3 Reasons Canadian Pacific Railway Limited Makes Me Nervous

Description

If you bought **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) a few years ago and held, you're sitting on some really attractive gains. We're talking clear over $100/share appreciation. But a lot of that has been built on the promise that earnings per share would double. And they did. But based on where the stock is today, I have a hard time seeing it grow as much, which could hurt people who are getting into this stock at the present time.

There are a few reasons that owning Canadian Pacific actually makes me nervous for investors. I'm not suggesting you should immediately liquidate, but have these reasons in mind when making any decisions about increasing or decreasing your position.

1. Crude by rail has some problems

There are two primary problems that Canadian Pacific is running into with respect to its crude oil business. The first has to do with decreased revenue. Canadian Pacific had to revise its 2015 guidance down from 200,000 carloads to 140,000 carloads. While it is still more than 2014, less growth is still less growth.

On top of that, other railroads have experienced problems with derailments. And we all know that when there are catastrophes, the regulations can often times become extreme very quickly. There are proposals that include increasing the wall thickness on tankers, which would decrease the amount of crude carried per car. And there is also a call for a $1.65 fee per ton of crude carried to compensate for these derailments.

Fewer cars, smaller cars, and more fees could really hurt the business's profit.

2. Long-term cutting is a failing strategy

I'm a big believer that you need to trim the fat to become more efficient. Plenty of companies have experienced amazing turnarounds once they got rid of unnecessary expenditures. Canadian Pacific is no different. Before Hunter Harrison took over as CEO of Canadian Pacific, the operation ratio was 80%. That meant it cost $0.80 to make $1.00. That's really bad.

But after a lot of smart cuts, the company has been able to cut the operating ratio down to 59.5%. Cutting over 30% in just four years is a feat worth commending. The problem is that there isn't that much more it can cut. A lot of the growth in the stock was because it was becoming so efficient.

The company is going to need to develop strategies to increase revenue if it wants to keep growing because cutting won't work.

3. It's just plain expensive

Because of the strategy of cutting costs, profits rose immensely. And they're still going to rise some more because of low fuel costs; though, that might be offset by decreased fuel shipments. However, they rose even faster than earnings because investors expected it to continue having so much success.

Unfortunately, the P/E of the company is 27.59, which is significantly higher than the sector average of 18.7. Now, I'm perfectly comfortable for a stock to trade at high valuations if it is growing really fast. But even its forward P/E of 21 is higher than the peer forward P/E of 17.9. And the reality is, this company isn't growing insanely fast.

What to do?

At the end of the day, what you do with the stock depends on when and why you bought it. If you're looking for income, turn and run because the dividend is paltry. If you bought recently, you have to hope the company executes flawlessly and that oil prices recover. And if you bought a while ago, enjoy your returns. But if you don't own shares, I would suggest waiting to buy. I don't view the company as a safe investment at this point in time.

CATEGORY

1. Investing

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