# CN vs. CP: Here's the railway stock most attractive, post earnings

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On Tuesday, the top performing stock in the S&P/TSX composite index in terms of moving the benchmark index was Canadian National Railway, which rose just over 2 per cent. Meanwhile, the worst performing stock in the index was Canadian Pacific Railway, declining over 5 per cent. Chalk up the extreme divergence to second-quarter earnings and guidance.

Let's tell the tale of two rails and do a comparison of the two stocks. And I'll provide my opinion on which railway stock is more attractive for investors to accumulate.

**CP Rail's Financial Results**

On Tuesday, CP Rail reported second-quarter earnings in-line with expectations; however, management reduced its guidance for 2015 sending the stock price down 5.5 per cent.

The company reported revenues of $1.65 billion, down 2 per cent year-over-year, and slightly below the Street's expectations of $1.682 billion. Adjusted earnings per share were $2.45, up 16 per cent year-over-year and in-line with the consensus estimate.

The company's operating ratio declined 4.2 percentage points to 60.9 per cent in the quarter. This ratio reflects operating expenses as a percentage of revenues, and a lower operating ratio is positive.

At the end of the first-quarter, management's 2015 outlook was for revenue growth between 7 per cent to 8 per cent, and adjusted earnings per share growth of 25 per cent or higher. In 2014, the company reported earnings of $8.50, and suggested an earnings target of $10.625 in 2015.

Management now forecasts revenue growth of between two and three per cent, and earnings per share is expected to be between $10 and $10.40, implying growth of between 18 per cent and 22 per cent.

In addition, investors have some concerns surrounding the company's leadership; several resignations were announced from the company's board of directors. There was also the announcement that the company's chief executive officer, Hunter Harrison, was on medical leave.

**CN Rail's Financial Results**

Meanwhile, things appeared greener on the other side of the tracks with CN Rail beating earnings expectations and re-affirming guidance.

CN Rail reported results on Monday after the market closed. Revenues were $3.125 billion, relatively in-line with the consensus estimate of $3.129 billion and adjusted earnings per share came in at $1.15, well above the consensus estimate of $1.05, with 12 per cent year-over-year earnings growth. Also positive was that management re-affirmed its guidance for double-digit earnings growth for 2015 despite industry challenges.

The company's strong operating ratio was the key takeaway from the financial results The company's operating ratio dropped 3.2 percentage points to 56.4 per cent, well below CP Rail's operating ratio of 60.9 per cent. Operating expenses declined mainly due to lower fuel costs and lower labour expenses. Despite declining volumes, management was able to successful execute and deliver solid financial results through effective cost management.

**Dividend Policies**

CN Rail offers investors a higher yield compared to CP Rail.

CP Rail currently pays a quarterly dividend of 35 cents per share, equating to a yield of 0.7 per cent. The company has been active with its share buyback program, repurchasing over 3 million shares in the second quarter at a weighted-average price per share of $193.10, and anticipates to be very active in its buyback program in the second half of 2015.

CN Rail's balance sheet remains strong and its free cash flow can support future dividend increases. Currently, the company pays shareholders 31.25 cents per share each quarter, equating to a yield of 1.6 per cent. Management intends to slowly increase the company's payout ratio to 35 per cent. Management is also actively repurchasing shares.

**Valuation**

CP Rail is trading at a lower multiple; however, in my opinion, CN Rail's premium is justified.

CP Rail is trading at a price-to-earnings multiple of 15.9 times the 2016 consensus estimate, below its three-year historical average of 17.3. However, I anticipate 2016 estimates will be revised down by analysts, reducing the stock's discounted valuation.

CN Rail's stock is trading at a price-to-earnings multiple of 17.1 times the 2016 consensus earnings estimate, above its three-year historical average p/e multiple of 16.0 times.

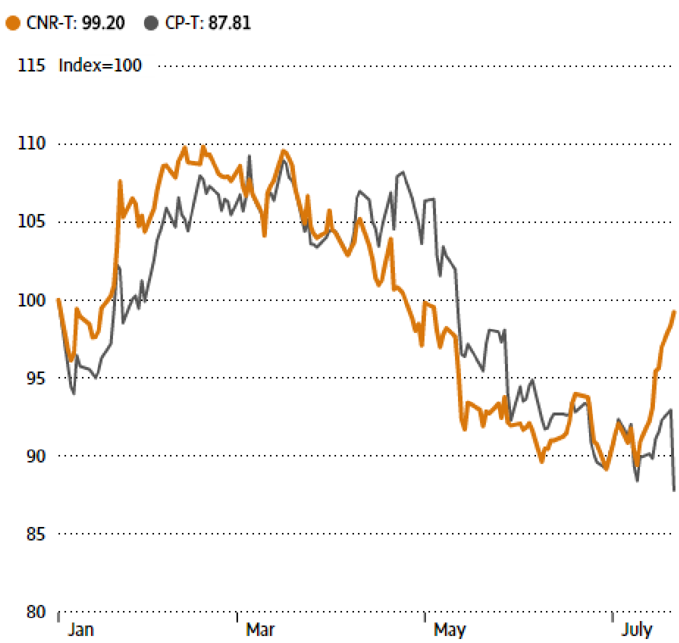
**Chart Watch**

CP Rail's stock price has negative near-term momentum. CN Rail's stock price is at overbought levels and may need to consolidate and is due for a pause.

**Bottom Line**

Of the two rail stocks, I prefer CN Rail due to diversity in its market exposure, its superior operational results, and its higher dividend yield. Investors don't need to chase the stock, however. As I mentioned in my earlier post, let it pullback and buy on the dip.

**CN vs CP: year-to-date stock performance**

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