What to Expect From an Investment in Canadian Pacific Railway Limited

Description

Canadian Pacific Railway Limited's (TSX:CP)(NYSE:CP) railroad network of 14,800 miles of track transports goods across most of Canada and parts of the United States. Transporting goods such as industrial products, grains, food products, fertilizers, coals, and forest products, is an essential part of the economy. Yet from a 52-week high of $247, Canadian Pacific Railway has gone down to $190, a decline of 23%.

Weakness due to slower growth

The price decline is partly due to the anticipated slow growth in the railroad company. In 2014 Canadian Pacific Railway's earnings per share (EPS) growth was 32%. At the time, it traded at a fair price-to-earnings ratio (P/E) of 28. However, the growth isn't continuing at that high rate, so the shares are experiencing multiple contractions.

EPS is expected to slow to 17-21% in the next couple years. So, one can argue that at a P/E of under 20, Canadian Pacific Railway is more fairly priced than when it was $247. Just because the price came down doesn't mean the shares are actually cheaper in a valuation sense.

Dividend

However, a lower price does equate a higher yield. For Canadian Pacific Railway, that means the shares are now generating 32% more income than when it was at $247.

Still, the shares only yield 0.7% today, but with a payout ratio of 16%, there's a big margin of safety for Canadian Pacific Railway's dividend. Its payout ratio was able to come down so much compared with its highest payout ratio of 48% in the last decade because the company had stopped increasing its dividend since 2012.

In 2012, the well-known railroad leader Hunter Harrison took over as the CEO of Canadian Pacific Railway. Instead of increasing dividends, capital has been allocated to reducing outstanding shares. From 2012 to the present, outstanding common shares has been reduced by 2.3%, so shareholders could have a larger stake in the company and its future profitability by simply holding on to the shares.

Some investors prefer stock repurchases over dividend growth as long as the company continues to deliver growth because dividends trigger a taxable event that is less tax efficient over the long term.

In conclusion

When we invest in a business, we should be doing it for the long term because short-term stock prices are highly unpredictable. In the short term, the price is based on a weighing machine. If there's negative sentiment in the market due to a negative economic outlook, for example, most stocks are going to decline in price whether the business is profitable or not.

For a cyclical business such as Canadian Pacific Railway, investors should expect occasional slow earnings growth. Cyclical businesses tend to do well in an expanding economy, and not so much in a contracting one. However, even the anticipated 17-21% growth would be phenomenal for a $30 billion market cap business such as Canadian Pacific Railway.

The shares are fairly priced today, but could decline further due to multiple contractions. By buying Canadian Pacific Railway at $190, investors can expect 17-21% growth of their investment in the next few years. If that materializes, that kind of return still beats the general market returns of 7%.

Because of Canadian Pacific Railway's small dividend, investors buying it wouldn't do so for the income, but for its potential growth. As usual, dollar-cost averaging into a position is generally safer because there's the potential to buy more shares at a lower price if the current market sentiment leans towards the negative side.

CATEGORY

1. Investing

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