Enbridge Inc.: The Risks Are Rising

Description

Enbridge Inc. (TSX:ENB)(NYSE:ENB) owns and operates the world's longest crude oil and liquids pipeline system and Canada's largest gas distribution network. The majority of its profits are generated from tolls and fees charged for the energy delivery services that it provides to its customers.

A reasonable full-year financial result

Enbridge announced adjusted earnings per share of $0.49 for the fourth quarter, which was 11% better than the comparable quarter last year while the full year result was 7% higher than the previous year.

Revenues increased by 14% as $10 billion of new assets were placed into operation during the year. Operating and other expenses increased by 9% while interest expenses for the year jumped by 19% as a result of higher debt levels.

Investors should note that the profit as sanctioned by the auditors and calculated according to generally accepted accounting standards, amounted to $1.15 billion which was 37% less than the "adjusted" profit as estimated by company management. The adjustments mainly reflect a net $320 million mark to market loss on derivative transaction mostly used for hedging purposes. While this is an uncomfortable large adjustment, a small consolation is that it less than half the adjustment made in 2013.

Liquid Pipelines, the largest of the three main divisions, had slightly lower quarterly profits but an 11% increase for the full year. The profit of this division was boosted by the Canadian Mainline system as higher crude oil supply in western Canada and higher downstream refinery demand, increased throughput volumes by 15% for the year.

The profits in the highly regulated Gas Distribution business were roughly unchanged for the the year while the Gas Pipelines, Processing, and Energy Services division experienced a sharp 33% decline in profits as the Aux Sable and Energy Services sections were impacted by unfavourable market conditions.

The sponsored investments, including the listed entities **Enbridge Energy Partners, LP** (NYSE:EEP) and Canadian listed **Enbridge Income Fund Holdings Inc.** (TSX:ENF), delivered a 37% increase in adjusted profits for the year mainly as a result of new assets that were placed in service.

Healthy cash flows but increasing debt levels

The operating cash flow of the business was 24% lower than the previous year and as a result of large capital expenditures, the free cash flow (that is operating cash flow minus capital expenditures) amounted to a whopping negative $8 billion for the year.

The negative free cash flow implied that Enbridge had to raise considerable capital from external sources, and in the process increased net debt levels to $39 billion, which is double the equity capital of the business.

Enbridge expects to finance the planned $44 billion roster of projects and the cost of the dividend through cash flow generated by the existing operating businesses, commercial debt, and sales of assets to its U.S. limited partnership, Enbridge Energy Partners, and Canadian-listed Enbridge Income Fund Holdings (ENF).

As part of the capital raising plans, Enbridge plans to transfer around $17 billion of energy assets with an associated capital expansion program of $15 billion to ENF by mid-2015. ENF will finance the acquisition and capital expenditure through multiple equity raisings over a number of years.

Despite the planned asset sales, the considerable additional capital expenditure plans for the next few years combined with the already stretched balance sheet are additional risks to the business and its ability to pay and increase the increased dividends, especially in a rising interest rate environment.

The dividend is safe – for now

Enbridge declared a dividend of $0.465 per share for the first quarter of 2015, which is 33% higher than the previous year. The dividend policy has also been revised to reflect higher payments at 75%-85% of adjusted profits compared to the previous 60%-70% payout ratio.

Enbridge has an enviable North American energy infrastructure and reasonable growth opportunities for the next decade. However, it will have its work cut out to finance the intended expansion plans, manage the operational and project risks, and at the same time generate a positive cash flow to support growth in the dividend payments over the next few years.

Perhaps I am overly risk averse but it does not seem to me that the 3.0% dividend yield adequately covers the risks. There is better value elsewhere.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
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Date
2025/08/20
Date Created
2015/02/20
Author

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