Is This 7.5% Dividend Stock Too Good to Be True?

Description

Enbridge (TSX:ENB)(NYSE:ENB) stock has long been a favourite with dividend investors. With the recent market pullback, the yield has hit 7.5%.

That payout may look steep, but keep in mind that Enbridge hasn't cut its dividend in more than two decades. In fact, it's *raised* the dividend every year since 1999. Over the last 20 years, the dividend has grown at an annual rate of 12%. Management has boosted the payout through several oil shocks and even the financial crisis of 2008.

Locking in a 7.5% dividend yield from a company with a stellar long-term payment history seems too good to be true. Is it time to buy?

Understand the model

Before we analyze how safe Enbridge's 7.5% dividend is, it's helpful to review how this business has been able to deliver such an impressive payout for decades at a time with zero interruptions.

Enbridge owns and operates the largest fossil fuel pipeline network in North America. Around 25% of the continent's crude oil is shipped via Enbridge pipelines. The company also delivers 20% of the continent's natural gas.

If you know anything about pipelines, you likely understand how valuable scale is. Fossil fuel producers need to get their production to refineries before it can reach the market. The safest, fastest, and most cost-effective way to do this is by using pipelines. With a network that spans multiple countries and two oceans, Enbridge can give its customers access to the cheapest refineries and the highest-revenue regions.

Without pipelines, fossil fuel producers are often unable to move their product at all. Most customers *require* pipeline capacity to stay economically viable. This gives pipeline operators incrediblebargaining power. Being the largest operator in North America compounds those advantages forEnbridge.

Demonstrating this bargaining power is the fact that Enbridge earns 98% of its revenue from cost-of-service or fixed-price contracts. This means that Enbridge charges its customers on shipped volumes, not prevailing commodity prices. So, even if energy prices fluctuate, Enbridge can maintain the same level of cash flow. For example, in 2014, when oil prices were cut in half, Enbridge stock barely budged.

Recognize the risks

Enbridge has the leading market position in an industry with extreme pricing power over its customers. Why, then, did the stock plunge in value? The argument that the market is weighing is that *this time is different*.

At the start of 2020, energy production in Canada was expected to rise every year through 2030. That was music to Enbridge's ears. This week, however, oil prices plunged to US$30 per barrel, the largest single-day drop in decades. Russia refused to comply with an OPEC supply cut, so Saudi Arabia waged an aggressive price war to flood the market with cheap oil.

The problem is that Canada has some of the highest price energy projects in the world, specially in oil sands regions. Breakeven prices range from US$30 to US$50 per barrel. Current oil prices are now around US$33 per barrel.

If the price war persists, several major Canadian producers could shutter production. Smaller competitors may find it difficult to borrow money, bringing even more supply offline. Due to structurally higher costs, these projects may never come back online. That's a huge blow to pipeline companies like Enbridge.

Additionally, the fossil fuel divestment movement is gaining steam. Larry Fink, the head of **BlackRock**, which manages more than $7 trillion, recently revealed that his firm would be actively divesting companies exposed to climate change. It wasn't an environmental decision, Fink claimed. Long term, BlackRock believes these businesses face steep financial risks.

Buying Enbridge's 7.5% dividend looks enticing, but the associated risks certainly have plenty of credibility. If you believe the oil market will normalize, this stock is a clear bargain. As for me, I'm not willing to make that bet yet. Due to the recent sell-off, there are plenty of other high-yield stocks to choose from with fewer long-term headwinds.

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