Why Enbridge Inc. Is Expecting Over $17 Billion in Funding This Year

Description

Enbridge Inc. (TSX:ENB)(NYSE:ENB) is currently embarking on a historic $44 billion capital spending program, which is expected to drive earnings growth of 10-12% annually until 2018, and potentially higher growth after 2018.

The problem is this degree of funding far exceeds Enbridge's ability to pay with its own cash flows. Out of Enbridge's $44 billion program, Enbridge spent about $10 billion in 2014, leaving $34 billion remaining (plus another $5 billion for maintenance spending). Enbridge estimates only about $14 billion of this can be funded through its own cash flows.

The result is that Enbridge needs to come up with $24 billion in funding. Instead of issuing excessive equity or relying entirely on debt, Enbridge is relying on asset drop downs to fund its projects, which will not only boost earnings, but will also provide very low-cost capital for their program—a win-win for Enbridge.

What is a drop down?

Drop downs refer to a parent company, like Enbridge, selling assets to a subsidiary company. Enbridge currently has three of these companies—Enbridge Income Fund (EIF), Enbridge Energy Partners, and Midcoast Energy Partners.

Drop downs can create tremendous value for shareholders. Firstly, when a company drops down assets to a subsidiary, it can often realize a premium valuation for the asset that it could not realize within the original corporate structure. This is due to the fact that investors in these subsidiary companies are income focused and want reward assets with high payout ratios, plenty of cash flow, and potential for income growth.

As well, some of these companies, like Enbridge Energy Partners, are structures as Master Limited Partnerships (MLPs). MLPs are tax advantaged and do not pay tax at the corporate level. Therefore, by dropping down assets into these structures, companies can realize a higher value since the cash flows within the MLP are more valuable due to less taxation.

In exchange for dropping down the assets, companies often receive both cash and equity in the subsidiary company, which allows the parent company to retain control of the dropped down assets, collect income from the asset, and receive cash for funding capital projects. Essentially, the costs for funding capital programs are transferred to the subsidiary company, which often have a lower cost of capital.

Enbridge is about to finalize a $17 billion drop down

Enbridge announced plans to drop down $30 billion in assets to its EIF subsidiary, and the deal is expected to be finalized sometime this summer. This drop down will include its entire Canadian Mainline pipeline, as well as its Regional Oil Sands system, and renewable energy assets.

The book value of these assets is expected to be about $17 billion, and this $17 billion will reduce the costs of Enbridge's capital program. This drop down will create value for Enbridge in a few ways.

Firstly, Enbridge will immediately note a 10% boost to its earnings per share. This is due to the fact that the majority of the $17 billion will be in the form of EIF equity. Although Enbridge will lose earnings from divesting its assets, Enbridge will earn more back from EIF dividends. In addition, Enbridge will also receive incentive earnings, which means since Enbridge is the parent company, it will receive a greater percentage of cash flows as they grow.

The dividends from Enbridge's EIF earnings, plus the greater proportion of EIF cash flows Enbridge is entitled to as they grow, will result in Enbridge having more funding for it capital program.

In addition, Enbridge will be receiving cash from EIF, which Enbridge can use to fund its capital program rather than issuing its own equity. The result is that Enbridge is receiving very low-cost funding, which will create value for shareholders.

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