



# STOCKTRADES PREMIUM COMPANY SUMMARY

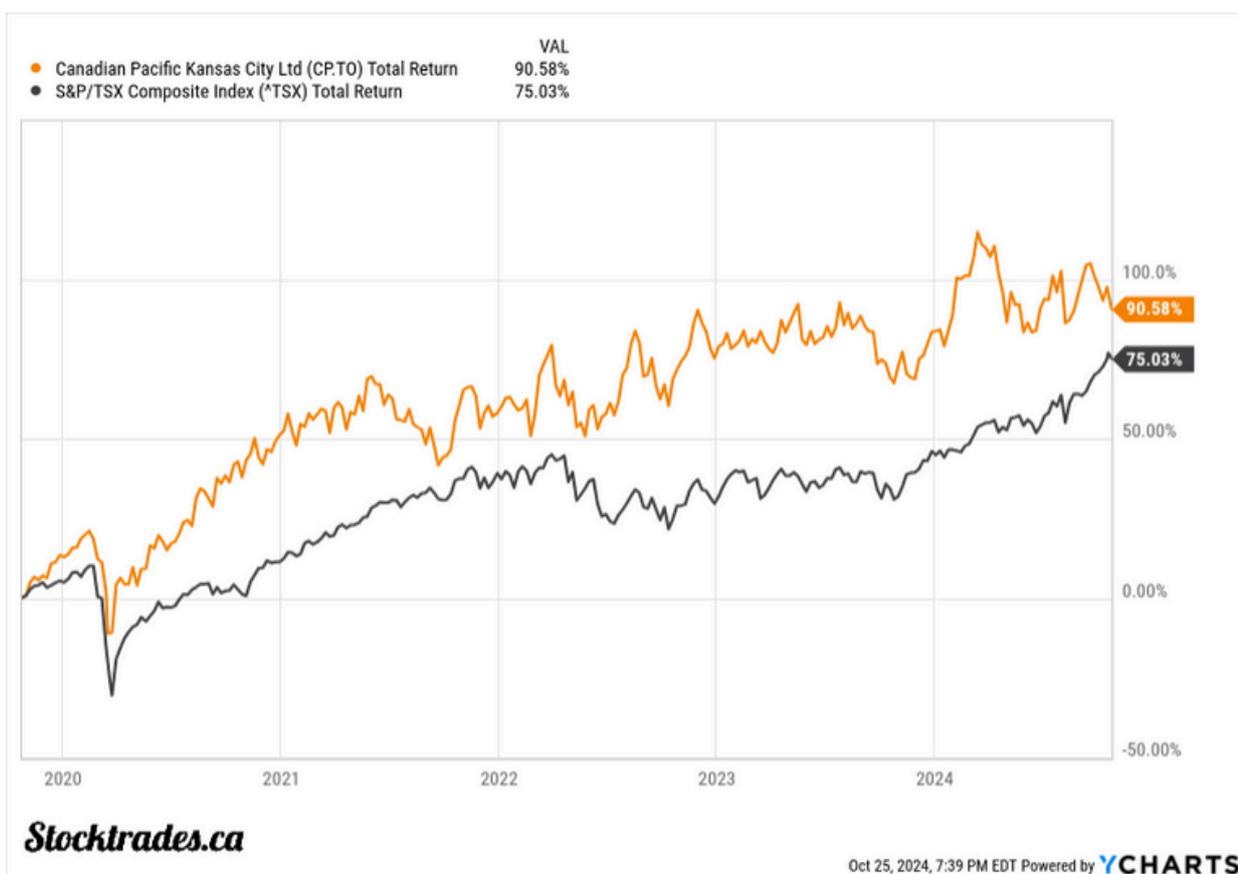
**CANADIAN PACIFIC KANSAS  
CITY**

**CP.TO**

**UPDATED OCTOBER 25, 2024**

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*Stocktrades Premium*



Canadian Pacific Kansas City is a Class-1 railroad operating on track that spans across most of Canada and into parts of the Midwestern and Northeastern United States. Following the April 2023 Kansas City Southern merger, CP operates new single-line-haul services from Canada and the Upper Midwest down through Texas, the Gulf of Mexico, and into Mexico. It also hauls cross border and intra Mexico freight via operating concessions on 3,300 miles of rail in Mexico. CP hauls shipments of grain, intermodal containers, energy products (like crude and frac sand), chemicals, plastics, coal, fertilizer and potash, automotive products, and a diverse mix of other merchandise.

