Is Canadian National Railway Company a Buy in 2017?

Description

Railroads are one of my favourite types of stocks to own because they are necessary for getting bulk goods around the country, they have an uncrossable moat, and they act as a barometre of the economy. If railroads are seeing fewer goods ship, that could be a sign that the economy's future isn't going to be bright.

The undisputed top railroad in Canada is **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI). But does that mean you should buy it? While Buffett is right when he says, "it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price," Canadian National Railway is trading at all-time highs despite 2016 being, as the company said, "a challenging year."

Let's look at the numbers.

In Q4, Canadian National Railway's adjusted diluted EPS was $1.23 — up 4% from Q4 2015. One reason for this was due to the 4% improvement in revenue tonne miles — a nice momentum swing considering there was some concern that shipments would continue to drop. And if we look at 2015 versus 2016 as a whole, adjusted diluted EPS was $4.59 in 2016 — up 3% year over year. More importantly, Canadian National Railway generated free cash flow of $2.5 billion, which is up 6% year over year.

While it's true that Canadian National Railway saw an improvement in revenue tonne miles, there's one ultimate reason the railroad consistently generates earnings, and that's its efficiency.

Between 2015 and 2016, there was a 7% improvement in gross tonne miles per train mile from 8,739 to 9,314. There was a 6% improvement in the number of cars per yard-switching hour from 48 to 51. Canadian National Railway had a 7% drop in terminal dwell (the lower, the better) from 15 to 14. It had a 5% increase in trailing GTMs per total horsepower from 219 to 230. It had a 5% improvement in car miles per day from 224 to 236. Lastly, it had an increase in train velocity from 26.3 mph to 27.3 mph.

These numbers might not seem significant at first glance, but consider the following: if a train can move one mph faster and three more cars can be unloaded at the yard, thus allowing the train to leave the terminal an hour earlier, that means the train can get back to carrying new goods. All of this contributed to a record operating ratio of 55.9% (i.e., its operating expenses as a percentage of revenue). The lower this is, the fewer expenses it has for every $1 in revenue.

And that's how Canadian National Railway is able to consistently generate profit. It operates an incredibly lean and efficient operation, which means it can stomach economic swings.

But what about the future? Is the stock a buy?

There are three factors to consider. First, management expects to volume growth of 3-4% in terms of revenue tonne miles. That should allow it to generate "mid-single-digit" growth in EPS over 2016. Second, the company has authorized a new share-buyback program from October 2016 to October 2017. From 2015 to 2016, the number of shares decreased from 805.1 million to 779.2 million due to the last program. And finally, management has increased its dividend by 10% — a sign that management is bullish on the company's prospects.

These are all good signs, but the railroad is still expensive. Fortunately, with management consistently cutting shares and the dividend increasing, this stock should continue to appreciate for some time. While I wouldn't buy it because the value isn't present, there are far worse stocks to buy than Canadian National Railway.

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