Deutsche Bank
Markets Research

North America
Canada
Industrials
Railroads

Industry
Canadian Rails

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Initiation of Coverage

Flipping the Script - Buy CP, Sell CNI

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Companies featured	
Canadian Pacific (CP.N),USD174.74	Buy
Canadian National (CNI.N),USD81.21	Sell

Source: Deutsche Bank

Initiating Coverage of Canadian Rails

We are expanding our coverage of Transportation companies with initiation of coverage of the Canadian railroad industry. We are positive on **Canadian Pacific** (CP, Buy) and cautious on **Canadian National** (CNI, Sell), as we see overall market share and earnings trajectory driving a reversal in recent relative value trends. All told we forecast CP to grow EPS at double the rate of CNI (+30% for CP vs. +15% for CNI cumulatively through 2019), which together with capex and free cash trends should drive re-rating at CP and de-rating for CNI. In this report we present a primer on the Canadian rail industry, with deep dives on Canadian Pacific and Canadian National.

CANADIAN NATIONAL (CNI): A Victim of Its Own Success; Initiate Sell/$73 PT

We see 10%+ downside in CNI shares as the company's strong outperformance starts to slow- driven by both the law of large numbers (the company already achieves a mid 40's operating margin, up from the high 30's five years ago) as well as catch-up performance from CP. For example, we note that from 2012-2016 CNI increased volumes at more than double the rate of CP, reflecting mix as well as market share gains during CP's implementation of Precision Railroading. The combination of CNI's slower prospective earnings growth and high capex (20% of sales) implies 15.5x P/E under our DCF-derived methodology, implying potential for 3.5 turns (20%) valuation de-rating vs. current trading levels. Initiate Sell.

CANADIAN PACIFIC (CP): Shifting Gears; Initiate Buy/$209 PT

Following its multi-year implementation of Precision Railroading, CP is shifting gears from cost take-out to top-line growth. As such, we see at least 15% upside in shares as CP leverages its reduced cost base, improved service levels, and recent capacity investments to retake market share. We expect this to translate to 30% cumulative EPS growth over the next two years, reflecting mid-single digit revenue growth, significant operating leverage, and accelerated share repurchase. Against this backdrop we see CP's relative valuation discount as unsustainable, which underpins our positive stance to shares. Initiate Buy.

Valuation and Risks:

We utilize P/E multiples to value rail stocks, with our target multiple assumptions heavily supported by our discounted cash flow models. Risks for the group include recession, industrial production, pricing, and mgmt. execution. For more details please company-specific CP and CNI sections within this note.