Read This Before You Buy Canadian National Railway Company or Canadian Pacific Railway Limited

Description

The past five years have been very good for the Canadian railroads and their shareholders. Over this time, the share price of **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) has nearly tripled, while **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) shares have more than quadrupled.

Much of the gains are due to growth in crude-by-rail. However, there are some signs that crude-by-rail is slowing, and this could be very bad for CN and CP's stock prices. We take a closer look below.

Worse economics

It's no secret why crude-by-rail experienced such dramatic growth until recently. Not only were oil prices strong, but Canadian oil was selling at a heavy discount relative to oil sold in the southern United States. This price differential even reached $40 at one point. So, it made perfect sense to transport oil from Alberta to Louisiana by any means necessary.

The economics aren't quite there anymore. Differentials have narrowed to about $15, making the rail journey much less economic. In fact, Canada's largest oil producer **Suncor Energy Inc.** no longer ships oil from Alberta to the U.S. Gulf Coast. CEO Steve Williams said that even the rail trip to Montreal is "marginal."

Safety and regulation

This is another big worry for the rails. A Reuters analysis has found that CN's safety numbers were downright awful last year. Train derailments spiked to 57 in 2014, up 57% from 2013, nearly double the figure from a year earlier and reversing years of safety improvements. At least 27 of these accidents were caused by track problems.

According to Canada's Transportation Safety Board, trains carrying nothing but crude oil (known as "unit trains") could be contributing to an increase in track failures. These trains tend to be heavier,which could be causing too much strain on track networks.

For this reason, many expect new regulations to be introduced to the crude-by-rail business. These new laws would likely mandate reduced train length, reduced speed, or lighter cars. As a result, costs would surely increase, right when crude-by-rail economics are very marginal. CN and CP shareholders should be very worried.

Plenty of room to fall

I'm not saying that the crude-by-rail business will plummet. However, the business could easily fall short of expectations. That would be very bad news for CN and CP's stock price.

Just look at their valuations: CN trades at 24 times earnings, while CP trades at 28 times earnings. These high valuations are driven by big growth expectations, and crude-by-rail plays an important part. So, if there's a slowdown, then these share prices could tank (no pun intended). This should not be lost on any investors.

CATEGORY

1. Investing

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

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