Is it Safe to Own Canadian Pacific Railway Limited?

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) has gone from being one of North America's worst railways to one of the best.

If you missed the train when the stock made its huge run, the recent pullback in the stock might be a tempting entry point.

Let's see if the is the right time to go all aboard on CP.

Earnings growth

CP delivered solid Q2 2015 adjusted earnings of $2.45 per share. That was good enough for a 16% gain over Q2 2014 and sends a strong message to investors that the company is doing well despite the weakness in the energy segment.

The great thing about the rail business is that it caters to all areas of the economy. When one segment struggles, another generally picks up the slack. For example, CP saw year-over-year gains in its forestry shipments.

This makes sense because the oil rout has driven down the value of the loonie, which make things a lot easier for the forestry guys to sell their products to the U.S. and overseas.

Oil worries

CP's stock is down more than 20% in the past six months, and much of that weakness is attributed to the latest round of pain in the oil patch.

It's understandable that the market is reacting so harshly because CP's big profit gains over the past few years came on the back of surging demand for oil transport.

Here's the thing to keep in mind: crude by rail might be slowing down, but it isn't going away.

CP's customers are still producing as much oil as possible, and getting the product to refineries in the

U.S. or to eastern Canada is still a problem because there simply isn't enough pipeline capacity. At the moment, pipeline-friendly politicians are few and far between, and that means major projects like Keystone and Energy East might not be built for quite some time, if ever.

Efficiency gains

Lower costs are the second part of the profit equation. CP used to be a very inefficient company, but Hunter Harrison, the current CEO, came in to shake things up back in 2012, and the results have been astounding.

Under his watch, CP has lowered its operating ratio from 80% to just 62% as reported in the latest quarter.

At this point, most of the low-hanging fruit on the expense tree has already been picked, and management will really have to work hard to get the number down much further.

Risks

CP is certainly facing some headwinds that could slow down the profit train in the coming year or two.

The energy sector continues to struggle and that might not be resolved as quickly as the market initially expected. At the same time, rail companies are also facing higher expenses for their energy segment because new regulations require the rail cars to have updated safety features. That could hit the bottom line if CP can't pass the costs on to its customers.

A slowdown in coal and potash production could also hit revenues, and western Canadian farmers have had a tough year. These issues are likely to be short term in nature, but the numbers over the next few quarters could be impacted.

Should you buy?

Railways are great companies to own and CP will continue to do well as the Canadian economy emerges from its cyclical woes. The stock now trades at a reasonable 15.3 times forward earnings, so investors with a long-term outlook should be comfortable holding the shares. For new buyers, the market might provide a better entry point in the coming months.

CATEGORY

1. Investing

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