Canadian Pacific Railway Limited: Should You Buy the Pullback?

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) is down 15% over the past three months and new investors are wondering if the pullback is a good opportunity to hop on for the ride.

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

Bad press

Canadian Pacific is getting a lot of attention in the media lately and it isn't the good kind. The company is being lambasted for throwing a wrench into the compensation plan for helping out victims of the Lac-Megantic rail disaster.

Canadian Pacific is the only company accused in the accident that hasn't agreed to pay into a settlement fund. The terms of the fund offer the other 25 companies a full release from liability for the disaster—which is why they all agreed to pitch in. Canadian Pacific says it isn't responsible for the accident and its refusal to contribute to the fund is linked to some complicated legal issues. The details are extensive, and we are not going to go into it all here, but the company believes it has good reason for digging in its heels.

If Canadian Pacific wins its argument, the result could mean a much longer, drawn out compensation process for the families of the victims.

As a business, Canadian Pacific has to consider the best interests of its shareholders, and management believes it is doing that. Whether or not the current tactic will pan out to be a good one for investors is yet to be seen, but the whole thing is shaping up to be a public relations nightmare, and that could result in other costs over the long term that are difficult to calculate.

Great earnings

Canadian Pacific reported record profits in the first quarter, with year-over-year net income growth of 33%. Most of the company's business segments are doing well, although the meteoric rise in crude shipments has tapered off and the rail industry as a whole is ratcheting down guidance for the energy sector.

Growth plans

Last fall, CEO Hunter Harrison unveiled plans to double earnings per share by 2018. Since taking the helm in 2012, Harrison has done a fantastic job of turning Canadian Pacific around. He slashed staff, shut down inefficient rail yards, and cut expenses wherever he could to reduce operating costs. The results have been impressive, with Canadian Pacific's operating ratio dropping from 80% to a record low of 63% in the most recent quarter.

But the low hanging fruit has already been picked and further improvements will be difficult to achieve, especially as new regulations on both sides of the border begin to impact the crude oil segment of the business.

Over the next three years Canadian Pacific and its peers will be forced to upgrade all of their oil cars to meet new safety standards. The railways are also required to reduce train speeds.

This could have an impact on Harrison's plan to double EPS because he wants to run his trains faster and make them longer in a bid to drive more efficiency into the operations.

Valuation

Canadian Pacific is cheaper now than it was a few months ago, and the drop in the share price is making it more attractive. At 16.5 times forward earnings, the stock is coming into a reasonable range, but it still isn't in oversold territory.

Should you buy?

Canadian Pacific is a solid long-term investment. The company serves a critical function in the operation of the economy, and there is little chance that a new railway will ever be built to compete with the existing players.

However, investors have to watch the crude-by-rail business carefully. It isn't going to go away, but new pipeline capacity will eventually come online and tight margins are already reducing the incentive for oil producers to send the oil by train.

Canadian Pacific's stock price is still a bit lofty given some of the current headwinds, and any disappointment in the Q2 results could send the shares into a tailspin. At this point, Canadian Pacific is probably a hold.

CATEGORY

1. Investing

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Author
aswalker