Canadian Pacific Railway Limited Ups the Dividend 40%: Is it Time to Buy?

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) reported earnings yesterday. Dividend investors should rejoice.

With record profits, management announced that it will now pay a quarterly dividend of $0.50 per share, which is up from $0.35. The company earned $540 million last quarter, or $3.51 per share. That's up from $320 million ($1.92 per share) a year earlier. Boosting profits was impressive given a drop in sales. Revenues fell to $1.59 billion compared to $1.67 billion in that same quarter last year.

"Despite weakness in the economy and volume headwinds, we focused on what we can control, our costs and our commitment to providing reliable service, and delivered a record performance," said CEO Hunter Harrison.

Is Canadian Pacific becoming a long-term option for dividend investors?

Not so fast

Last week, Canadian Pacific cancelled its proposed merger with **Norfolk Southern Corp.** (NYSE:NSC), a move that would have doubled the size of the company. The move faced stiff resistance from Norfolk's management team and shareholder base as well as customers and government officials. "With no clear path to a friendly merger at this time, we will turn all of our focus and energy to serving our customers and creating long-term value for CP shareholders," said Harrison.

While Canadian Pacific's executives put on a brave face, the merger would have removed several structural issues hindering the company's growth outlook.

First, it would have provided a rare opportunity to diversify the company's revenue stream given the majority of its freight loads originate in Canada. Second, Canadian Pacific is overexposed to commodities; 42% of volumes come from bulk sources such as grain or coal, and 17% comes from metals, minerals, and crude oil. Third, Canadian Pacific is already one of the most operationallyefficient railroads in North America. While this is a testament to its savvy management team, it limitsfuture opportunities to cut costs and boost margins.

The merger would have allowed Canadian Pacific to connect and leverage many of its complementary lines, allowing the combined company a unique opportunity to boost profitability.

Only so much it can do

According to John Larkin, an analyst at Stifel Nicolaus & Co, the company needs an acquisition to push up its value after it cut costs as much as possible and a bear market in commodities revealed its limited diversification. "They might look for some more opportunistic times, maybe when the regulatory environment is a little better," he said. "They will continue to look toward M&A to enhance their network."

In 2014 Canadian Pacific tried to start merger talks with **CSX Corporation** but was quickly rejected. The company tried to rekindle talks but was rebuffed again. Its attempt to buy Norfolk Southern represents yet another failure in management's plan to expand and diversify its rail network.

Until it can leverage its cash flow in an acquisition, Canadian Pacific has no choice but to return cash to shareholders; there simply aren't enough growth projects in its existing business lines.

In addition to its higher dividend, the company said it may buy back up to 6.9 million shares, roughly 5% of its float. In its last buyback, the company repurchased 11,375,189 of its shares at a weighted average price of $198.46.

Moves like these should keep shareholders happy in the short term, but they mostly indicate that management has no other viable options to reinvest its cash flow. Even if the company paid out 100% of its earning, shares would only yield 4.5%. There isn't much room for growth beyond that.

CATEGORY

1. Dividend Stocks
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1. NYSE:CP (Canadian Pacific Railway)
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