Where to Find Value in the Canadian Pipeline Space

Description

Unlike the S&P 500, the TSX is overwhelmingly exposed to the volatile energy and materials sectors, which often features companies with minimal pricing power and is subject to the whims of global commodity markets.

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For this reason, having some exposure to the Canadian pipeline space is essential, since these companies often have minimal commodity price exposure, and have revenues that are often underpinned by long-term contracts that guarantee returns in excess of cost of capital.

With this in mind, the decision to choose one pipeline over another should come down to the pipelines current valuation and the company's ability to generate value going forward. With **Enbridge Inc.** (TSX:ENB)(NYSE:ENB), **TransCanada Corp.** (TSX:TRP)(NYSE:TRP) and **Pembina Pipeline Corp.** (TSX:PPL)(NYSE:PBA) being Canada's largest pipelines by market capitalization, which currently offers the best value?

Enbridge is creating value through its secured capital growth program

Enbridge currently has a $44 billion capital growth program, of which, approximately $34 billion is secured. This $34 billion will be put into projects that are set to be in service by 2018, which should drive substantial earnings growth in the next several years.

In addition, Enbridge is creating additional value through its decision to utilize their Enbridge Income Fund and Enbridge Energy Partners subsidiaries to fund their capital growth program through drop downs. Enbridge is currently dropping down $17 billion worth of assets to its Enbridge Income Fund subsidiary.

This drop down should be 10% accretive to earnings, as the earnings lost from the divestment is more than recuperated by taking back shares in the Enbridge Income Fund (which pays dividends), as well as from special incentive fees.

Currently, Enbridge trades at a price-to-earnings (P/E) ratio of 33, which is in the upper range of its peers. However, thanks to Enbridge's large earnings growth going forward, Enbridge trades at a low

2016 forward P/E of 23. This is well below the peer average of 24.8. Given Enbridge's dominance in the pipeline space, its strong growth through to 2018, the potential for stronger growth afterwards, and a solid 14-16% dividend-growth rate annually, Enbridge seems undervalued.

TransCanada appears to be undervalued if its major projects gain approval

Like Enbridge, TransCanada's ability to grow and create value is dependent on its large $46 billion capital growth program. The issue, however, is only $12 billion of these projects are slated to be in service before 2018 and need to be approved by regulators. As a result, TransCanada has poorer visibility into its earnings growth than Enbridge does.

The remainder of TransCanada's projects, which includes the $8 billion Keystone XL project, the $12 billion Energy East project, and nearly $14 billion in natural gas pipeline projects, are all uncertain from a regulatory perspective, and it is possible that some—and more unlikely, all—of the projects could be rejected.

Currently, TransCanada trades at a P/E ratio of 23. Looking out to the company's 2016 earnings, this results in a very low P/E ratio of 20. This is well below both Enbridge, and the peer average, which likely means the current share price is not factoring in the estimating 16% annual growth that would occur between 2017 and 2020 should the companies major projects get approved.

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This means that if the major projects do not get approved, TransCanada is likely fairly valued now, but if they do get approved, TransCanada has huge upside potential as the stock should trade above the peer average with that level of growth.

Pembina seems expensive, but its high growth rate may justify it

Like its peers, Pembina is currently in the middle of executing a $5.9 capital program before 2017. These projects are committed, and the company also has an additional $1.5 billion in uncommitted opportunities, which have the potential to add even further growth.

Even more favourable, Pembina has been reducing its risk, as it's been adding to its growth. All of Pembina's new projects are fee for service, which means the company is exposed to no commodity price risk. As a result, the company is expected to generate 80% of its earnings before income, taxes, depreciation, and amortization (EBITDA) from fee-for-service contracts by 2018, compared with 64% now.

Pembina estimates these projects could double EBITDA by 2018, and given this, Pembina's high forward P/E of 27 may be justified.

With this information in mind, Enbridge seems to offer the best value, but TransCanada has significant upside if you are willing to bet on the approval of its projects.

CATEGORY

1. Investing

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1. NYSE:ENB (Enbridge Inc.)

2. NYSE:PBA (Pembina Pipeline Corporation)
3. NYSE:TRP (Tc Energy)
4. TSX:ENB (Enbridge Inc.)
5. TSX:PPL (Pembina Pipeline Corporation)
6. TSX:TRP (TC Energy Corporation)

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