Can Canadian Pacific Railway Limited Stay on Track?

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) delivered mediocre numbers in its Q3 earnings report last week. There are several headwinds preventing Canadian Pacific Railway from moving back to its all-time highs in the near term, including low commodity prices and the lack of costs to cut to improve operational efficiency.

Cost cuts aren't going to cut it anymore

Cost cutting has done wonders for the company in the past, but there's only so much you can do before you run out of areas to cut costs. Bill Ackman realized this, and this is a big reason why he decided to reduce his large stake in the company.

In one of Canadian Pacific's cost-cutting measures, the management decided to retire several hundred locomotives and rail cars. There are many cases of weird accounting practices that skewed the operating ratio in the favour of Canadian Pacific Railway, but as of now there's simply no more costs to cut that won't affect long-term profitability of the business.

Low crude oil shipments will continue to drag down revenues in the near term

A lot of the revenues lost this quarter were an effect of the crude oil segment. Oil freight revenues declined by a nasty 88% in Q3 with only 5,000 carloads of oil versus 25,000 carloads in Q3 2015. This weakness in the crude oil segment is expected to go on at least for the rest of 2016. As we turn a corner into 2017, we may see this headwind turn into a tailwind if the price of crude oil increases back to its historical average levels.

Canadian Pacific Railway can expect further revenue declines going forward and margins may face pressure as the cost-cutting spree is over, and it's time to spend money to grow the business for the long run instead of focusing on near term operational efficiencies.

Valuation

Canadian Pacific Railway has its back against the wall regarding operational efficiency. It's only logical to assume that the efficiency will go down once the management team figures out it needs to spend money in order to grow. The stock currently has a P/E of 19.5 and a P/B of 6.2, both of which are much more expensive than the industry average of 17.3 and three, respectively.

Simply put, the stock is trading at a huge premium compared to its peers and is priced like a growth stock. The thing is, Canadian Pacific Railway is no longer the high-flying rail stock that it was when Bill Ackman was fully invested. The company has seen every last bit of cost cutting, and there's simply nowhere to go from here unless the proper investments are made back into the company.

Canadian Pacific Railway's ROIC and ROE are quite impressive at 14.2% and 32.2%, respectively, so I believe the company can turn things around with some good investments if management can take their minds off cutting costs.

I would wait for a further pullback in the stock price such that the dividend yield is at least 1.3% before owning shares of Canadian Pacific Railway.

CATEGORY

1. Investing

TICKERS GLOBAL

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Date
2025/08/29
Date Created
2016/10/27
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