Should You Buy Enbridge's (TSX:ENB) 8.4% Dividend?

Description

Enbridge Inc. (TSX:ENB)(NYSE:ENB) is a fortress of a stock. Past recessions have had *zero* impact on the stock price. The recent coronavirus pandemic, however, has sent shares spiralling, pushing the dividend yield up to 8.4%.

Value investors argue that this is a once-in-a-lifetime opportunity to buy a bulletproof stock at a discounted price. Others are saying that this is the first downward move in a long race to the bottom.

So which is it? Should you jump on Enbridge's 8.4% dividend, or avoid the stock at all costs?

Enbridge has a simple business

Enbridge operates a massive business with thousands of employees, but the value proposition is quite simple.

Fossil fuel producers drill for oil wherever there's oil. While this could be close to a major metropolitan area, more than not, the drilling locations are in remote areas with little existing infrastructure.

Energy producers first need to get their output to refineries, where the substances are converted into usable form. Then, from the refineries, the output needs to be transported to the end-user or an export terminal.

In total, crude oil or natural gas could travel hundreds, even thousands of miles before its final use. Railroads and highways are costly, dangerous, and rife with delays. Pipelines, in comparison, are cheaper, faster, and safer. So whenever a pipeline is close by, energy producers will be sure to use it.

As the largest pipeline operator in North America, Enbridge is the first choice for most producers. Enbridge has coast-to-coast access, with the ability to ship to dozens of refineries and export facilities — capabilities that allow customers to lower costs and maximize selling prices.

Because pipelines cost millions of dollars per kilometre to construct, industry capacity is limited. It can take more than a decade to build additional pipeline space, creating immense pricing power for existing operators.

Enbridge, for example, secures customer commitments that can span a decade. Pricing is based on volumes, not commodity prices, so profits are consistent.

For all of these reasons, Enbridge stock has been a consistent money maker. Even when oil prices swing, the company generates a predicable level of cash flow, which is what fuels the high dividend yield.

But there's a problem — one that could upend the entire business model.

Here's the problem

You've likely seen the headlines. Oil prices are plunging. The current environment could permanently impact pipeline operators like Enbridge.

But isn't Enbridge insulated from pricing volatility because it charges customers on volumes? Therein lies the problem.

North American fossil fuel production doesn't usually respond on a daily basis to fluctuations in commodity prices. That's because, on average, Enbridge's customer base has remained profitable. As long as profits are positive, volumes remain steady, benefiting Enbridge.

But current energy prices are so low — below US$20 per barrel — that most of Canada's energy producers are racking up *huge* losses. This can only go on for so long.

If prices remain depressed, we could see huge chunks of the market be taken offline. New investors could be hard to source, meaning energy production could take a permanent hit. That's terrible news for Enbridge.

So here's the bet: how quickly will oil prices normalize?

If prices revert higher by the summer, the continent's production will likely continue at historical levels. Enbridge's cash flow will remain steady, ensuring plenty of cash to service the 8.4% dividend.

But if oil prices remain depressed, Enbridge will see its revenue base shrink. And because it operates a high fixed-cost business, profits will fall even further.

Many of its customers break even at US$40 per barrel oil prices, so pricing needs to improve dramatically to avoid any permanent volume reductions.

What will the future be? That's incredibly difficult to predict. But for Enbridge to deliver on its dividend, prices need to move higher *quickly*.

A slow recovery will save the company, but not the near-term dividend.

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