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Why analysts are still bullish on Enbridge

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With Enbridge's shares sinking last week amid growing concerns about its dividend growth outlook, today I'm presenting a Q&A to help investors put the pipeline giant's challenges into context.

Analysts still have lofty price targets for Enbridge shares, even after the stock got crushed last week when the company failed to reiterate its 10- to 12-per-cent dividend growth guidance. Do you think these price targets are realistic?

It's true that analysts have been largely unfazed by the recent pullback in the stock. According to Thomson Reuters, of the 16 analysts who follow the company, there are nine buy ratings, seven holds and no sells. The average 12-month price target is \$60.73 – or nearly 30 per cent more than Enbridge's closing price of \$46.95 in Toronto on Tuesday.

That's a huge implied return, and it's even bigger if you include Enbridge's dividend, which currently yields 5.2 per cent. I'd be thrilled to make such an outsized return on a stock, but I'm certainly not counting on it. I do, however, expect that the share price and dividend will grow over the long run, for reasons that I'll explain shortly.

If analysts are so positive on Enbridge, why is the market so negative?

Analysts are focusing on the long-term benefits of Enbridge's \$31-billion capital program (from 2017 through 2019) and its recent \$37-billion acquisition of Spectra Energy Corp., whereas bearish investors are focusing on the short-term uncertainties regarding how Enbridge will fund its capital plans without impairing either its credit ratings or its dividend growth – one of the key reasons people own the stock.

As an Enbridge shareholder myself – I own the stock personally and in my Yield Hog model dividend growth portfolio (tgam.ca/dividendportfolio) – I believe the company's short-term challenges are manageable, although I suspect the stock will remain under pressure until there is more clarity on how Enbridge intends to proceed.

What role do Enbridge's credit ratings play in this?

Enbridge, which has about \$64.9-billion of debt, stressed on the third-quarter conference call that protecting its strong investment grade credit ratings is a priority. It's worth noting that three of the four major credit agencies – namely Standard & Poor's, Fitch and DBRS – assign Enbridge a stable triple-B-plus (or equivalent) rating. That is three notches above speculative grade and speaks to the company's sound financial position.

The one exception is Moody's, which rates Enbridge's debt at Baa2 – two notches above speculative – with a negative outlook. Moody's (which in October downgraded subsidiary Enbridge Income Fund to Baa3 from Baa2) has said that Enbridge "could be downgraded" if the company fails to reduce its ratio of debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization) to about 5.5 by the end of 2017. As of the end of the second quarter, the ratio was about 6.5, according to Moody's.

Will Enbridge cut its dividend growth target?

When Enbridge failed to reiterate its dividend guidance, many investors assumed it was signalling a slowdown in the growth rate from its 10- to 12-per-cent target as a way to save cash and help to preserve its credit rating. However, most analysts say it's more likely that Enbridge will come in at the low end of the current dividend growth range when it unveils its plans at its annual investor day in mid-December.

Why not just trim its dividend guidance?

For one thing, it could damage management's credibility. For another, Enbridge has other options for raising cash, including asset sales.

"We believe that a stepped up asset monetization program could be unveiled at the upcoming Enbridge Day," RBC Dominion Securities analyst Robert Kwan said in a note. "Assets that we believe could be attractive ... sale candidates include the North American renewable power business, minority interests in long-term contracted pipelines and holdings in other partially owned assets."

What about the longer term?

Regardless of what happens in the short term, Enbridge's cash flow and debt ratios are poised to improve meaningfully over the next few years as the Spectra acquisition and new capital projects both start contributing fully to Enbridge's results, analyst **Darryl McCoubrey** of **Veritas Investment Research** said in an interview.

Including a full year of results from Spectra (which was acquired in late February) and from about \$13.5-billion of capital projects that will have been put into service by the end of 2017, Enbridge's available cash flow from operations (ACFFO) is poised to rise to a range \$4.30 to \$4.50 a share in 2018, up from an estimated \$3.60 to \$3.90 this year, **Mr. McCoubrey** said.

That makes the stock's valuation look attractive, particularly after last week's sell-off. Applying a \$4.30 ACFFO estimate for 2018 to Enbridge's current share price of \$46.95, "that's like a 9-per-cent free cash flow yield on a pipeline company," he said. "Even if they're growing at anything above 5 per cent, that's such a better value proposition than we would see within our other utility names we cover."

So why didn't Enbridge reiterate its dividend guidance?

"That's a good question," **Mr. McCoubrey** said. "I suspect that they're still grappling with the decision of which is more important to their value proposition right now. Is it trying to appease concerns around heightened financial risk that's being highlighted by Moody's, or is it to keep the story intact that they are the premier dividend growth name for Canadian investors?"

Virtually everyone agrees Enbridge's dividend will continue to grow. By how much? We'll soon find out.