Don’t Buy Enbridge Inc. for its 4.5% Dividend

Description

Enbridge Inc. (TSX:ENB)(NYSE:ENB) has been a favourite with income investors for over five years, paying out a steady stream of income along with a consistently rising stock price. Management has regularly pitched the advantages of its business model (mainly operating pipelines) with only 3% of revenues being directly impacted by commodity prices. As we’ll see, however, there are some cracks starting to show in its core business of transporting fuel.

Not as safe as you think

Management’s claim that most of its business is not affected by commodity prices is not as straightforward as it seems. Yes, nearly all of its revenues are based on volumes, not energy prices, but over the long term, volumes are very much dependent on market prices.

With oil at over $100 a barrel, long-term production would surely be much higher than it is at $30 a barrel. Now that oil prices have stayed low for much longer than most anticipated, we are starting to see how Enbridge’s business isn’t as stable as previously thought.

The first sign of trouble came from the recent announcement that the company will defer $5 billion in spending until 2018, delaying multiple projects that would have commenced over 2016 and 2017.

“Given a higher cost of capital today that we are seeing, we will be lowering the microscope even further to make sure that we are deploying the most optimal projects,” the CEO said.

A major reason for this deferment is that oil sands projects (previously thought to provide long-term volume growth) are struggling due to their natural high costs of extraction. Nearly every oil sands producer is posting massive losses right now. On a recent conference call management said it is looking for ways to reduce its dependence on oil sands growth, given the growing viability concerns regarding future projects in western Canada.

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Financing is harder to get

Management has noted that financing is getting more expensive due to pervasive fears surrounding the energy sector. This is of major concern given the company's plans to spend over $18 billion on projects through 2019 (the major driver of dividend growth).

Last month shares fell 6.2% after Enbridge announced plans to issue 49 million shares, raising roughly $2 billion. Even if the company maintains its dividend, shareholders are paying for part of that yield with a lower share of earnings, given the higher number of outstanding shares.

The company noted that the latest equity raise should only be sufficient to fund its growth program through the end of 2017. Because capital costs are expected to skyrocket starting in 2018, there will likely be further dilution over the coming years.

Targeted dividend-growth rate is unlikely to be reached

Previously, management touted a target annual-dividend-growth rate of 14-16%. Capital spending delays combined with struggling customers slashing expansion plans will likely cause Enbridge to come up short of that goal.

Recently, the company noted that it's looking at diversifying into power generation and energy services to continue fueling growth. This should set off alarm bells for most investors as these businesses are much less profitable and reliable than running pipelines.

Long term, investors buying Enbridge for its supposed dividend-growth potential will likely be disappointed.

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