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Canadian Pacific Railway Limited: Be Wary of This Expensive Stock

Description

The last few years have been good for railroads, particularly **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP).

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It wasn't always this rosy. In 2011 shares slumped to below $50 thanks to bloated costs and investor dissatisfaction with the management team. Pulled out of retirement by activist investor Bill Ackman, former **Canadian National Railway Company** CEO Hunter Harrison took over the top job in 2012 and the stock hasn't looked back since. Shares currently sit at $236, which is close to a record high.

As much as Harrison deserves credit—after all, he did create billions in savings by cutting costs and laying off thousands of workers—I'm not sure CP's transformation is as successful as it's been without the huge tailwind of the crude-by-rail market.

Buoyed by western Canada's lack of new pipelines capacity and high oil production, CP's trains were loaded to the brim with crude headed to refineries. It got to the point where Canadian Pacific and Canadian National were ignoring grain shipments in favour of crude, which led to a public relations gaffe.

Now that the crude-by-rail market looks to be weaker in 2015, is CP set to fall? I think so. Here are three reasons why investors should be nervous.

You can't cut forever

When Harrison took over, CP's operating ratio was a dismal 80%. In comparison, Canadian National's ratio was closer to 65%.

Operating ratio is simply the percentage of operational costs compared to revenue. The lower the number, the greater the profit. In less than four years, CP has lowered its ratio to 59.5%, which is one of the best in North America. And unlike its main competitor, it hasn't sacrificed safety to do so. CP's safety record remains top notch, while CN has suffered through four derailments so far in 2015.

But these cuts have come at a cost. According to reports, relations between CP and its unions are strained. Union leaders use words like “aggressive” and “frustrated” when describing relations with the company. Those aren’t the words used by a union that’s happy with management.

And finally, there just aren’t many more cuts left to make. Harrison has picked all the low hanging fruit. Anything that happens further won’t matter so much.

An expensive stock

Harrison’s cuts have come through to the bottom line. Net profit was $2.79 per share the year he took over. In 2014 profit surged to $8.46 per share. With that kind of growth, there’s little wonder why investors have been so excited about the stock.

And, at least according to analysts, the party is expected to continue. Buoyed by lower fuel prices, earnings are expected to be $10.92 per share in 2015 and to rise to $13.04 in 2016.

But perhaps those numbers are a little optimistic. The crude-by-rail market will likely be weaker in 2015, and lower fuel costs will make other transport options more attractive. There’s also the possibility of poor crops eating into earnings.

Shares currently trade at 28 times earnings. If earnings aren’t higher in 2015, CP looks like a very expensive stock. There’s very little margin of safety in a company where shares are nearly 30 times earnings.

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Weakening crude-by-rail

Depending on the distance traveled, it costs between $10-15 per barrel of oil for rail transportation costs. In comparison, pipelines cost less than $5 per barrel.

When oil flirted with $100 per barrel, paying the extra costs wasn’t a big deal. But now that crude is half that price, paying $15 per barrel is pretty pricey, especially for high-cost producers.

We haven’t really seen the effects of this yet, since companies are producing from already drilled wells as quickly as they can. But come the summer, when supply inevitably leaves the system, the oil-by-rail business will suffer. This is the main reason why I think analyst expectations in 2015 and 2016 are a little rosy, and is something investors need to keep an eye on.

CP is a great operator. When Harrison retires in 2017, he is going to leave the company in much better shape than he found it. It’s just an expensive stock that investors have priced aggressively. Be wary before you go chasing this name.

CATEGORY

1. Investing

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1. NYSE:CP (Canadian Pacific Railway)
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