Canadian National Railway Company: Buy or Sell?

Description

Despite falling commodity volumes, **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) has weathered the storm quite well. While the prices of oil and many metals have been cut in half, shares are roughly flat since the commodities rout began.

Is the stock now on sale after a pause in its five-year run-up? Or is the company still set to feel further financial pain from weakening fundamentals?

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How tough are the struggles?

For the first quarter, Canadian National reported revenues of $2.96 billion, over $100 million less than what analysts were expecting. Earnings of $1.00 a share, however, beat expectations by $0.08. What's going on?

Across nearly every commodity segment, Canadian National is feeling volume pressures. Executive Jean-Jacques Ruest said that "volume is weak, will get weaker, and pricing is not the greatest." For example, the North American oil rig count just hit historical lows. This caused year-over-year petroleum revenues to drop 18% this quarter. Metals revenues also fell 18%, and coal revenues fell a steep 42%.

"Our crude-by-rail volume dropped by half to 14,000 carloads, for the more relevant aspect of the crude story is a prevalent incremental rail capacity pricing that brought crude by rail to become the least profitable for the unit train business," the company explained. "The downturn in oil and gas capital program also impacted our steel, cement aggregate and frac sand business. Frac sand was down 45% in volume to 13,000 carloads in Q1."

Despite the heavy pressure on sales, Canadian National has boosted profitability through aggressive cost cutting. This quarter, EBITDA margins jumped from 44% to 51% year over year. This was made possible through lower fuel costs (dropping to 8% from 12%) as well as lower labour costs (now down to 19% of revenues). The average cost per employee was down about 2% year over year, and the employee count fell by 2,400.

What are the long-term possibilities?

On the valuation side, shares have gotten consistently cheaper due to a stagnant share price and improving profitability. Today shares trade at a similar valuation as they did in late 2013.

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Bears believe that cost-cutting initiatives, while helpful, are limited in scope. Unfortunately, cost improvements are typically non-recurring. Should volumes and pricing fail to improve, the latest dip in valuation should prove ephemeral. Long term, the business will only grow in value if volumes and pricing pick up.

To invest in Canadian National today, you must believe in a few things. First, the United States will avoid slipping into another economic recession. Second, commodities will continue their latest rebound, boosting both pricing and volumes for those segments. Additionally, rising commodities would help reverse the slide of Canada’s economy. If those conditions are realized, Canadian National Railway Company is likely a buy at these levels.

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1. Investing

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1. Editor's Choice

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rvanzo