Should You Own Canadian National Railway Company Forever?

Description

Railroads are often deemed "forever" stocks, meaning their services will always see growing demand, hopefully leading to long-term profit growth. Buying forever stocks has gained popularity in recent decades, partly off the backs of famous investors like Warren Buffett.

As one of Canada's largest railroads with a market cap of $63 billion, **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) is a perfect example of a stock that many investors tout as a buy-and-hold-forever company. It has a leading and sustainable position in North America's transportation network, industry-low costs, and limited exposure to volatile commodities like coal and oil.

Still, the company's advantages have already been noticed by the market, with shares trading at a valuation of over 17 times earnings, higher than the both its historical average and the market overall. Is Canadian National still a forever stock even at these high prices?

Image not found or type unknown
generate_fund_chart

A tremendous run

Since 2008 shares of Canadian National have run from $12.50 to around $80 a share. In the first quarter of this year it posted record revenues of $2.96 billion and earnings of $1.00 a share, beatings expectations by a sizable $0.08.

However, while earnings are still rising, the underlying health of the business has been stalling. 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."

How are profits still rising then? Canadian National has boosted profitability through aggressive cost cutting. Last 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.

Priced for perfection

Over the past few years, Canadian National has generated an average return on invested capital of about 15% with a 25% annual return on equity. With its valuation currently nearing historic highs, the market is clearly betting on this trend continuing. There are a few factors that could derail the company's success, however.

Foremost, cost-cutting initiatives, while helpful, are non-recurring. What that means is that while Canadian National has seen margins expand based on lower expenses, these cost cuts will eventually reach diminishing marginal returns. Once that happens (some argue that it's already happened), only volumes and pricing will drive shares. On that front, company management sees plenty of headwinds.

"We continue to experience high volatility and weaker conditions in a number of commodity sectors," CFO Luc Jobin said on the company's conference call. "We've got our work cut out … there are some challenges out there," added CEO Claude Mongeau.

There's no doubt that the company as a whole has a great future, but at these prices, it's unlikely that shareholders will reap the entirety of that success.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
2. TSX:CNR (Canadian National Railway Company)

Category

1. Investing

Date
2025/08/24
Date Created
2016/07/14
Author
rvanzo