Is Enbridge Inc. Ready for Higher Interest Rates?

Description

Investors have heard time and time again over the past several years that Canadian interest rates are imminently going to rise. Instead, they have done the opposite—in January 2015 the Bank of Canada dropped the key overnight interest rate from the already low 1% to 0.75%, a figure that it has since been maintained.

This is the second-lowest overnight rate in the Bank's history, and it is mirrored by 10-year bond yields of only 1.5%. It is uncertain when the Bank will boost rates, especially with depressed oil prices and a low GDP growth rate. What is more certain though is that the U.S. will likely hike their rates very soon, and Federal Reserve Secretary Janet Yellen recently warned of an interest rate hike this year if the economy stays on its current track.

Canada will likely be shortly behind as the stronger U.S. economy and weak Canadian dollar provide a headwind for the Canadian economy, and as oil prices recover. For capital-intensive, dividend paying pipeline companies like **Enbridge Inc.** (TSX:ENB)(NYSE:ENB), it is a common perception that higher interest rate increases result in share price decreases. Let's take a look at why this is, and if Enbridge will be affected.

How could higher interest rates affect Enbridge?

Utility companies, REIT's, and pipeline companies are traditionally known as interest rate sensitive stocks, often falling in price as interest rates rise. There are two major reasons for this.

First, these companies, and Enbridge in particular, are extremely capital intensive. Enbridge is in the midst of a $44 billion capital spending program, and the company—like most in its sector—carries above average debt loads. Enbridge has a net debt-to-total capital of about 65%, and a debt-to-equity ratio of about 3.5. Compared to other sectors, this is considered a high level of leverage.

As a result, Enbridge has high interest payments as a percentage of cash flow and operating income. This means that should interest rates rise, Enbridge could see pressure on its cash flow and its cost-of-capital rise for its new projects. This translates into lower earnings, and a lower share price.

The second major way Enbridge would be affected by an interest rate increase is due to the fact that stable dividend payers with solid yields are considered bond substitutes. When interest rates are low, investors flock to relatively high yielding pipeline companies like Enbridge for both stable and growing dividends. However, when interest rates rise, Enbridge will have competition as investors will be able to earn a similar yield risk free.

Will Enbridge be affected?

Fortunately, while Enbridge may note some pressure from an interest rate increase, the effect should be mild and possibly short lived for several different reasons. The key reason is because Enbridge is able to offer significant earnings growth as well as dividend growth, with a reasonable payout ratio.

Companies with little to no dividend growth are similar to bonds, but with more risk, and as a result are more sensitive to interest rates. Enbridge, however, due to its huge growth program, is anticipating a 10-12% earnings compound annual growth rate (CAGR) until 2017, with a 14-16% dividend CAGR thanks to an increasing payout ratio (up to as high as 85%) and growing earnings.

In addition, thanks to Enbridge's recent drop downs and near-term nature of its capital projects, the compound should see a low cost of capital. Many of Enbridge's projects will be in service before a potential increase in interest rates, and will be using its Enbridge Income Fund subsidiary to raise low-cost equity to fund its projects, as well as increased cash flows, meaning there will be less reliance on debt.

With regulated assets that allow Enbridge to pass higher interest costs to customers, Enbridge should see little effect from an interest rate hike.

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1. Editor's Choice

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