Should Investors Buy Canadian Pacific Railway Limited?

Description

In hindsight, buying **Canadian Pacific Railway Limited** ([TSX:CP](TSX:CP))(NYSE:CP) at the end of June would have been a really nice buy. However, investors are now questioning whether there is more room for Canadian Pacific to grow or if it's best to just avoid this stock.

My stance on Canadian Pacific has always been rather tepid.

Its revenue dropped 12% to $1.45 billion in the second quarter year over year. Its net income dropped by 16% to $328 million. Its diluted earnings per share declined by 9% to $2.15. Whenever a company's revenue and earnings drop by double digits, you have to pause.

Fortunately, this doesn't seem like it will be a recurring issue. Canadian Pacific got hit by a perfect storm with lower-than-expected volumes, wildfires in Alberta, and a Canadian dollar that got stronger far faster than analysts had expected. So while the bad quarter certainly hurt, it shouldn't repeat itself.

And there was good news in the quarterly report. Its operating performance has been on the rise with network speed increasing by 11% and time in terminal down 3%. If it can get goods to their destination faster, trains can be used for other shipments, thus increasing earnings.

Here's the good news: perfect storms only hit once in a while, and I don't expect last quarter's results to be repeated. However, Canadian Pacific is not out of the doghouse yet.

One of its top advocates was hedge fund manager Bill Ackman. On August 3, Ackman revealed that he had sold his entire stake of 9.8 million shares for about $1.9 billion. He had already sold his first batch of shares back in April. When an activist investor gets out, it means one of two things: he has either failed to turn the business around, or he has turned it around and sees no future growth ahead. Canadian Pacific certainly turned around, so Ackman's decision to sell shows little faith in future earnings.

Management disagrees. It believes that it will be able to push double-digit growth in earnings per share, so long as it can keep its operating ratio around 60%. In the last quarter the operating ratio increased to 62%–a 1.1% rise. This is the amount of money it costs Canadian Pacific for every one

dollar in revenue. The lower this number, the better. In future earning reports, it is very important that Canadian Pacific continues to push its operating ratio down.

Then there's concern about management changes. E. Hunter Harrison, CEO of CP, is retiring in 2017. He is one of the most successful railroaders in the business and is responsible for seeing Canadian Pacific turn into the juggernaut it is. Again, management is not worried because Harrison's number two and replacement, Keith Creel, has worked with Harrison for 20 years.

So, all of this means you should avoid Canadian Pacific, right?

Not exactly…

Management has been returning money to investors in large amounts. In the second quarter it repurchased 5.13 million of its common shares for a total cost of $867 million. Based on its announcement earlier this year, it could buy upwards of 6.91 million between May 2, 2016, and May 1, 2017. Therefore, there is still another ~1.8 million shares it could buy between now and then.

The other big return for investors is the dividend. While a 1.03% yield is paltry, the dividend was increased by 42.9% in April to get it to the current $0.50 per share. However, this was the first hike since 2012.

Canadian Pacific is a large, secure railroad that will ebb and flow as commodity prices go on a roller coaster. However, the expectation is that it will see double-digit EPS growth and, so long as it continues to buy back shares, this might be a decent investment. However, I'm still not a buyer of this railroad. If you ask me, Canadian Pacific is the number two railroad in the country.

CATEGORY

1. Investing

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Date
2025/08/29
Date Created
2016/08/15
Author
jaycodon

Footer Tagline