What Happened to Canada's Railroads?

Description

The past six months have seen a clear division in the performance of Canada's railroads. Shares of **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) have moved almost sideways for the past six months in spite of a dividend increase, while shares of nearest competitor **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) are another story. Over the past half-year, shares have increased by almost 25%, reaching a 52-week high of $237 this past Friday.

Although Canada's second-largest railway has performed extremely well, the result of this performance is an investment that appears to be less attractive to current buyers. For an investor seeking a high-quality investment, the better choice may just be Canadian National Railway, which now offers a dividend yield of almost 2%, as a lower price translates to a higher dividend yield.

In spite of having more than a decade to analyze each of these names, investors need to understand that the status quo has not changed (and will not change) in the future. Due to the superior physical footprint that was attained by Canadian National Railway during the time that it was a Crown corporation, the infrastructure (which cannot be duplicated) is substantially better than that of competitor Canadian Pacific Railway.

As a response to this, Canadian Pacific Railway, with a market capitalization of $34 billion, has had to repurchase substantially more shares (as a percentage of the total float) to maintain a comparable return on equity and share price appreciation. In spite of a market capitalization of more than $72 billion, Canadian National Railway has only repurchased 8.25% of the float in comparison to 12.7% for the smaller competitor.

For income investors considering the dividend, shares of rail giant Canadian National Railway also hold the edge. Although the yield remains considerably higher, the payout ratio represents 22.6% of earnings, which is a relatively low amount for a capital-intensive industry (that is more defensive than cyclical). The little brother offers a yield of less than 1%, but it paid only 13% of earnings as dividends.

When considering the dividend and how it has grown over the past four years, the behemoth has done very well. In 2014, Canadian National Railway paid investors $1 per share, which accounted for 26.7%

of earnings. The compounded annual growth rate of the dividend has been 18% since then.

Canadian Pacific Railway paid $1.40 in 2014, which accounted for 16.5% of earnings in 2014. The growth rate of the dividend has only been only 16% over the same period of time.

Although the dividend yields seem very similar, the reality remains that Canadian Pacific Railway was forced to undertake a bigger share buyback to keep up with the bigger and better Canadian National Railway.

Given the current performance of each of these two names, investors may be able to find value hiding in plain sight.

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2. NYSE:CP (Canadian Pacific Railway)
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Date
2025/08/29
Date Created
2018/02/28
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