Enbridge Inc.: Is This Great Stock Worth the Inflated Price?

Description

In the energy sector, investors have flocked to the pipeline space, eager to continue being invested in energy while avoiding many of the peaks and valleys that plague oil producers.

So, even though the price of crude has declined nearly 50% over the past year, shares of the pipelines haven't seen the same kind of carnage. In fact, many of the pipelines have seen their share prices go up, like **Enbridge Inc.** (TSX:ENB)(NYSE:ENB), which is up more than 15% once you include dividends.

The future also looks pretty bright for Enbridge. It has several new pipelines coming online over the next few years, which should add to the bottom line significantly. It also has the Northern Gateway pipeline in the works, a potential mega-project that could cost upwards of $7 billion, with a slated completion date of sometime after 2020.

But is this potential enough to buy this stock, which currently trades at more than 131 times earnings? Let's take a closer look and see whether the company is worth the inflated price.

The issue with P/E

The first issue is using the price-to-earnings ratio to value Enbridge. It's a wildly misleading metric for a pipeline.

The issue comes down to accounting. Without getting too technical, let me try to explain. Because virtually all of Enbridge's assets are in pipelines, it actually generates much more in cash flow than the net income line would indicate because it's allowed to write off a certain percentage of the value of these fixed assets each year. After all, pipelines do wear out over time.

This results in a reduction in net income, but not in the amount of cash generated. So, instead of net income, investors should look at cash flow for an indication of how profitable the company is.

In 2014 the company generated $2.5 billion in cash flow, much higher than the $1.1 billion it reportedas net income. That puts it at about 20 times earnings, which is a pretty reasonable valuation,especially in a zero interest rate world.

What about the future?

If Enbridge can find a way to grow earnings, we can even make the argument that the company is cheap at today's levels.

Growth is certainly coming. Over the next few years more than $20 billion worth of pipelines will come online, with the majority in Alberta. That doesn't even include Northern Gateway, which alone could add significantly to the bottom line.

The company plans to pay for these projects with new capital obtained by "dropping down" old assets to its subsidiaries, **Enbridge Income Fund** and **Enbridge Energy Holdings**. These companies borrow to buy the old assets, which is essentially a way to transfer cash from the junior companies back to the parent. This frees up capital to invest in new projects, which in turn adds to the bottom line. And since the parent owns a chunk of the subsidiaries, it'll still continue to enjoy its share of the earnings from these divested assets.

By 2018 the company estimates profit growth of between 30-40% compared with 2014, which is good enough for cash flow of between $3.25-3.5 billion. That works out to as much as $4.10 per share, putting shares at approximately 15 times projected 2018 cash flow.

While investors wait for these projects to come online, management has committed to increasing the dividend. According to company estimates, dividends will increase as much as 18% annually until 2018, meaning investors who get in today could be looking at a yield on cost of more than 5% by the end of 2018. That's not a bad source of income, especially if interest rates stay low.

Is it worth it?

In a world where it seems like every prominent TSX stock trades at about 20 times earnings, there's certainly an argument to be made that Enbridge is a decent value—provided that it can deliver on promised earnings and dividend increases.

Considering the company's history of outperformance and its stellar portfolio of assets, I think investors should be in good shape if they hitch their wagon to the company. And with Northern Gateway as a potential addition to the bottom line post-2018, Enbridge could end up being a real long-term winner.

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