Focus Areas	Score (0/100)	Focus Areas	Score (0/100)
Valuation	44	Dividend	79
Profitability	53	Outlook	78
Risk	88	Debt	40
Returns	57	Growth	55
Overall	57		

\*Our Risk Rating: Our opinion of the overall risk an investment presents. Can be shown as Defensive (DEF), Moderate (MOD), or Aggressive (AGG). By no means is this an indication of future potential gains or lower volatility.

## PROS

- Significant moat - duopoly with CN Rail
- KCS deal significantly improves CP Rail's reach and adds a level of additional diversification (material increase in US and Mexico revenue)
- KCS - \$1B in potential EBITDA synergies
- A top performer even before the KCS deal
- Despite harsh economic climate, cash flows remain consistent
- Expected to grow much faster than CN Rail over the next few years if synergies with KCS go well
- Guided to double digit earnings growth despite harsh economic climate in 2024

## CONS

- The KCS deal was not cheap, and there is a risk that the expected synergies do not materialize
- Higher than average debt load
- While it is technically an 'Aristocrat,' CP has a spotty history of dividend growth and unattractive yield
- Economic slowdown is impacting volumes
- We are already seeing lower carload and intermodal volumes
- While the company expands its US business and enters Mexico, currency exchange fluctuations will have more of an impact
- Not much of a discount in terms of valuation

## OVERALL THESIS

CP Rail could arguably be added to the Foundational Stock list. After all, it does form a duopoly with CN Rail (former Foundational stock). One might also question why we decided to add a railroad when there is a real possibility of a slowdown in activity in 2024 which could impact earnings.

The reason is quite simple - the Kansas City Southern Railway acquisition opens the path to significant growth in the coming years. The deal nearly didn't happen, as the aforementioned CN Rail came in with an offer that regulators ultimately rejected. There was also plenty of uncertainty around the deal itself, and as we know, markets don't like uncertainty.

However, now that the deal formally closed, the deal's regulatory risk is behind it, and we are now comfortable adding it to our Growth Bull List. Growth, because the company is expecting strong double-digit growth in the next few years and doesn't pay that much of a dividend for income-seeking investors.

The \$31B deal significantly expands the company's network reach and, along with it, new markets. In fact, it is now the country's only railway that connects Canada, the U.S., and Mexico. It now operates nearly 20,000 miles of rail, up from ~12,500 miles previously. It is worth noting that CP Railway rebranded to Canadian Pacific Kansas Southern (CPKC) and will be referred to as such moving forward.

CPKC is targeting \$820M in EBITDA growth and \$180M in cost savings for approximately \$1B in EBITDA growth opportunities over the next three years. It is worth noting that the \$820M is up from the \$600M it set out to achieve when the deal was first announced.

Since the deal only recently closed and the company has a short history as a fully integrated company, estimates will likely be all over the map for the upcoming quarters. That said, there is general weakness across the board regarding volumes as the U.S. and Canada are trending towards a recession.

Regardless, we believe CPKC is a strong addition to the Growth list and one with long-term potential to deliver outsized returns. The merger with Kansas City has caused the company to be boosted into the top 10 growth stocks inside of our screener. We would view any short-term weakness as potential buying opportunities.

