3 Risks Every Canadian Pacific Railway Limited Shareholder Needs to Know

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) and its CEO Hunter Harrison deserve ample credit where credit is due—they executed perhaps the most remarkable, short-term turnaround in Canadian corporate history.

Harrison inherited the worst performing railroad on the continent, with a horrible 80% operating ratio (a measure of a railways expenses as a percent of revenues), and a profit margin of only 18%—well behind any of its North American peers.

After slashing the workforce by 5,000 employees, returning leased cars, cutting locomotive numbers, and closing terminals, CP Rail posted an impressive 200% growth in earnings, sending the stock up 160%. Harrison also unveiled an ambitious plan to increase revenues to $10 billion and double earnings from 2014 levels.

Investors, however, need to look beyond CP's stellar track record and understand that there are significant macroeconomic, regulatory, and valuation risks that could derail CP's share price.

1. CP Rail faces risks in its crude-by-rail business

One of the main levers CP is planning on using to attain its revenue targets is to dramatically increase the amount of crude-by-rail carloads it hauls by 2018. Currently, energy-related traffic accounts for about 10% of CP's total revenue, and about one-third of CP's targeted revenue growth is expected to come from crude by rail.

The recent decline in crude prices to under $50 per barrel, however, has put pressure on profit margins of oil producers and caused capital spending reductions, which will in turn lead to decreased oil production and reduced volumes for CP. Canadian oil producers are expected to cut capital spending by 33% in 2015 alone.

The result is that CP had to revise their 2015 guidance from 200,000 crude-by-rail carloads down to 140,000 carloads, only 20,000 ahead of 2014. So far, much of the immediate reduction is because shipping crude by rail is uneconomical in a low oil-price environment. Prices to ship crude by rail can be nearly $22 per barrel, and with WTI prices at $48, this eats into margins significantly.

Major producers like **Suncor** and **Cenovus** have already both stopped shipping crude by rail down to the Gulf Coast for this reason and volumes could continue to decrease into 2015, especially as the effects of capital investment reductions start to take hold. This represents a challenging environment for CP Rail

2. CP faces regulatory risks

With four major explosive train derailments occurring in the past four months alone (though none involving CP), there is increased pressure for more stringent regulations and increased awareness about the massive risk that hauling crude by rail poses.

The first of the regulations being proposed by Transport Canada is that cars would require thicker steel walls and a protective thermal layer outside. Under these regulations, steel walls would need to be nine-sixteenths of an inch thick, which is more than the half an inch thick preferred by industry.

Thicker walls means less oil per car, and therefore less revenue. This is just one way regulation could affect CP rails earnings. In addition, the industry is being required to contribute to a compensation fund, which would cover the costs of any potential derailments. Overall, this will be financed with a new $1.65 levy per ton of crude carried. This, once again, adds further costs and reduces CP's bottom line.

3. CP Rail's shares are expensive

Currently, CP's shares are priced for perfection. This poses a significant risk since there is very little margin of safety should the company underperform on its lofty growth objectives.

Currently, CP trades at a price-to-earnings ratio (P/E) of 27, well above the peer average of 18.7. CP has a forward P/E of 21, which is still above the current peer average of 18.7, and also above the forward P/E group average of 17.9

With this kind of valuation, it seems CP has little room for upside if earnings targets are met, and plenty of downside risk if they do not perform perfectly.

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Date
2025/08/26
Date Created
2015/04/07
Author
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