Can Canadian Pacific Railway Maintain its Incredible Momentum?

Description

Canadian Pacific (TSX: CP)(NYSE: CP) reported second-quarter results recently, and it appears to be defying gravity and all naysayers. It delivered another record quarter, the best in the company's 133-year history and did so despite continued operational challenges in the U.S. Midwest after a harsh winter.

For the second quarter, total revenues increased an impressive 12% to $1.68 billion and operating income grew an astounding 40% to $587 million. Reported net income in the second quarter was $371 million, or $2.11 per diluted share, versus $252 million, or $1.43 per share, in the second quarter of 2013. This represents a 48% year-over-year improvement in earnings per share, and $0.01 better than the consensus estimate.

Here are two important takeaways from Canadian Pacific's latest earnings release, and what it means for investors.

Exceeding expectations

With two quarters in the books, Canadian Pacific is well on its way to surpassing expectations it set for 2014. So far this year, revenue is up 7% and EPS is better by 33%, exceeding guidance on both accounts. And for the all-important operating ratio, Canadian Pacific's first half performance of 68.3%, 560 basis points lower compared to the first half of 2013, demonstrates solid progress towards its full-year objective of 65% or better.

It's important to put this progress, particularly with respect to Canadian Pacific's operating ratio, into perspective. At the end of 2012, Canadian Pacific's operating ratio — how much of its revenue goes toward funding operations — was 77%. The company's goal was to reduce it to 65% by 2015, initially thought impossible by many analysts, appears well in hand. Hunter Harrison, Canadian Pacific's current CEO, took 12 years to accomplish a similar task when he was at **Canadian National Railway** (TSX: CNR)(NYSE: CNI), reducing its operating ratio from 77.3% in 1997 to 66.7% in 2009. The team at Canadian Pacific is on track to a similar achievement in just three years.

It appears that if you've already designed the playbook, implementing it a second time can be done that much more quickly.

Going with the grain

If there is one area of concern in Canadian Pacific’s second-quarter results, it would be the company’s reliance on grain revenue.

The 13% revenue gain achieved during the second quarter was due primarily to the increased movement of Canadian and U.S. grain. For Canadian grain, revenues were up 32% on 28% more carloads and 34% greater revenue ton miles (RTM). And for U.S. grain, revenue was up 26% for the quarter, driven by 5% more carloads and an 11% increase in revenue ton miles (RTM).

Western Canadian farmers harvested a record 80 million tonnes of grain and oilseed last year, a crop 27% above the previous 2008-2009 record and 37% above the five-year average. And in the U.S., the yield was well above its five-year average. After a slow start, that crop is now getting to market in earnest. And given the sizeable backlog, grain transport should provide a considerable tailwind to Canadian Pacific’s results for the balance of 2014 and into 2015.

But long-term investors should pay careful attention to how a smaller revenue contribution from U.S. and Canadian grain will affect results near the end of 2015, and into 2016.

What’s a Foolish investor to do?

Canadian Pacific stock has been priced for perfection for well over a year – and for investors, it’s delivered. The stock is up 32% YTD, and 62% over the past 12 months. Today, the stock sports a lofty P/E ratio of around 40, the highest among Tier I railroads, along with the lowest dividend yield of 0.70%. Continued strong stock gains will require Canadian Pacific to not only exceed already lofty expectations, but also be supported by a strengthening economy. If either fails to materialize, Canadian Pacific stock may just run out of track.

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