## POTENTIAL RISKS

Since the KCS deal is the crux of the investment thesis, we'll start with the risk that the expected \$1B in synergies doesn't materialize. This is a real risk and one worth monitoring. Big deals that don't integrate as well as expected or take longer than expected to achieve usually end up being a drag on the company's stock price.

As a railroad, CPKC does transport dangerous goods. As such, a train derailment could have catastrophic consequences resulting in significant losses and claims. One needs only to look at the Lac-Mégantic disaster to see how such an event can be devastating.

<b>Beta</b>	<b>1.6</b>
<b>Alpha</b>	<b>N/A</b>
<b>Our Risk Rating</b>	<b>Mod*</b>
<b>Max Drawdown</b>	<b>68.7%</b>

As the primary method of transportation of goods across the county, it can be the target of terrorism or blockades by those seeking to disrupt the supply of goods. While the terrorism risk is low, we've seen many blockades over the years. Similarly, as a unionized company, a long-term strike could materially impact the company. In other words, any event that disrupts the movement of goods is a risk.

The single biggest operating expense for CPKC is fuel, so commodity price fluctuations will

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impact margins. While it does use a cost adjustment program, it may not be able to mitigate the price fluctuations fully.

Finally, since railways are considered bellwethers of the economy, an economic slowdown or recession can also impact the CPKC. This usually comes in the form of lower volumes and RTMs, thus impacting margins and profitability.

## VALUATION

	TTM	5 Year Average	Industry Average
P/E	29.6	24.1	22
P/S	7.3	8	6.27
P/B	2.4	2.7	3.1
P/FCF	56	38	33
PEG Ratio (FWD)	1.26	N/A	N/A

At first glance, CPKC doesn't exactly look cheap. That's because it's not - not that it ever is. Since the company forms a duopoly with CNR and is one of the most widely held stocks on the TSX Index, it will always have strong demand.

On a trailing basis, the company looks quite expensive in terms of price-to-earnings and price-to-free cash flow. However, lower volumes and a general slowdown of the economy are impacting earnings. We must look at CPKC from a forward standpoint. In this case, the company's 26X forward price-to-earnings ratio aligns with historical averages. It is relatively safe to say you are not paying a premium nor are you getting a steep discount on its shares.

The company's forward earnings are even more important now that the acquisition will start factoring into full-year results. Although its trailing earnings are weighed down by acquisition-related costs and a general slowdown of the economy, its forward price to earnings will start to reflect higher earnings from the Kansas City Southern acquisition. At this point in time, the company is trading at a 15% premium on a forward price-to-earnings basis versus Canadian National Railway. However, I feel the valuation is justified considering the potential for outsized earnings growth in the future from the acquisition.

After a flat year, CPKC is expected to grow earnings in the high teens over the next couple of years, supported by revenue growth in the low teens. It is worth noting this is down slightly, given recent macro pressures. But again, comparing that to its main competitor, CN Rail is only expected to grow revenue and earnings in the low-to-mid single-digit range over the next two years.

Will CPKC achieve lofty growth rates? The company has a pretty solid history of meeting and beating estimates. Of course, it will be dependent on the state of the economy. As we are seeing right now, volumes continue to trend lower, which could impact overall growth. This is likely why you see analysts continually downgrading earnings.

Again, the main wild card is their ability to integrate Kansas City Southern effectively. Should they prove capable, investors will be well rewarded. However, we could see downward pressure if they struggle to achieve posted targets. In the event of a recession and slower economic activity, we feel the merger will somewhat cushion the company. We would expect it to outperform CN Rail in this type of situation.

Just be aware that this company is fully valued at the moment, but as the saying goes, buy good companies at fair prices.

## COMPETITOR ANALYSIS

	CP.TO	CNR.TO
P/E	29.6	18
P/S	6.9	5.7
P/B	2.2	4.9
P/FCF	48	27

When it comes to railways, there are only two that dominate the Canadian market - CPKC Rail and CN Rail. They form a classic duopoly, and both are stalwarts in many investment portfolios. We have no qualms with owning either. As of right now, it certainly looks like CN Rail is the more discounted railway. This is likely because Canadian Pacific is putting up some solid results and guiding to stronger growth.

