



Canadian National Railway Company: Should You Buy the Pullback?

Description

Canadian National Railway Company ([TSX:CNR](#))([NYSE:CNI](#)) is down nearly 15% in the past three months and new investors are wondering if this is the right time to buy the stock.

Let's take a look at the current situation to see if the company deserves to be in your portfolio.

Earnings watch

CN reported strong year-over-year earnings for Q1 2015. Net income for the quarter was \$704 million or \$0.86 per share compared with \$0.75 per share in Q1 2014. Revenue ton-miles rose 7% and total carloads jumped 9% compared with the first quarter of 2014.

Free cash flow increased to \$521 million in Q1 from \$494 million in the same period last year. Overall revenue increased 15%, driven by strong gains in shipments of grain, fertilizer, forest products, automobiles, metals, minerals, petroleum, and chemicals. Coal revenue was the only weak spot, with a decline of 13%.

Analysts are concerned the ongoing rout in the oil and coal markets will hit earnings in the second half of this year. CN still expects crude oil and frac sand deliveries to increase by 40,000 carloads in 2015, but this is down from the previous growth target of 75,000.

Coal deliveries will continue to remain weak as miners shut down production amid a slump in global prices.

Dividend growth and share buybacks

CN has a strong history of dividend growth. The company has raised the distribution every year since 1996 and recently hiked the payout by a record 25%. CN plans to increase the target payout ratio to 35%, which means shareholders should see the distribution growth continue.

CN also has an aggressive share-repurchase program. Under its current normal course issuer bid, CN can repurchase and cancel up to 28 million shares before October 23, 2015. As of March 31, the

company had already repurchased 11 million shares. Shareholders benefit from share buybacks because the process gives them a larger stake in the company.

Productivity improvements

Canadian National reported a Q1 operating ratio of 65.7% compared with 69.6% in the first quarter of last year. In the rail industry, a lower operating ratio is desired because it shows the cost of adding additional revenue. CN is regularly cited as the best run railway in the industry.

This year, the company plans to spend \$2.7 billion on capital projects. About \$1.4 billion is earmarked for track infrastructure, which includes safety improvements and upgrades to busy feeder lines. Growth and productivity initiatives will see \$800 million spent on intermodal terminals, yard improvements, and IT upgrades. Another \$500 million is being spent on equipment, including 90 new locomotives.

Risks

New safety regulations in the U.S. and Canada will result in higher costs over the next three years, as rail companies are forced to upgrade tank cars used for carrying crude oil. Train speeds are also being reduced.

Should you buy?

The growth of crude-by-rail transport is slowing, but it is not going to disappear. Major producers are pumping (or mining) as much oil as possible to cover operating costs and maintain their multi-billion dollar facilities. With the ongoing shortage of long-haul pipelines, CN should continue to see strong demand for its services, even in a low-price environment.

CN now trades at a reasonable 16 times forward earnings. The company operates in an industry that enjoys huge barriers to entry. Let's face it, there won't be any new rail networks built to compete with the existing carriers, and CN has an advantage because it is the only North American railway company with routes that reach three coasts.

The shares could see further weakness in the coming months, but the long-term fundamentals look good, and investors now have a chance to pick up the stock for a fair price. From a technical perspective, the stock is showing signs of being oversold.

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Author

aswalker

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