Canadian National Railway Company: Are Profits About to Peak?

Description

Since 2006, shares of **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) have exploded, increasing by nearly 400%. Encouragingly, a large part of that performance has been financially related. Over the past decade, gross margins have increased dramatically, resulting in record profits.

For nearly two years however, the company's shares have flatlined, stuck at around $80. Gross margins have also leveled off at around 80%. Is it possible that Canadian National is experiencing peak margins, and therefore peak profitability and share price?

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Running a railroad hasn't always been that profitable

Following the deregulation of the railroad industry in the late 1980s, railroads gained immense pricing power, leveraging their newfound ability to price competitively and negotiate private contracts. This pricing power resulted in record volumes and profits. Not until roughly 2010 have railroads been able to consistently earn profits in excess of their cost of capital. This was spurred not only be deregulation, but by rising China and the commodities super-cycle.

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Looking at Canadian National specifically, it's no surprise to see its valuation multiple increase as the rate of profit growth expanded. Since 2000, the company's EV to EBITDA multiple has nearly doubled, a big factor driving the stock's outperformance. While the valuation has come down in recent months, it's still higher than anytime between 2000 and 2013.

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Is margin expansion over?

There are a few reasons to believe that profit growth and margin expansion will slow considerably or halt altogether.

Despite the heavy pressure on sales in recent quarters, 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.

The first driver of lower costs (fuel) typically accounts for 10-15% of the company's operating expenses. Because a limited portion of revenues are derived from the oil and gas sector, rising oil prices will tend to hurt the company more than help. With oil prices hitting US$50 a barrel, operating cost reductions will be tougher to come by.

The second driver (labour expenses) is also hitting diminishing marginal returns. In the past 12 months, the employee count has fallen by over 2,400. Due to the size of the business, there isn't much more room for cuts when you compare the employee count to other major railroads. Additionally, wage inflation is continuing stronger than expected. Management's estimate of 2.5% wage inflation for 2016 was recently upped to 3%. While that's not a crazy increase, it is enough to slow one of the major drivers of profit expansion.

Priced for perfection

Canadian National rode the wave of deregulation and global commodities growth to increase profit margins substantially. With that, the market assigned it an ever-increasing valuation multiple. Today, it appears as if the easy money has been gained as cost-cutting initiatives, while helpful, are limited in scope. The future business will only grow in value if volumes and pricing pick up. While that's certainly possible, profiting from Canadian National is much trickier than any time over the past decade.

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