Canadian Pacific Railway Limited Slashes Outlook: Time to Dump the Stock?

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) stock dropped to its lowest levels in nearly four months earlier this week after the railroad giant issued a dismal preliminary guidance for its second quarter. With key end markets deteriorating, the loonie proving to be a major headwind, and unexpected developments pulling the brakes on Canadian Pacific's growth, is it time to sell the stock?

Wildfires and loonie: a double blow

Canadian Pacific expects its Q2 revenue to be 12% lower and earnings per share to fall almost 18%, year over year. The key factors driving Canadian Pacific's revenue lower are

- weak volumes in bulk commodities, especially potash and grain;
- Alberta's wildfires, which hurt crude shipments; and
- a stronger loonie.

Among these, the first factor is perhaps the strongest hurdle for Canadian Pacific right now, simply because bulk commodities make up a major portion of the company's revenue. Nearly every commodity within the segment, from grain to potash fertilizer to coal, is currently under pressure.

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Canadian Pacific's revenue by segment, and break-up of bulk revenue. Source: Company Annual re
Canadian Pacific's revenue by segment and breakdown of bulk revenue.
Source: Company Annual Report 2015

Whether or not the second half of 2016 will get any better for Canadian Pacific depends a great deal on the crop harvest in the U.S. While the Canadian grain market is expected to pick up, activity in the U.S. remains uncertain on subdued crop prices.

Meanwhile, I see dim chances of the potash markets recovering as key players, such as **Potash Corporation of Saskatchewan Inc.**, are yet to get annual export contracts for the year from China and India–the two largest potash-consuming nations. In fact, potash poses a longer-term threat for railroads. According to its market-overview report released last month, Potash Corporation is indefinitely suspending potash mines with capacity of nearly two million tonnes this year in the wake of a downturn.

It’s also important to note that Canadian Pacific expects its Q2 operating ratio–a measure of efficiency for railroads as it compares operating expenses to net sales–to be 62%. That sounds uninspiring given that the company’s operating ratio hit a record low of 58.9% during the first quarter.

Why Canadian Pacific still remains a buy

Interestingly, Canadian Pacific’s CEO E. Hunter Harrison remains optimistic even in these challenging times. Harrison is betting on a stronger second half and aggressive cost control within the company to boost sales and profits as the year progresses. Accordingly, Harrison still expects Canadian Pacific to end 2016 with double-digit growth in EPS despite a dismal second quarter.

Is Canadian Pacific being a little too optimistic here? I’m not ruling out the possibility. However, even if things were to worsen, Canadian Pacific’s EPS this year looks poised to end on a stronger note than 2015. That combined with the company’s growing dividends should prevent the stock from falling further.

In fact, Canadian Pacific stock is already trading at a significant discount to its five-year average P/E and price-to-cash flow ratios. So there appears to be greater potential upside and limited downside in the stock from here.

Don’t let one weak quarter send you scurrying for cover. Canadian Pacific has been a top stock to own for years and continues to be so.

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