With Lower Oil Prices, Why Are the Railroads Lagging?

Description

The cost of fuel is a major expense for many companies, and especially for the transport operators. The airlines are clear beneficiaries of lower fuel costs with the share prices of major operators such as **Air Canada** (TSX:AC) and **Delta Air Lines Inc.** surging ahead by 57% and 38% respectively over the past three months. During that time, the price of oil declined by more than 40% and the price of jet fuel by more than 30%.

In contrast, the share prices of the two major Canadian Rail companies, **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) and **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) have not shared the joy, with CN Rail increasing by only 5% while CP Rail declined by 7% over the past three months. The major U.S. rail companies have also performed better than the Canadian counterparts with **Union Pacific Corporation** adding 8% and **CSX Corporation** 10% over this period.

The question is why are the share prices of the Canadian railroads are not keeping pace with their U.S. counterparts or the airline companies?

How sensitive are the profits of the railroad companies to fuel costs?

This is not a simple question to answer as the impact is not limited to the direct cost saving of lower fuel costs. The offsetting influences of fuel-hedging programs, reduced fuel surcharges and for the Canadian companies, the impact of the weaker Canadian dollar, have to be considered as well. The railroads may eventually also experience reduced demand for the transport of crude oil or related products.

In the case of CN Rail, between 15%-16% of the revenues is spent on fuel, which is the second largest operating expense after labour. A 10% decline in the fuel bill will add 5% to operating income, based on the 2013 operating structure of the company.

Obviously the positive impact on net income will be more muted as a result of reduce fuel surcharges, fuel hedges installed at higher prices and the weaker Canadian dollar. The company has a diversified revenue base with only 10% of revenue being derived from the transport of crude oil and refined petroleum products. Reduced revenue caused by lower oil volumes should be minor.

CP Rail spends around 16% of revenues on fuel which is also the second largest operating expense item. A 10% decline in the fuel bill will add around 6% to operating income, based on the 2013 operating structure of the company. CP Rail also has a fuel surcharge program in place, which will probably be reduced as fuel costs decline. CP Rail does not have a fuel cost-hedging program in place and will therefore be able to benefit earlier from lower fuel prices. The company has a diversified revenue base with only 8% of revenue being derived from the transport of crude oil. Reduced revenue caused by lower oil volumes should be minor.

Fuel cost absorbs 29% of the revenue of Air Canada, making it the single largest expense item by a considerable margin. The income statement is therefore substantially leveraged to a decline in the fuel bill — on my estimate, a 10% decline in the fuel bill will result in a 42% increase in operating income based on the 2014 operating structure. Air Canada also has a fuel surcharge program in place as well as a hedging program. These factors, as well as the weaker Canadian dollar will reduce the benefit of the fuel cost reduction to some extent.

Company	Fuel Costs/Total Revenue	Operating Income Sensitivity to a 10% Decline in Fuel Costs	Revenues From Petroleum and Crude Oil-Related Activities	Share Price Over the Pa Months
Canadian National Railway	15.7%	5%	10%	5.2%
Canadian Pacific Railway	16.4%	6%	8%	-7.2%
Air Canada	29%	42%	NA	57.1%

Sources: Company Financial Reports and Thomson Reuters

Transport companies will benefit from lower fuel costs

Should oil and fuel prices remain at the sharply lower levels for an extended period, as may well be the case, a variety of companies, including the transport companies mentioned above, will benefit considerably. The weaker Canadian dollar as well as fuel-hedging programs and reduced fuel surcharges, will reduce the overall benefit. However, the net benefit will remain positive with the Canadian rail companies seemingly not being credited with the full benefit as yet.

CATEGORY

1. Investing

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2. NYSE:CP (Canadian Pacific Railway)
3. TSX:CNR (Canadian National Railway Company)

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