Enbridge Inc. Looks Undervalued, But Beware of These Risks Before Jumping In

Description

Enbridge Inc. (TSX:ENB)(NYSE:ENB) seems like an awfully tempting buy. The stock has recently been trading at prices not seen since October 2014. The stock price has been affected by the plunge in oil prices, despite the fact that Enbridge has only 3-5% of its earnings exposed to commodity prices.

Enbridge is not directly exposed to the price of oil, and it has $24 billion in commercially secured projects due to be in service by 2019, and these projects are largely stable cost-of-service and regulated contracts. These projects will ensure that Enbridge will not only recover its operating and capital costs, but also earn a solid return. Enbridge also primarily serves large, well-funded integrated shippers like **Suncor.**

Because of these projects Enbridge is expecting an 11-13% earnings per share compound annual growth rate between 2015 and 2019. Very few companies are able to reliably offer and guide double-digit growth for five years.

With all of this in mind, Enbridge does seem like a screaming buy. No company is without risk, however, and while Enbridge has a bright future, it is important to consider potential risks. There are two main risks to be aware of.

1. Low oil prices could jeopardize future oil sands production

Enbridge may have very low direct exposure to the price of oil, but the reality is, it is indirectly exposed to the price of oil through the volumes it transports. Enbridge is generally paid by the barrel transported, and fewer barrels means less revenue.

The price of oil has a strong bearing on how much oil is produced and therefore how much oil is transported. This is because high oil prices encourage production and make projects more economic, whereas low prices lead to production cuts and project cancellations.

At Enbridge's recent Investor Day, the company reiterated the Canadian Association of Petroleum Producers (CAPP) prediction that there would be 800,000 to one million barrels per day (b/d) of oil sands production coming online between the end of 2014 and the end of 2019. According to Enbridge, this would require about 450,000-650,000 b/d of additional pipeline capacity.

While this production is highly certain, the future after 2020 is very uncertain. One scenario laid out by both Enbridge and CAPP states that oil sands production growth would basically remain stable from 2020 to 2030 (in fact, it could decline slightly). In this scenario, very little pipeline capacity would be needed after 2020.

The other scenario sees the price of oil recovering and new production coming online, which would require another 500,000 b/d of pipeline capacity by 2025 (and potentially another 500,000 b/d on top of that by 2030).

This means that Enbridge's future growth ultimately depends on the price of oil. While Enbridge is forecasting strong growth through to 2020, should the more pessimistic scenario come to fruition, Enbridge could see significantly reduced growth prospects after 2020.

Enbridge itself estimates that its returns after 2020 would only be about 3% per year if the more pessimistic scenario comes through. If the more optimistic scenario comes through, Enbridge estimates double-digit growth.

2. Enbridge has competition from railways and other pipelines

Enbridge is projecting that 450,000 b/d of capacity will be needed by 2020 and potentially another 500,000 b/d will be needed by 2025 (if the optimistic scenario comes through). This means the industry will require 950,000 b/d over the next 10 years.

Enbridge has identified various expansions to its Mainline that could unlock about 800,000 b/d of additional capacity, which would meet a good chunk of future demand and provide Enbridge with a strong future growth trajectory.

Unfortunately, Enbridge is not the only provider competing to transport those additional barrels. While the 830,000 b/d Keystone XL may have been rejected, **Kinder Morgan's** proposed Trans Mountain pipeline expansion would bring about 590,000 b/d from Alberta to the coast of British Columbia where it can be exported.

This project will come online in early 2019, and its approval will put a dent in Enbridge's plans. In addition to Trans Mountain, **TransCanada's** Energy East pipeline is slated to come online in 2020, and this pipeline would transport 1.1 billion b/d of crude.

While there is a chance that one or both of these projects could be rejected, Enbridge shareholders should be aware of the risks they both pose to Enbridge's post-2020 growth.

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