Why the Worst Is Yet to Come for Canadian Pacific Railway Limited

Description

Back in April I warned investors that **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) was an expensive stock. When I wrote the article, shares were trading hands at approximately $235 per share, which was near an all-time high.

Currently, shares trade hands at approximately $198 each, which is a pullback of nearly 20% in just a little more than two months. That's a huge move, especially while the TSX Composite has been close to flat.

Many investors in the stock have been left scratching their heads. Analysts were almost universally bullish on the stock, with CEO Hunter Harrison viewed as one of the best in the business. Why exactly is the stock down? And is now the time to average down?

I doubt it. In fact, I think the stock is still a sell at today's levels. Here are three reasons why.

Still expensive

Even after shares have declined almost 20%, they're still not exactly cheap.

The company is currently trading at more than 22 times earnings, and a whopping 48 times free cash flow. That's expensive, especially for a cyclical company like a railroad.

Let's compare that to its biggest competitor, **Canadian National Railway Company**. Shares of it currently trade hands at 18 times earnings, and more than 28 times free cash flow. It's still expensive, but comparatively less so than Canadian Pacific.

If you go across the border, railroad stocks are even cheaper. **Union Pacific Corporation** trades hands at just 16 times earnings, and at just 21 times free cash flow.

CP is a terrific operator, I'll give it that. But is it worth a 30% premium compared with Union Pacific, which is also good at what it does? I'm doubtful.

Weak outlook

Two things are bringing down Canadian Pacific shares. The crude-by-rail market is much weaker in 2015, and the decrease in the price of crude has made other forms of transport more attractive.

When oil traded at $100 per barrel, it was easy to justify the $10-15 per barrel cost to transport it over rail. Besides, there just wasn't the pipeline capacity, especially in newly explored areas.

But additional pipeline capacity has been added, and more is on the way over the next few years. And as production goes down, additional pipeline capacity will open up. At $60 per barrel, many producers just can't justify shipping by rail.

All these factors combine to make the crude-by-rail outlook pretty poor. There's also the possibility of poor crops also hurting the bottom line later on in the year, since much of Alberta is practically in a drought. And low fuel prices have made trucking certain goods more attractive than shipping them over rail.

Anything left to cut?

Normally during lean times management will use weak results as an excuse to lay off a bunch of underperforming employees.

When Harrison took over in 2012, one of his first actions was to cut a bunch of jobs. This, combined with other improvements in efficiency, took the company's operating ratio from a dismal 80% to closer to 65%. That new number is among the best in North America.

But those cuts have come at a cost. Relations between the company and employee unions is strained. Harrison has driven several top execs out and replaced them with his own people. After years of attempting to squeeze the most out of employees, I'm not sure there's much fat left to cut.

Thus, investors can't look forward to further operational improvements. All the company can really do is ride out the storm, where it could lose its premium valuation.

CP is a great company; it's just trading at an elevated price. It's also suffering from a poor outlook, which could get ugly if Canada's energy sector continues to be weak. For those reasons, this stock won't get anywhere near my portfolio—at least until it's much cheaper.

CATEGORY

1. Investing

TICKERS GLOBAL

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