Canadian National Railway Company and Canadian Pacific Railway Limited: Only 1 Is Worth Buying Today

Description

Deciding between **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) and **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) has always been a difficult choice for Canadian investors.

On the one hand, CN is North America's most efficient railroad. It recently set a new record of a low operating ratio (operating costs as a percentage of revenue) of 53.8%—well below all of its peers. CN also leads the industry in speed as well as free cash flow. CP, however, has been in the midst of an impressive multi-year turnaround and has outperformed CN slightly over the past five years.

Now, however, with major weakness in coal, grain, and crude oil markets, railroads are facing several headwinds, and in this environment—which is expected to persist—CN becomes a clear favourite due to its lower bulk commodity exposure and multiple competitive advantages.

CN has a greater exposure to merchandise and less exposure to bulk

CN is down only 4.3% YTD compared to 15% for CP, and part of the reason is because CN and CP have different exposures. CP for example, is heavily focused on bulk commodities. It gets 33% of its revenues from grain and fertilizers compared to only 16% for CN. It also gets 10% of revenue from coal compared to 5% for CN.

CN is slightly more weighted towards merchandise and intermodal, and these are segments that are heavily exposed to consumer spending. For example, CN gets about 23% of revenue from its intermodal segment (which largely transports consumer goods via truck, boat, and rail to domestic and international destinations).

CN also gets 13% of revenues from forest products (like lumber and panels), which are largely destined for the U.S., supplying the booming U.S. housing market, which has been on a steady recovery path with housing starts recently hitting an eight-year high.

Overall, between CN's automotive, forest products, and intermodal businesses, CN is heavily exposed to improving U.S. consumer spending. About 44% of CN’s largest segment’s revenues (intermodal) is traffic to, from, or within the U.S. This gives CN exposure to an area of economic growth (U.S. consumer spending) as opposed to weakening bulk commodity markets, where CP is focused.

CN has an opportunity to gain market share from CP

CN has a history of winning high-profile contracts from CP, and this is thanks to the various competitive advantages that CN has. In 2013 CN won major international intermodal contracts from CP, including contracts from shipping lines MOL, APL, and OOCL, as well as Chrysler.

CN has several advantages over CP, including a faster network as well as greater geographic reach. CN has strong access into the U.S., including a direct line to the Gulf Coast, something which CP does not have. CN also has access to five separate ports as opposed to three for CP, and when you combine speed with geographic reach, there is a great potential for market share gains.

A recent report by **RBC** confirms this. In a survey of North American railroad shippers, 51% of respondents indicated that they are either certain to switch providers or are considering switching providers. About 67% of these providers indicated that they are planning on making the switch from CP to CN, which puts CN in a position to gain market share in 2016.

In addition, this same survey indicated that shippers of consumer goods were very optimistic about volume growth for 2016 (with a large portion expecting 6% or more growth), whereas commodity shippers were far less optimistic. This news benefits CN, since they are more weighted to consumer goods shipments, and the end result is that CN has significant opportunity to grow its top line ahead of CP for the next year.

CN seems to be better choice

CN has a greater exposure to markets with strong economic fundamentals. It also has faster velocity, better geographic reach, and better efficiency than CP. This should lead to stronger performance in today’s weaker and more competitive market.

Analysts seem to agree, with RBC predicting revenue growth of 5% for CP in 2016 as opposed to 13% for CN.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
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3. TSX:CNR (Canadian National Railway Company)
4. TSX:CP (Canadian Pacific Railway)

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