Which of the Top Railroads Should You Buy Today?

Description

Some investors have been watching the rally in commodity prices and wondering if they should buy energy and precious metal mining stocks to join in on the potential continuation of the rally.

No one knows how long the rally is going to last. While commodity stocks have rallied, the share prices of other stocks have declined.

Since an important factor in successful investing is buying low, it makes sense to consider quality stocks that have declined in price but not in fundamentals.

Of the quality stocks that I follow, one in particular stands out: **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP). Its share price has declined 21% in the past year.

A discussion about Canadian Pacific Railway is incomplete without also talking about its competitor, **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI). Canadian National Railway's share price rose 1% in the same period.

Although Canadian Pacific Railway's share price experienced a big decline and Canadian National Railway's hardly budged, their 2015 earnings per share (EPS) rose by 19% and 18%, respectively.

Both railroads have carved a wide moat for their businesses; when a railroad is built along a route, it doesn't make sense to build another one in the same location.

Railroad businesses also require huge amounts of capital reinvestment, so there are huge barriers to entry, and there's a slim chance for new competitors to share the pie.

Which top railroad should you buy?

Both Canadian Pacific Railway and Canadian National Railway are top railroads that remain very profitable. So how do you choose between the two?

One simple way to make a decision is by looking at their valuations. Which is a cheaper investment today?

At under $168 per share, Canadian Pacific Railway trades at about 16.1 times its earnings. At about $75.50 per share, Canadian National Railway trades at about 16.9 times its earnings.

At first glance, we see that Canadian Pacific Railway is cheaper. However, we should also compare their anticipated earnings growth.

In the medium term, Canadian Pacific Railway is expected to grow its EPS at 13% per year, while Canadian National Railway is expected to grow its EPS by about 8%.

Profitability

The higher the return on equity (ROE) and operating margins, the more profitable a company is.

Canadian Pacific Railway achieved an ROE of more than 10% in eight of the past 10 years with particularly strong percentages of 23-26% in the past two years. Additionally, it has achieved an operating margin of 41% in the first quarter.

Comparatively, Canadian National Railway achieved an ROE of more than 17% every year in the last decade with particularly strong percentages of 24-25% in the past two years. And it has also achieved an operating margin of 41% in the first quarter.

Conclusion

Both companies are excellent businesses to invest in. However, for an investment today, Canadian Pacific Railway is a stronger total-return investment candidate because of its cheaper multiple and estimated higher earnings growth compared with its peer.

If Canadian Pacific Railway's multiple remains constant at 16.1, it can deliver annualized returns of about 13% if its medium-term earnings growth estimate materializes.

A 13% annualized return is 3-6% higher than the average market returns. For an investment of $10,000 over a five-year period, that's an extra return of $1,592-3,382.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

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

Category

1. Dividend Stocks

2. Investing

Date
2025/08/24
Date Created
2016/05/20
Author
kayng