



Great-West Lifeco Inc. Buys \$383 Million of Canadian National Railway Company: Should You?

Description

According to a disclosure report filed with the SEC on Oct 27, **Great-West Lifeco Inc.** ([TSX:GWO](#)) has purchased 184,013 additional shares in **Canadian National Railway Company** ([TSX:CNR](#))([NYSE:CNI](#)). This brings its total investment to 6,075,760 shares and is worth roughly \$383 million.

Should you also be buying Canadian National?

Here's what we learned from last quarter

On October 25 Canadian National reported third-quarter earnings. While the headline numbers looked so-so, a deeper dive reveals some troubling concerns, particularly with commodities.

Here are the numbers to know:

- Net income was \$972 million (\$1.25 per diluted share) compared with \$1 billion (\$1.26 per diluted share) for the third quarter of 2015
- Operating income declined 5% to \$1.4 billion
- Revenues decreased by 6% to \$3 billion due to carloads declining 4% and revenue tonne-miles declining 3%
- Operating expenses declined 7% to \$1.6 billion.
- A record 53.3% operating ratio
- Free cash flow for the first nine months of 2016 was \$1.7 billion—roughly flat compared to a year earlier.

Results were underwhelming, especially compared to Canadian National's history. They would have been even more disappointing had it not been for strict cost controls.

Operating ratios are used to assess what proportion of revenues is required to pay for operating expenses. At 53.3% for the quarter, Canadian National leads North American railroads as one of the most efficient businesses out there.

But those cost-cutting initiatives, while helpful, are limited in scope. Unfortunately, cost improvements are typically non-recurring. Should volumes and pricing fail to improve, lower costs can only go so far.

Long term, the business will only grow in value if volumes and pricing pick up. Legendary investor David Einhorn doesn't seem very confident that Canadian railroads can avoid these pressures.

In September competitor **Canadian Pacific Railway Limited** ([TSX:CP](#))([NYSE:CP](#)) announced that famed hedge fund manager Bill Ackman has resigned from its board of directors, effective immediately. Ackman and his firm, Pershing Square, sold out of their position in Canadian Pacific in August.

It's worth noting that Ackman had held shares since 2011, leading the company through an impressive turnaround. He sold his entire stake of 9.8 million shares worth around \$1.5 billion.

Across nearly every commodity segment, Canadian railroads are feeling volume pressures. Canadian National executive Jean-Jacques Ruest said this year that "volume is weak, will get weaker, and pricing is not the greatest."

"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 former CEO Claude Mongeau.

Today, Canadian National shares are trading at an EV/EBITDA of 11.4 times. That's higher than its valuation any time between 2000 and 2014. Clearly, investors are still pricing in rosy expectations. Looking at Einhorn's latest move, the best times may already be behind us.

CATEGORY

1. Investing

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1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:CP (Canadian Pacific Railway)
3. TSX:CNR (Canadian National Railway Company)
4. TSX:CP (Canadian Pacific Railway)
5. TSX:GWO (Great-West Lifeco Inc.)

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Date

2025/08/26

Date Created

2016/11/08

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