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CN and CP are offering enormous sums for Kansas City Southern, but history suggests the payback will be robust

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Railway investors have enjoyed a decade of epic gains. The fight for control of Kansas City Southern suggests the party isn't over yet.

Canadian Pacific Railway Ltd. and Canadian National Railway Co. have tabled competing bids for the venerable Midwestern rail operator. Both bids place a staggering value on Kansas City Southern KSU-N -0.81%decrease

Yet the price tags seem justified when placed against the strategic value of the acquisition.

Investors looking for a relatively safe way to play the reopening North American economy should take a long look at the Canadian rail stocks. No matter what happens in the Kansas City Southern battle, CP and CN can churn out steady profits. Both are likely to benefit from the robust recovery that most economists see ahead over the next couple of years.

To be sure, future returns are unlikely to match the enormous gains of recent years. The bidding war for Kansas City Southern demonstrates that railways are no longer the hidden gem they were back in 2009, when Warren Buffett announced a US$44-billion bid for Burlington Northern Santa Fe, the giant U.S. rail operator.

Since the Buffett acquisition, major North American railways have generated total returns of more than 800 per cent on average for their shareholders.

The six independent operators – CN, CP, Kansas City Southern, CSX Corp., Norfolk Southern Corp. and Union Pacific Corp. – as well as Burlington Northern (now a division of Mr. Buffett's Berkshire Hathaway Inc.) form an exclusive and highly profitable club.

What makes them particularly attractive is that their core businesses are next to impregnable. Given land acquisition costs and regulatory challenges, no one is building new rail networks these days.

This dearth of new entrants helps to explain why Kansas City Southern is so valuable to potential suitors. Its rail network stretches south from Kansas and far into Mexico. A combination of Kansas City Southern with either CP or CN would create the first railway to seamlessly connect Canada, the U.S. and Mexico.

So how much is that opportunity worth? CP's US$29-billion offer amounts to 31 times what the market expects Kansas City Southern to earn this year. CN has fired back with a US$33.7-billion counterproposal that works out to more like 36 times forecast earnings. To put that into perspective, Facebook Inc. and Apple Inc. both trade for around 28 times earnings.

It may seem ridiculous to put a higher valuation on a century-old railway operator than a fast-growing tech giant, but it is not as outrageous as it first appears.

In its original presentation in March, CP argued that a merger of its rail network with Kansas City Southern's would generate US$780-million in added EBITDA (earnings before interest, taxes, depreciation and amortization). About US$600-million of that EBITDA would come from new revenue opportunities and about US$180-million from cutting costs.

Dan Fong, an analyst at **Veritas Investment Research** in Toronto, says achieving those targets would result in double-digit returns on the acquisition for CP. Assuming the US$780-million in synergies is achieved by 2025, the internal rate of return on the deal – a widely used measure of profitability – would be around 16 per cent, Mr. Fong calculates. Even if CP bumped its offer higher to match CN's, it could still generate an internal rate of return near 11 per cent.

Mr. Fong says he has confidence in CP's ability to achieve the EBITDA gains it has outlined if its bid does win approval. "Management has a track record of delivering on its promises," he said in an interview. "If anything, I think the [US]$780-million estimate is probably low."

CN, of course, would benefit from many of the same synergies if its higher bid manages to take the prize. But even if its offer ultimately fails, CN could wind up strengthening its competitive position by forcing rival CP to raise its bid. The extra cost "could constrain CP's financial flexibility and potentially inhibit its ability to invest for growth," Mr. Fong noted in a recent report.

How all of this will shake out is uncertain. The Surface Transportation Board in the U.S. has to approve the acquisition and it could wind up rejecting either or both proposals. It could also impose conditions on a successful bidder to maintain competition. Meanwhile, the board of directors at Kansas City Southern has to decide which offer is better for shareholders.

But all of that uncertainty may be obscuring the simple fact that Canadian railways are robust businesses well positioned to capitalize on the economic rebound now under way. Freight volumes are likely to expand as vaccines, low interest rates and plentiful fiscal stimulus drive strong growth over the next couple of years.

Meanwhile, the railways' dedication to wringing costs out of their systems remains intact. Thanks to a strategy known as precision scheduled railroading, operating costs as a percentage of operating revenue keep falling.

By Mr. Fong's reckoning, both Canadian railways are trading below their intrinsic value, even ignoring any potential benefits from a Kansas City Southern acquisition. He estimates CP to be worth $510 a share and CN to have a fair value around $150 a share. His advice? Own both.