Could TransCanada Corporation Outperform Enbridge Inc. Over the Next 10 Years?

Description

Generally speaking, investors would have done well investing in any Canadian pipeline over the past 10 years as the sector as a whole has expanded due to the rapid "re-plumbing" of North American energy infrastructure due to rapid growth in North American energy supplies.

It is important to note, however, that while both **Enbridge Inc.** (TSX:ENB)(NYSE:ENB) and **TransCanada Corporation** (TSX:TRP)(NYSE:TRP) have both done well over the past 10 years, there are large differences in overall return. Since 2004, TransCanada has returned a fairly impressive 71% to shareholders (not including dividends). Enbridge, however, returned a much bigger 247% over the exact time period, once again, not including dividends.

There are multiple reasons for why TransCanada has outperformed Enbridge, and currently TransCanada trades at a 2016 forward price-to-earnings ratio of only 19, compared with Enbridge's 23. Here's why over the next several years, TransCanada has the opportunity to close that valuation gap and generate strong growth.

TransCanada will see its capital programs de-risked over time

One reason for TransCanada's underperformance is the fact that its $46 billion capital program is highly uncertain in comparison to Enbridge's $44 billion capital program. In fact, about $10 billion of Enbridge's $44 billion program has already been placed in service, with $24 billion planned to enter into service before 2018, leaving $10 billion risked. This means Enbridge has a very clear, high-certainty growth trajectory through to 2018.

TransCanada, however, only has about $11.8 billion of its small and mid-sized projects scheduled to be in service before 2017, with the remainder of its capital program in various states of regulatory limbo. As a result, shareholders are undervaluing TransCanada due to the lack of certainty in its capital program.

It is likely that TransCanada will, even in a pessimistic scenario, see a solid portion of these projects approved. Even if its largest project—the $12 billion Energy East pipeline—were to be approved, analysts at Royal Bank estimate it would lead to $11 per share in upside due to the higher growth rate.

If all the projects were approved, TransCanada could easily trade at the same valuation as Enbridge, which would result in share price outperformance, since TransCanada shares are currently not factoring in approval of these projects.

TransCanada could boost its payout ratio

Pipeline investors deeply value a high payout ratio. In a low interest rate period, investors looking for income are attracted to pipelines since they offer stable cash flows and have low maintenance and operating costs, meaning plenty of cash can be returned to shareholders.

The companies that return more of their cash flows to shareholders (i.e., a higher payout ratio) receive a higher valuation. Currently TransCanada only pays out 79% of its earnings compared with 121% of its overall peer group, and Enbridge recently announced intentions to boost its payout ratio to 85% of earnings by 2015.

This low payout ratio, however, is unlikely to persist. TransCanada is currently reluctant to raise its payout ratio due to the fact that the company's capital projects are largely insecure and fairly far off into the future. If TransCanada were to boost its payout ratio now, it would have less cash flow available to fund its capital program, therefore it would need to rely more on debt or equity.

This would not be an issue if capital markets stayed the same as they are today, but if interest rates were to rise, TransCanada could see its cost of debt increase, and its share price decline, which would result in more dilution when equity is issued. Once TransCanada's projects get closer to approval, the company will likely feel more comfortable in boosting its payout ratio, especially if interest rates are still low.

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