Much like the market, we're bullish on the acquisition and do believe CP Rail has a strong chance of outperforming its main competitor, CN Rail, over the short to mid-term, so we don't mind the premium valuation. However, this is also a situation where one could own both railways to benefit from the discounted valuation of CN Rail and the growth potential with Canadian Pacific.

## DIVIDEND ANALYSIS

Annual Dividend	Payout Ratio	5 Year Dividend Growth %	Dividend Growth Streak
\$0.76	20%	11.68%	0

CPKC currently yields under 1%, which isn't likely to attract many dividend investors. Furthermore, the company doesn't exactly have a strong and reliable history of dividend growth either. While the dividend has averaged double-digit growth over the past half-decade, it has remained steady for the last couple of years.

This is not unusual, as CPKC has a history of mini-periods of dividend stagnation. But is the company not an Aristocrat? Technically, it is, but without a raise for multiple years now it will be removed in 2024.

We had previously expected the company to return to dividend growth by the end of 2023. However, they did not. They will effectively be removed from the S&P/TSX Canadian Dividend Aristocrat Index when rebalancing occurs.

It's not like CPKC lacks room. The company has low payout ratios (20%~) across earnings and cash flow. That said, the company may want to reach its targeted debt ratio of 2.0-2.5x before it resumes dividend growth materially.

The company will likely continue to focus on debt reduction from the acquisition prior to returning to dividend growth. We're okay with that, as there is a good chance this will prove to be the better choice for shareholders over the long term.

## RECENT EARNINGS

Earnings Estimates	2024	2025	2026
EPS	#4.24	\$5.01	\$5.76
Revenue	\$14.6B	\$15.8B	\$17.3B
EBITDA	\$7.3B	\$8.3B	\$9.2B
EBITDA Margins	50.41%	53%	54.2%

CPKC reported yet another strong quarter against a pretty tough economic backdrop. Revenue and earnings per share of \$3.54B and \$0.99 aligned with analyst expectations.

The story is similar across both railways here in Canada. Operational costs are rising, and although demand has somewhat stabilized, it is still relatively weak. There is nothing CPKC can do about this, as it is just a company that is highly susceptible to fluctuations in economic activity.

However, when we look to year-over-year numbers, we're starting to see the benefits of the Kansas City Southern acquisition hit results. Revenue is up 6% year-over-year, earnings are up 8%, and its operating ratio sits at 62.9%. Top and bottom line numbers remain over and above CN Rail, largely due to the acquisition. Although operating ratios increased by 120 basis points (1.2%) on the quarter, they're mostly in line with its major competitor as well.

The operating ratio is an important indicator in the railroad industry. In a nutshell, this ratio calculates the amount of money the railway has to spend relative to the revenue it generates. For CPKC, an operating ratio of 62.9% indicates it has to spend \$62.90 to generate \$100 in revenue. Ultimately, the lower the operating ratio, the better.

Work stoppages were a short-term headwind for the company on the quarter, impacting quite a few segments like intermodal and coal shipping. It is highly unlikely the market will factor in any sort of downside in terms of price from the labour headwinds, as they're resolved.

Lumber demand remains relatively soft, which is to be expected during times of economic weakness, as housing starts generally go down. However, the demand for automotive and petroleum shipping remains well ahead of that of its major competitor, CN Rail.

In terms of outlook, the company expects to close the year out with double-digit earnings growth and high single-digit revenue growth. When you look at CN Rail's earnings, you'll likely notice that CN's revenue is flat, and earnings are growing in the low single-digits, primarily fueled by buyback activity. It is important to note that CN Rail doesn't have the tailwinds of the Kansas City Southern acquisition. As such, we can't expect the company to grow at the same rate.

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