Canadian National Railway (CNI)

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments

Canadian National Railway – business

- Railway ;)

Canadian National Railway– business (cont’d)

Canadian National Railway– Misc thoughts

- What can go wrong?
  - Less commodity transport?
- Recession – less transport
- Opportunities:
  - More commodity transport?
  - Lower cost than trucking (but is there any competition left?)

Strategic considerations

- Moat (*switching costs, habit, low cost*):
  - What are the moats? Infrastructure buildout
  - What does it take to sustain the moats? Pretty much super moat just stays unless something else is cheaper/more efficient (not going to happen)
  - Bargaining power of suppliers/customers? Large customers may have some power? Government controls?
- Is it a low risk business? Yes, but cyclical
- Is there high uncertainty? No, apart from cyclicality
- How capital intensive is the business? High
- Future growth – unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Not clear

Management

- I don’t usually do management analysis. Included for template completeness
- No dilution
- Can I trust management?
- Management shareholding (> 10%)
- Management incentives?
- Are the salaries too high?
- Is there heavy insider buying?
- Is there heavy insider selling?
- Do I like the management? (Operators, capital allocators, integrity)
- Profitable reinvestment
- What has management done with the cash?
- Where is Free Cash Flow invested? Share buybacks, dividends, reinvested, ROE & ROCE, incremental BV

Is it a good business?

- >10 year history of profits
- ROE:
  - 2008:17.9 2009:16.5 2010h1:17.90
- Margins
  - 2008: 22 2009:25 2010:25
- Growing earnings: 3 year sales growth 0%, earnings growth -2%
- No dilution
- Somewhat weak balance sheet
  - Cash 900M, debt 7.5B
- ROIC = Earnings / (Equity + Debt – Cash) = Earnings / (Assets – non-debt liabilities - Cash)
  - 11% ROIC

Is it a good business? Cash flow

- Strong cash flow
  - H1 1456M operating cash flow, 1000M FCF (FCF = OCF – capital expenditures)
  - Operating cash flow higher than earnings
  - Free Cash Flow/Share higher than dividends paid

Is business cheap? – Buffettology calculations

- ROE 17% - assume 15%
- Earnings in 10 years = ROE*Equity*$(1+ROE)^9$ = $6B
- Equity in 10 years = Equity*$(1+ROE)^9$ = 41B
- Market cap = 6B x P/E (15) = $90B
- Rate of return = ~11% after tax (calculations omitted)

- 9 year earnings growth: 22%. Assuming same earnings growth for 10 years into the future and 15 PE at the end, shareprice would grow 20% annually. Assuming 15% earnings growth: 14% share price growth.
- Not very realistic to expect such growth either in equity or earnings

Is business cheap? DCF

- Discounted cash flow
  - Current earnings of ~2B
  - 10% growth for 5 years, leveling after that
    - 10% discount -> $30B current valuation (if you buy company at <$30B, you will get 10% return or higher)
    - 15% discount -> $19.44B current valuation
  - 5% growth for 10 years, leveling after that
    - 15% discount -> $17.9B current valuation
- Owner's yield = earnings / (market cap + debt - cash) = earnings/EV
  - 2B / (27.5B+7.5B-.9B) = 6.3%

- What makes up the margin of safety? Moat
- Is there a sufficient margin of safety? Not clear

Is business cheap? – Graham investment considerations

- N/A for CNI – included for completeness
- >2 P/Book – not a net net
- Altman Z score (http://en.wikipedia.org/wiki/Altman_Z-score)