



Surprise! Coal Is a Major Bright Spot for Canadian Pacific Railway Limited

Description

The past year or so may have come as a surprise for many **Canadian Pacific Railway Limited** ([TSX:CP](#))([NYSE:CP](#)) investors. After a massive rise beginning in 2009, shares have leveled off considerably with profits flattening out as well. Fortunately, one of the railroad's weakest segments may turn into a profit driver.

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Coal to the rescue

Last quarter, Canadian Pacific Railway posted a 10.4% decline in rail car volumes. During the period, it shipped an average of 30,000 rail cars a week compared to more than 33,000 a week the year before. Excluding coal shipments, however, volumes were down 13.3%. There are a few factors allowing coal to mitigate some of Canadian Pacific's volume drops.

First, coal prices are rising considerably due to shrinking supply and surprisingly resilient demand. Since the year began, coal prices have shot up by over 30%. Major producers such as **Teck Resources Ltd.** have seen their shares soar by over 400%.

Shrinking supply (especially from higher-cost Chinese mines) has helped fuel the strong rally in recent months. Over the long term, there are also some exciting demand drivers.

According to Zacks Investment Research, "World demand for coal is expected to grow by 7% through 2030 as a result of emerging markets prioritizing cost effective energy production methods over environmental sustainability."

While many investors are scared of renewable technologies eating into coal demand, many analysts are now calling those claims overdone. "While renewable energy demand in the developed world is expected to increase 53% over the next 15 years," the report continues, "it will remain a modest threat, as coal demand will still be significantly higher."

How much impact will surging coal prices have?

Today, coal shipments only comprise about 10% of Canadian Pacific's volumes. So while surging prices have helped offset weakness in the company's other segments, it hardly represents a long-term solution to current ailments. The company's main issues stem from its huge exposure to Alberta, where commodity weakness has roiled profitability. Abysmal volumes for commodities, such as grain, oil, coal and potash, have been killing revenues.

When you break it down, Canadian Pacific's business was ripe for a downfall. A massive 42% of volumes come from bulk sources such as grain or coal with another 17% coming from metals, minerals, and crude oil. Prices in all of these commodities are down more than 50% in the past 18 months.

Worse yet, one of the major drivers of the company's multi-year run (shrinking costs) has nearly reached its limit. Aggressive cost-cutting measures, such as reducing the workforce count, can't be repeated continually to boost margins. For example, since 2012 the railway has cut over 6,000 jobs, including 1,200 in 2015.

Over the long term, it appears as if volume growth will be the only thing that can drive higher profitability. While the surge in coal certainly helps, Canadian Pacific will need oil, gas, and minerals to follow suit. Unfortunately, China has historically contributed over a third of global growth, including rising demand for nearly every commodity. With the country posting its lowest growth rates in over 15 years, many say that the commodity super cycle is over, potentially spelling major trouble for Canadian Pacific.

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