Why You Should Avoid Canadian Pacific Railway Ltd. and Buy Transforce Instead

Description

With **Canadian Pacific Railway Ltd.** (TSX:CP)(NYSE:CP) dominating media coverage over the past several years due to its hugely successful turnaround led by veteran CEO Hunter Harrison, it is often easy to forget that Canada's transportation sector is indeed a multifaceted one.

In fact, within Canada's $53 billion transportation sector, transportation by rail only accounts for 11% of the sector's GDP share, whereas trucking represents 31%, making it Canada's dominant mode of transportation. This GDP share currently represents about $17 billion and is expected to rise 26% to $21.5 billion in 2020.

Although CP Rail has seen very real efficiency improvements (decreasing its operating ratio from 81% to an industry-leading 59.8% in Q4 2014), and it has an ambitious plan to boost revenue, Canada's dominant trucker **Transforce** (TSX:TFI) offers similar growth with much less risk due to better valued shares.

CP Rail shares are priced for perfection

CP Rail has had a legendary turnaround story, going from being North America's least efficient railroad to one of the industry leaders. It all started when U.S. activist investor Bill Ackman took control of CP Rail after a lengthy proxy battle and installed CEO Hunter Harrison to lead a massive turnaround effort.

Harrison promptly cut 4,500 jobs, dropped unprofitable routes, shut down rail yards, and reduced the number of locomotives operated. Since CP Rail was enormously inefficient, there was immense upside to net income that could be realized by simply cutting costs and increasing efficiency.

Since December 2012, CP Rail stock has surged 158% to present level as the market responded to net income increases as a result of efficiency gains, and most recently, as the market priced in Harrison's ambitious plan to focus on revenue growth and double earnings per share within four years.

The result?

CP Rail's share price is currently reflecting a company that will perfectly execute its earnings growth plan over the next several years. With a price/earnings (P/E) ratio of 35.2, ahead of the previous historical high of 32.6, CP seems very expensive. Analysts are projecting a five-year growth rate of 18.09%, which would give CP a high price/earnings-to-growth (PEG) ratio of 1.93.

Research has shown that stocks with high P/E ratios underperform their low P/E peers by an average of 12% annually in Canada. This is because the market is overly optimistic, meaning that when the company reaches goals, the market is not overly surprised, but when the company fails to reach goals, there is enormous downside potential.

When future growth is priced in, CP Rail seems like a risky bet. With railways reducing shipping loads due to low oil prices, potential government interference regarding increasing rail speeds (a key aspect of CP's growth plan), and less efficiencies left to gain, investors would be wise to look to more affordable alternatives.

Transforce offers similar growth at a cheaper price

Transforce is Canada's largest trucking company. It's currently providing package and courier services, truckload and less-than-truckload services, and waste management services.

Like CP Rail, analysts are predicting a five-year growth rate of 18.80% for Transforce, but with a current P/E of 18.45 and low forward price-to-earnings ratio of 12.2, this growth comes at a much more affordable price.

Although Transforce shares have performed well over the past several years, a general pessimism around Transforce caused by an exceptionally harsh winter in 2014 and high fuel prices have led the shares to inaccurately reflect the company's strong growth potential.

Transforce has been expanding aggressively through acquisitions, most recently acquiring rival Contrans for $495 million. As Transforce digests its recent Contrans acquisition, analysts estimate the acquisition will be 17% accretive to earnings per share, providing strong growth.

In addition, there has been talk of Transforce spinning off its truckload business in 2015. This would allow the truckload business to achieve a higher multiple and would provide a boost to Transforce shares while allowing Transforce to focus on its higher margin package and courier services.

Like CP Rail, Transforce offers strong growth potential, but without the risk provided by a lofty valuation. With low fuel prices providing tailwinds, now is the time to pick up shares.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CP (Canadian Pacific Railway)
2. TSX:CP (Canadian Pacific Railway)
3. TSX:TFII (TFI International)

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