Canadian Pacific Railway Limited: Should You Buy Now or Bail Out?

Description

Shares of **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) are down nearly 25% over the past six months, and investors are wondering if this is the right time to add a new position or avoid the stock altogether. Let's take a look at the current situation to see if Canadian Pacific deserves to be in your portfolio.

Earnings stability

Second-quarter adjusted earnings came in at a healthy $2.45 per share. That was good enough for a 16% increase over the same time last year, despite the tougher economic situation in Canada and the much weaker energy market.

Much of CP's growth in recent years has come on the back of the boom in oil-by-rail shipments as pipeline bottlenecks have driven producers to send their oil via trains in order to reach refineries and overseas markets. New pipelines are facing a lot of resistance and it will be years before any of the major projects get built. This should put a floor under crude-by-rail demand, although the freight numbers might continue to weaken as the oil industry works its way through some tough times.

CP gets its revenue from a variety of business segments, and the slowdown in oil shipments is being offset by strength in other areas. CP saw year-over-year Q2 gains in the transport of forest products, chemicals, and crop nutrients. Overall freight shipments in Q2 2015 were pretty much in line with the same period last year.

Looking ahead, there could be some trouble on the way. Drought is hitting western Canadian farmers and one report suggests they might be looking at a 25% drop in crop production this year. That would have an impact on CP's agriculture segment.

At the same time, the oil sector continues to take a beating, so carloads in that segment are likely to drop through the end of the year.

Efficiency gains

CP used to be one of the most inefficient companies in the sector with an operating ratio north of 80%. When it comes to this metric, a lower number is better because it indicates the amount of revenue the company is using to run the business.

In recent years, new management has done a fantastic job of cleaning things up. For the first six months of 2015, CP had an operating ratio of 62%, down from 68% in the first half of 2014. The efficiency gains have been a big reason for the company's soaring earnings and subsequent stock-price appreciation, but most of the low-hanging fruit has been picked on that front and it will be harder for the company to deliver the same results in the coming years.

Growth outlook

CP is targeting revenue growth of about 50% over the next three years and hopes to double earnings per share at the same time. In a statement made last fall, CEO Hunter Harrison said he wants to achieve this goal by running longer trains at faster speeds.

That might work, but governments on both sides of the border have altered safety requirements for rail operators when carrying dangerous cargo such as oil. Train speed is one of the items on the list, although the new speed limits shouldn't impact the company that much. A larger concern could be the costs associated with upgrading rail cars to meet new safety standards. The transition could be expensive and might cut into CP's bottom line in the next few years if it can't pass the costs on to customers.

Should you buy, hold, or sell CP?

CP has a fantastic management team and the stock is now trading at a reasonable 15 times forward earnings, but the company expects revenue growth of 2-3% for 2015, so that makes the 50% jump projected for the next three years look a bit ambitious. As a long-term bet, Canadian Pacific is a great stock to own. If you already own the shares, I would hold them. New investors might want to wait for the Q3 earnings to come in before starting a new position.

CATEGORY

1. Investing

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