CN Railway (TSX:CNR) vs CP Railway (TSX:CP): Who Will Win?

Description

Canada's two biggest railroads are in the middle of a bidding war. And only one will emerge victorious.

Shortly after the **Canadian Pacific Railway** (TSX:CP)(NYSE:CP) proposed a $29 merger with **Kansas City Southern** (NYSE:KSU), the **Canadian National Railway** (TSX:CNR)(NYSE:CNI) swooped in with a competing offer. Valued at $33.7 billion, CNR's offer easily beat CP's. Initially, the CP-KSU merger looked like a done deal.

The two companies had already agreed to the terms of the deal, which looked set to close pending regulatory review. Then, the CN Railway bid came out of left field, and totally changed the conversation. While CP dismissed the bid at first, Kansas City execs were willing to meet CN's team to discuss their offer. Quite possibly, this could end with the original bidder being left in the dust.

CN outbids CP

Based on their most recent offers, CN has what looks to be a higher bid for Kansas City than CP does. The former has said it will offer $33.7 billion, the latter $29 billion. That seems to give CN a $4.7 billion lead over CP. However, the devil is in the details. Large acquisitions like this are rarely pure cash transfers. Canadian Pacific's offer was actually to be structured as a merger, where CP would assume KSU's debt and other obligations.

CN's offer, on the other hand, included a mix of cash and stock: $200 plus 1.059 CNR shares per KSU share. So, the true value of the company's bid depends on market valuations and is not set in stone.

Regulatory approval needed

If the bid for Kansas City Southern was simply a matter of getting the company to agree, then CNR would be leading over CP right now. Its bid is worth more at face value, and Kansas City executivesare willing to negotiate. Seems like a pretty straightforward matter. But in reality, it's not. Biginfrastructure deals like those involving railroads always require regulatory approval.

Sometimes regulatory *dis*approval can end them. For example, just recently **Air Canada's** bid to buy **Transat** was thwarted by EU competition regulators. CN will need to get all the necessarily approvals before its bid can close. And Canadian Pacific seems to think that it will not. In his first quarter conference call, Canadian Pacific CEO Keith Creel called CN's bid a "fantasy," saying that it would not receive the needed approvals in the U.S.

The "winner's curse"

Another big question regarding Kansas City Southern is whether it will be worth it to the companies bidding on it.

Over the last five years, KSU has averaged 1.8% revenue growth and 8% earnings growth per year. Not exactly a gushing river of growth. Yet the stock is priced like a growth stock, trading at a 45 P/E ratio. Depending on how heated the race to acquire KSU becomes, it could become a losing prospect for the eventual winner. The "winner's curse" is a well=known principle in economics, which occurs when buyers in auctions end up spending more money on an asset than it's worth.

Normally, this doesn't apply to stocks, whose valuations are known. It could, however, apply to a bidding war between two companies that are offering above-market prices for the target. If that's the case, then the eventual winner of the war for KSU, could in fact be the loser.

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