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Enbridge shares are popular – but heavily shorted

The majority of investment analysts following Enbridge Inc. rate its stock a buy. But short sellers have a large position in the Calgary-based pipeline operator and natural-gas distributor. Why the divergence?

Enbridge has been on the Toronto Stock Exchange's "Top 20 Largest Short Positions" table for more than a year. And during the two weeks ended Aug. 31, its short position recorded the largest increase of all the companies on the table, jumping 25 per cent.

Video: Enbridge to transfer assets worth $30.4-billion to Enbridge Income Fund

Video: Globe Now: Why the Northern Gateway Pipeline will be a 'Mount Everest' for Enbridge

Enbridge's shares also trade on the New York Stock Exchange. There is a short position there, as well (that has increased). Adding the level for Aug. 31 to the Canadian position brings the total to 30.2 million, or 3.5 per cent of shares outstanding.

On the high side is the short interest ratio (number of shares short divided by average daily trading volume over the past three months). It stands at 11.4.

One of the few analysts to advise selling Enbridge shares is ***Darryl McCoubrey*** of ***Veritas Investment Research Corp***. Why the sell advisory? "Specifically, the marked decline in crude oil prices … could undermine Enbridge's growth profile and investment appeal," he notes.

Enbridge's revenue doesn't depend directly on commodity prices but it does depend on volumes – similar to road toll booths. ***Mr. McCoubrey*** thinks the volumes could drop as oil producers shut down wells in response to low prices.

Low-cost producers in the Middle East want to regain market share by forcing cutbacks at high-cost operators, which would include those in the oil sands and other parts of Canada. The adjustment process might take some time but eventually the throughput on Enbridge's pipelines could be materially lower in relation to capacity.

Patrick Horan, manager of the Agilith North American Diversified Fund, is short pipeline companies such as Enbridge. He believes valuations are rich because people see them as: 1) toll-booth businesses not affected by low prices and 2) alternatives to bonds thanks to their ample dividend streams.

Yet Mr. Horan has argued, like ***Mr. McCoubrey***, that pipeline customers are becoming a weak bunch. As for pipeline stocks being bond proxies, they look fully valued given bond yields are currently so low. Indeed, the yields should begin rising as inflation picks up.

That a dozen-and-a-half (or so) sell-side analysts have a consensus buy on Enbridge is perhaps not surprising from one perspective. In recent years Enbridge has used brokerage firms extensively to raise financing for a major expansion of its pipelines.

The floating of preferred shares has been particularly substantial. As James Hymas, manager of the Malachite Aggressive Preferred Fund, noted in his blog (prefblog.com) in late 2014, Enbridge's issuance "comprises roughly 10 per cent of the Canadian preferred share market, virtually all of which has come out since … [2011]."

Still, the bullish case for Enbridge is not without its persuasive aspects. A main point is that the completion of the steps in the multibillion-dollar expansion of its pipelines will provide earnings growth in years ahead. And "as the current [capital expenditure] program winds down," free cash flow will rise, CIBC World Markets analyst Paul Lechem adds.

It's hard to tell if the well-publicized bullish aspects will supersede the bearish aspects, at least in the short run. But the large short position in Enbridge shares and ailing state of Canadian oil producers are some red flags to consider.

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