Why Canadian Pacific Railway Limited is Simply Too Expensive

Description

On a cold winter day in February 2012, hundreds of analysts and shareholders gathered in a conference room at the Hilton Hotel in downtown Toronto. They were there to hear William Ackman of Pershing Square Capital Management present his plan for **Canadian Pacific Railway Limited** (TSX: CP)(NYSE:CP).

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In his presentation, Mr. Ackman made the case that shareholders should elect 5 new people to the board of directors, including himself. The newly-formed board would then choose a new CEO. Ackman had his sights set on Hunter Harrison, former CEO of **Canadian National Railway Company** (TSX: CNR)(NYSE: CNI).

As it turns out, Mr. Ackman got his way, and the results have been fantastic with Mr. Harrison as CEO. But is now the time to jump on board? Below we take a closer look.

A surging stock

CP's shares currently trade for about $235, a massive jump over the $70 share price in early 2012. To determine whether the company is overvalued, let's take a look back at Mr. Ackman's presentation.

In the presentation, Ackman indicated that with Mr. Harrison as CEO, earnings per share in could range between $7.95 and $12.34 by 2015. At 14 times future earnings, that would put the share price between $111 and $173 by the end of this year.

The earnings number seems to have come true – analysts now expect CP to earn $11.08 per share in 2015 (according to Reuters). But the stock trades at over 21 times this number. If Mr. Ackman had suggested that CP would trade at 21 times forward earnings by now, he would have been laughed at.

Ackman selling stake

It's hard to say that CP is still undervalued. In fact even Mr. Ackman has been selling down his stake. About a year ago, he sold nearly 6 million shares at an average price of roughly $150. So imagine what he thinks of CP shares at $235.

Simply too expensive

Interestingly, CN Rail is also trading for 20 times forward earnings. But this does not justify CP's expensive valuation.

For one, railroading is a business that requires constant capital investment, just to maintain existing operations. Locomotives and railcars need to be replaced, and track networks are constantly in need of maintenance. This ties up money that otherwise could fund growth or dividends.

Secondly, growth is not that easy to come by. Track networks can only be expanded so quickly, and government regulation can hold a railroad back too.

CP is also facing some headwinds, particularly surrounding its track network, which doesn't reach the East Coast nor Gulf Coast. Worse still, CP must rely on the heavily-congested Chicago hub. CN Rail does not face any of these problems.

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So at this point, if you didn't participate in the CP rally, in my opinion, it looks like you're simply too late. You should look elsewhere.

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Date
2025/09/14
Date Created
2014/11/27
Author
bensinclair

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