Are Railway Stocks Still a Good Buy?

North American railway stocks have had a strong run over the past three years. Some, including Canadian Pacific Railway Ltd. (TSX:CP), have more than doubled in price. To determine whether any North American railway stocks are worth buying today, we need to understand the industry and the key companies.

To begin with, the companies under consideration carry freight, as opposed to passengers. Few parts of North America boast passenger rail infrastructure of the type found in Western Europe. Second, the industry has consolidated over time. In 1900, there were over 100 railway companies in North America. Today, a handful of large players control the prize assets. Third, the industry was deregulated significantly in the 1980s and 1990s, allowing for the strong financial performance we see from the key companies today. Prior to deregulation, railways were often forced to maintain unprofitable routes for the benefit of their customers. It was not that long ago that Canadian National Railway Co. (TSX:CNR) was owned by the Canadian government, as privatization was only finalized in 1995.

In recent years, the strong competitive position of the railways has become obvious to investors. Traffic congestion in major North American cities has put the trucking industry at a disadvantage. Rising oil prices have highlighted the fuel efficiency advantage of railways over trucks. Also, intermodal freight transport continues to grow. “Intermodal” refers to the use of shipping, rail and trucking to move a standardized container without handling the contents while changing the mode of transportation. Decades ago, railways realized that they could doublestack shipping containers on a single rail car, increasing freight volumes and efficiency. Railways continue to modify their lines today so that they have sufficient vertical clearance to double-stack containers.

Even with all of these positive characteristics, we would be reluctant to call the railway industry a “great” business. We do think that owning key pieces of rail infrastructure can be a “good” business, but there are challenges. First of all, railways are quite capital-intensive, as track maintenance and upgrades are constantly required. Second, the industry is cyclical, as its fortunes rise and fall with the overall economy. For example, in a recession, railways will suffer due to reduced demand for commodities and manufactured goods. Third, there are always competitive and regulatory challenges.

The trucking industry is trying to lower its costs, and railway regulators, in response to recent rail accidents, could impose costly new standards. Therefore, despite the strong competitive position of the major North American railway companies, we cannot provide a blanket response to the question posed by this article. We have to consider the merits of each company independently. One company we are avoiding at today's (Aug. 19) price of $124.87 per share is Canadian Pacific. The shares have risen rapidly over the past two years based in part on changes to senior management and cost-cutting. It is a solid company, but trading at around 20 times 2013 estimates of earnings per share (EPS), it does not seem undervalued.

On the other hand, we have recently started buying shares of CSX Corp. (NYSE:CSX), which are currently trading at US$24.89. CSX's network serves 23 states in the eastern U.S., including some of the most densely-populated areas. We believe that EPS growth could average around 10 per cent per year over the next several years, in part due to share buybacks. Trading at less than 14 times 2013 EPS estimates and paying a dividend of around 2.4 per cent, CSX looks like a solid multi-year investment.

Out of all of the North American railways, Canadian National may possess the best assets. Its routes cross Canada and mid- America, connecting the Atlantic and Pacific coasts with the Gulf of Mexico. CN is well-managed and efficient, and those attributes are reflected in its stock price of $100.85 and its valuation of just over 16 times 2013 earnings estimates. We are not currently buying CN shares, but we may become interested at lower levels. The strong performance of North American railway stocks in recent years has been justified. Even so, we believe today's investor will need to be selective within the sector in order to achieve a decent return.

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