Kinder Morgan Inc. Cut its Dividend. Will TransCanada Corporation Be Next?

Description

Kinder Morgan Inc. (NYSE:KMI) has long been a favourite of dividend-growth investors, especially stateside.

Investors loved the company's steadily increasing payout. In 2015 the company made four dividend payments, each higher than the last. It started out at $0.45 per share, then rose to $0.48, $0.49, and finally $0.51. And according to comments made by management around the time of that last dividend, investors could expect a dividend raise of between 6-10% in 2016.

Oh, what a difference a few months makes. Essentially, investors lost all confidence that Kinder Morgan would be able to afford the dividend, the interest on its debt, and still be able to finance its ambitious expansion plans. Ratings agencies threatened to downgrade the company's debt if something wasn't done, which would have made borrowing much more expensive.

Something had to give, and it ended being the dividend. Kinder Morgan shocked investors by cutting its dividend from $0.51 per share quarterly to $0.125. Founder Richard Kinder told investors the company weighed other options, but ultimately decided that slashing the dividend was the best move.

This sent shockwaves through the investing world. Up until a few months ago, nobody was questioning Kinder Morgan's dividend. The market assumed pipeline companies were immune to the kind of pressures that have brought so much pain to the rest of the energy sector.

It left investors with one question. Which company will be next to slash its payout? Will it be **TransCanada Corporation** (TSX:TRP)(NYSE:TRP)?

How risky is the yield?

From a traditional free cash flow perspective, it's easy to see why some investors are concerned about TransCanada's dividend. The company generated more than $3.7 billion in cash from operations over the last year, but ended up spending $3.9 billion on capital expenditures. A shortfall of almost $200 million meant the company had to borrow $1.9 billion to cover the dividend and the remaining capex.

But many of those capital expenditures were for growth projects. TransCanada has more than $13 billion in projects slated for completion between 2016 and 2018, and an additional $14 billion in long-term plans, including Energy East, Coastal GasLink, and a LNG plant in Prince Rupert. Thus, that much capital spending isn't such a big deal.

Once these projects go into service, they should add to the bottom line. Between 2016 and 2018, earnings are expected to grow about 8% annually from these new additions.

At the end of the expansion program in 2018, TransCanada should be generating anywhere from $4.5 to $5 billion in cash from operations annually. If the dividend grows as fast as earnings, it'll cost about $2.1 billion annually. That leaves between $2.4 and $2.9 billion the company can spend on capital expenditures without having to borrow.

The only real issue I can see is getting access to debt that will be needed to finish these growth projects. There's always the chance that bankers turn off the debt taps. But at this point, that risk looks to be minimal. TransCanada just announced a US$654 million acquisition of a natural gas-fired power plant in October, and it hasn't had any trouble with financing it even as Kinder Morgan all but imploded at the same time. And if worse comes to worse, the company can always tap its US$6 billion in available credit.

And remember, TransCanada isn't wholly a pipeline company like many of its competitors. Approximately a third of its assets are in power generation, primarily in Canada's eastern provinces. It's a part owner of Bruce Power, which provides about 30% of Ontario's electricity. Investors are attracted to those sorts of assets.

Ultimately, I'd say the chances of TransCanada cutting its dividend are remote. The only way it'll happen is if debt financing for new projects dries up. That's always a risk for a company that has to aggressively borrow. TransCanada's exposure to the safer power sector and its reasonable valuation should help alleviate those fears.

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1. NYSE:KMI (Kinder Morgan Inc.)
2. NYSE:TRP (Tc Energy)
3. TSX:TRP (TC Energy Corporation)

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