the new management team, CP Rail has improved its ratio considerably over the past two years to 66% in the first nine months of 2014. According to CP Rail management, this could still improve further, but at the moment CN Rail is clearly the more efficient operator.

Financial performance: CN Rail is well ahead

CP Rail improved its profitability dramatically over the past three years with earnings per share jumping by more than 150% between 2011 and 2014 (as expected for the full year). CN Rail only managed about a third of that growth as the base was already much higher. However, with fewer cost-saving opportunities now available to CP Rail, the growth trajectory should in future be more similar.

The cash flow of CN Rail remains extraordinary strong with 36% of revenues currently being converted into operating cash. CP Rail lags considerably with 30% of revenues currently being converted to operating cash.

CN Rail has an excellent dividend payment track record, having increased the dividend every year and on average by 16% per year since going public 18 years ago. In addition, the company regularly buys shares back and has managed to reduce the share count by 10% since 2011 and intends to by another 3.9% of the outstanding shares by October 2015. CP Rail also has a sound dividend-paying track record having increased the dividend on average by 13% per year over the past 13 years. The

company also has a share repurchase program in place, but the share count is currently still higher than in 2011.

Longer-term prospects: Both are good

Both companies have excellent and almost irreplaceable infrastructure, with CN Rail covering 20,000 route miles that span Canada and mid-America, reaching the Pacific, Atlantic, and Gulf Coast. CP Rail has 13,700 route miles that span Canada and include the industrial areas of Chicago and Detroit. CN Rail, however, again has the edge as its lines are able to bypass the congested Chicago hub, saving valuable travel time.

The business mix for both companies is well diversified with intermodal, grain, and petroleum products the most important categories.

CP Rail recently announced 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%.

Whether these objectives will be met, only time will tell; however, the growth profile and prospects to increase revenues seem to be rather similar for both companies. CP Rail may be able to push its operating ratio down further and in the process grow profits somewhat faster than CN Rail over the next few years.

Valuation: CN Rail has the easier valuation

Based on consensus forecasts, the price-to-earnings ratio for CN Rail for the 2014 financial year is 20 times and 18 times for 2015. This represents a premium of 10% to its peers and a 25% premium to its own valuation history.

Again based on consensus forecasts, CP Rail's P/E ratio for the 2014 financial year is 27 times and 20 times for 2015, a premium of more than 25% to its peers and a 45% premium to its own valuation history.

CN Rail is probably the better investment today

Neither company is, in my view, a bargain at current prices. However, CN Rail is a high-quality operator with a superior rail network, excellent cash flow generation, reasonable growth prospects, and a more attractive valuation.

CATEGORY

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3. TSX:CNR (Canadian National Railway Company)
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