



## Is Canadian Pacific Railway Limited a Safe Investment?

### Description

**Canadian Pacific Railway Limited** ([TSX:CP](#))([NYSE:CP](#)) has been a great holding over the past four years, but recent weakness in some of the company's core business segments is putting pressure on the stock.

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

### Earnings

CP recently reported solid Q2 2015 adjusted earnings of \$2.45 per share, a 16% increase over the same period last year.

Gains in shipments of forest products, chemicals, and crop nutrients helped offset weaker freight revenues from crude oil, automotive, and mining customers. All in, total freight revenue was essentially flat compared with Q2 2014.

The company is being impacted by lower production of core commodities as mining and energy companies reduce output amid difficult global markets. Western Canadian farmers are also feeling the heat as they battle severe drought conditions. One estimate suggests overall crop production could be down 25% compared with 2014. If that turns out to be true, CP could see lower farm-related freight revenues in the coming quarters.

### Efficiency

CP used to have one of the worst operating ratios in the industry. That has changed over the past three years and the company continues to deliver impressive numbers. For the first six months of 2015 the operating ratio fell to 62%, down from 68% for the same period last year. A lower number is better because it indicates the percentage of revenues used to operate the railway.

Much of the low-hanging fruit has already been picked on this side of the earnings equation. Investors shouldn't expect cost cutting to deliver the same outsized effects on the bottom line going forward.

## Growth

CP wants to grow revenues to \$10 billion by 2018 and double earnings per share over that time frame. Last fall the company's CEO, Hunter Harrison, said he plans to achieve this by running longer trains at higher speeds on key routes.

Hitting these targets will also require an average USD:CAD exchange rate of \$1.10, average fuel costs of US\$3.50 per gallon, annual capital expenditures of about \$1.5 billion, and an income tax rate of 27.5%.

That's a lot of moving parts given the volatility in FX and energy markets and the uncertainty surrounding the upcoming federal election, but the company has the right management team in place to pull it off.

The biggest question mark probably sits on the projection for sales. In 2015 the company is targeting revenue growth of 2-3% compared with 2014. The next three years will have to be stellar if revenue is going to jump by roughly 50% from the 2014 level of \$6.6 billion to the \$10 billion the company is aiming for.

## Should you buy Canadian Pacific Railway?

CP is facing near-term headwinds and shareholders should be prepared for more volatility in the stock. Given the cyclical nature of most of the company's business segments, there is definitely a risk the stock could drop to new 12-month lows.

I think the 2018 revenue and earnings targets are a bit ambitious and that might be why the stock is taking a breather. Having said that, CP has pulled back to the point where it is trading at 17 times forward earnings. This is a reasonable price compared with the average for the past five years, so existing shareholders should probably stay put.

New investors with a long-term outlook might want to consider wading in on further weakness. CP is a very well-run business and the big picture on this name is still attractive.

## CATEGORY

1. Investing

## POST TAG

1. Editor's Choice

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