



## Is Enbridge Inc.'s Recent \$30 Billion Deal Good for Shareholders?

### Description

In December 2014 **Enbridge Inc.** ([TSX:ENB](#))([NYSE:ENB](#)) announced its new “financial optimization strategy.” While this strategy had several parts, its central component was a huge \$30 billion drop down of assets to its subsidiary, **Enbridge Income Fund Holdings Inc.** (TSX:ENF). These assets include the Canadian Mainline Pipeline, the Alberta Regional pipelines, renewable energy projects, and \$15 billion of commercially secured growth projects.

This transaction was finally closed on June 19th, and shareholders reacted favourably; Enbridge experienced a 3.2% leap in share price. Although shareholders certainly seem happy with the transaction, it is important to look at its rationale, the specific transaction, and what effect this will have on Enbridge shareholders to see if it will be good for shareholders over the long haul.

### Why Enbridge performed the drop down

When Enbridge announced its financial optimization strategy in December, it outlined several problems. While Enbridge as a whole benefits from extremely transparent long-term growth (thanks its commercially and mostly politically secured \$44 billion capital growth program), and deep expertise in executing major projects, it is lacking in a few key areas.

Firstly, Enbridge suffers from weak valuation compared with its major pipeline competitors. In fact, out of 10 major competitors, Enbridge has the seventh-lowest earnings multiple. This means Enbridge shareholders are not getting proper value for Enbridge's solid assets, secure earnings growth, and stable, growing dividend.

Secondly, Enbridge is weak in its ability to actually fund its huge \$44 billion capital program at a competitive low cost. Thanks to Enbridge's lower multiple, it needs to issue more shares to fund its projects, which dilutes shareholders and reduces the earnings-per-share growth from any earnings growth from new projects.

The recent drop down should solve both of these problems. Shareholders of subsidiaries like the Enbridge Income Fund place a very high value on assets that can have a high, secure dividend payout, and solid, secure future growth. These assets aren't as highly valued within a large, diversified

corporate structure like Enbridge. When Enbridge drops down the assets, it can receive a premium multiple for its assets, therefore realizing the proper value for them.

In addition to this, the drop down has the potential to seriously reduce Enbridge's cost of capital down to more competitive levels for several reasons. By dropping down its assets to Enbridge Income Fund, Enbridge is essentially transferring responsibility for funding a portion of its capital program to the subsidiary.

Due to the higher multiple that Enbridge Income Fund trades at, it is effectively able to fund the capital projects at a lower cost than Enbridge. Enbridge Income Fund is estimated to issue approximately \$600-800 million in equity to the public every year to fund the capital projects for a total of approximately \$3 billion before 2018.

This, in turn, is equity that Enbridge itself does not need to issue, reducing the amount of shares that Enbridge needs to issue to fund its program, and therefore reducing the amount of dilution. This means Enbridge shareholders will benefit more from growth from the capital projects. Even better, when Enbridge drops down or sells its assets to Enbridge Income Fund, a large part of the proceeds are in equity of the subsidiary. This means that Enbridge still retains earnings from the assets it drops down.

### **Do shareholders benefit?**

The answer is largely yes. By needing to issue less equity, Enbridge shareholders should see more accretion from its capital program. In addition to this, Enbridge should see an overall boost in cash flow from the drop down because of the earnings from the equity that Enbridge Income Fund takes back.

Enbridge, being the parent company, will receive a special claim on Enbridge Income Fund's earnings; this is known as an incentive distribution. Enbridge is entitled to receive 25% of distributable cash flow above a certain level in addition to the amount it is already entitled to. This means that as Enbridge Income Fund grows its dividend, Enbridge will benefit greatly through increased earnings.

### **CATEGORY**

1. Energy Stocks
2. Investing

### **TICKERS GLOBAL**

1. NYSE:ENB (Enbridge Inc.)
2. TSX:ENB (Enbridge Inc.)

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