Don’t Be Tricked by Canadian Pacific Railway Limited’s Q3 Results

Description

Canadian Pacific Railway Limited (TSX:CP)(NYSE:CP) released its third-quarter results on Tuesday. The company posted a modest 2% growth in its sales, but earnings per share of $3.50 were up 50%. Investors reacted positively to the release, as the stock reached a new 52-week high in trading on Wednesday. Canadian Pacific Railway also boosted its forecast for the full year with growth in earnings expected to be in the double digits.

Let’s have a deeper look into the railway operator’s results to see if the stock is still a good buy.

What drove the sales growth?

Canadian Pacific Railway tracks nine different freight revenues, and more than half were down this quarter. Grain revenue saw the largest decrease of $21 million as carloads were down 5%. Automotive-related freight also dropped $18 million in sales and saw the biggest drop in carloads, with a 13% decline this quarter. Fertilizer and sulphur also saw a double-digit drop in revenue with $12 million less this quarter coming as a result of a 3% drop in carloads. Intermodal and forest products were the other two segments that showed declines in revenue this quarter and combined for a decrease of $10 million in sales.

On the plus side, metals, minerals, and consumer products saw a $50 million rise in revenue as carloads were up 36% year over year. Potash had the second-largest growth with revenue rising $22 million, as it saw a near 20% increase in activity. Energy, chemical, and plastics were not far behind, as the segment contributed an additional $21 million in revenue for the quarter on a 13% increase in carloads. Coal-related revenue saw the smallest increase with $5 million in additional sales this year.

Increased revenue was the primary reason for the operating income

The improvement in the company’s foreign-exchange adjusted operating income was 7%, but with expenses up 3%, it was sales growth that fueled the company’s improved bottom line.

Foreign exchange played a big role in producing a strong quarter

Operating income was up 5% for the quarter, and it was the company's foreign-exchange gains that led to the strong growth in net income. Last year, the company's other income and expense line added $71 million to its costs, while this year that line item added $105 million to income for a total improvement this quarter of $176 million.

A breakdown of this line item shows that the entire benefit this quarter came from foreign exchange gains (mainly from changes in the company's long-term debt), whereas last year the company incurred a $46 million expense. As a result of this large swing in foreign exchange, the company saw a 45% increase in its income before taxes. Without the gain from foreign exchange, the company's net income before tax would have been just 22%, as it still would have benefited from the currency impact in last year's totals.

What this means for investors

Canadian Pacific Railway had a good quarter, but its profits don't tell the whole story. A headline of the railway operator posting a 47% improvement in its profit sounds great, but it can be misleading since much of that improvement isn't directly related to the company's operations. Foreign exchange can create a lot of uncertainty, and a gain this year could be a loss in the next.

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