Canadian Pacific Railway Limited – How Much Better Can it Get?

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) announced another strong quarterly performance on Thursday and indicated that further robust growth is expected in the year ahead. But does the share price already incorporate most of the good news?

Excellent financial and operational performance

CP Rail announced profits per share of $2.68 for the fourth quarter, 40% ahead of the comparable quarter last year. For the full year, earnings per share were 32% higher than the year before. Somewhat surprisingly, the dividend was unchanged at $1.40 per share for the full year although the company did spend more than $2 billion buying back about 6% of the outstanding shares.

Revenue was up by 8% for the full year driven by double-digit gains in Canadian grains, chemicals, and crude oil while potash and U.S. grains jumped ahead in the final quarter. The company has an excellent diversified customer based with all of the top 10 categories contributing more than $300 million (or 5%) to total revenue.

Adjusted expenses for the full year were unchanged from 2013 with declines in the largest component, labour while fuel costs showed a small increase. The labour and fuel bills both declined in the fourth quarter as the benefits from earlier staff reductions and lower fuel prices kicked in.

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

The operating ratio, a key performance measure in the railroad environment that measures operating expenses as a portion of revenues, improved again to 64.7% from 70% in 2013. In the last quarter the ratio was measured at 59.8% which now compares with the best in the industry.

Management predicts further strong growth

Management communicated a very positive outlook for 2015. Based on revenue growth of 8% and an operating ratio of 62%, earnings per share is expected to grow by 25%. This is based on various assumptions including a further 21% drop in the price of diesel, a Canadian dollar that will be 9% weaker than in 2014, and a 27% increase in crude oil carloads.

At the October investor's day (and confirmed at the conference call today), management set 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%.

Cash flow is good and the balance sheet is sound

CP Rail converted about 32% of revenues to cash which indicated a solid ability to generate cash. It also created about $1 billion of free cash flow, which was not enough to finance the repurchase of shares and pay the dividend. That implies that debt had to be increased. However, debt is still at a very manageable level with a debt-to-equity ratio of 1.03 times and an interest cover of 7.8 times.

Valuation remains high

The company has without any 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 expensive. Based on management's profit estimate, the price-to-earnings ratio for the full financial year 2015 is 21 times. This represents a premium of 15% to the other Class 1 listed North American railroads, although it is more or less in line with the valuation of **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI). On an alternative valuation measure, EV/EBITDA the premiums are even higher while the dividend yield remains minuscule at 0.6%.

High 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 the company 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.

CATEGORY

1. Investing

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