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TSX 6 M Daily (May 16, 2022)

Range Bound: Fears – Inflation; Interest Rate hikes; Crude Oil Supply restrictions; Supply Chain problems etc., Covid in China etc.,

COVID RECOVERY

TSX had recovered despite major claims of recession etc.

Enbridge Does Well in Q1; Reaffirms 2022 EBITDA Guidance While Highlighting LNG Exposure

Stephen Ellis
Sector Strategist

Analyst Note | by Stephen Ellis Updated May 08, 2022

Enbridge's first-quarter results aligned with our expectations, and it reaffirmed 2022 EBITDA guidance of a midpoint of CAD 15.3 billion compared with our CAD 15.4 billion forecast. As a result, we expect to maintain our fair value and narrow moat rating.

While Enbridge is primarily oil-related, it does have some exposure to the attractive liquefied natural gas, or LNG, markets as well. Enbridge has been working to expand its LNG exposure in Canada and the United States. Currently, its Texas Eastern system feeds gas to the U.S. Gulf Coast LNG markets, and it supplies about 2 billion cubic feet per day (bcf/d). Enbridge also has capacity agreements with three additional projects (Plaquemines, Rio Grande, and Texas LNG) that could take that supply to about 9 bcf/d by 2025. Further, with European gas prices at such extreme levels, Western Canadian LNG projects could start to see positive momentum as well. Per Enbridge, LNG breakeven prices at around CAD 6 to CAD 8. The major advantage of Canadian LNG is that it offers materially lower shipping times at about two weeks to East Asian markets versus four to six weeks out of the U.S. Gulf Coast via the Panama or Suez Canals. Enbridge's CAD 2.5 billion T-South expansion effort can support demand from the Woodfibre LNG effort, and it has pipeline routes outlined to serve demand from Ksi Lisims LNG and Cedar LNG.

Beyond LNG, Enbridge also outlined some early plans to maximize its recently acquired Enbridge Ingleside Energy Center. Given the likely highly contested bidding process for the asset, we think expanding the center's efforts outside of oil are smart ways to leverage the brownfield infrastructure. To date, the center has exported oil, but Enbridge is exploring opportunities to add natural gas liquids exports.

Business Strategy and Outlook | by Stephen Ellis Updated Jan 19, 2022

Enbridge stands out among North American midstream operators with a focus on oil pipelines and a utility-like earnings profile. The firm's most important asset, its Mainline system, controls over 70% of Canada's takeaway capacity and is linked to highly complex U.S. refineries that value heavy oil, meaning demand remains secure in the near to medium term despite the increase in U.S. light oil production.

Enbridge's size and high profile invites challenges for new projects, which we expect to become a permanent feature. The multi-year effort to bring Line 3 into service due to opposition from indigenous tribes has essentially concluded with the line entering service in late 2021. At the same time, Line 5 is entering what is likely to be a protracted series of legal challenges with the state of Michigan regarding regulatory oversight. A third effort to shift Mainline contracting to long-term decade-plus contracts from an uncontracted monthly nomination system has been undertaken to lock in customers as competing projects were proposed. The Canadian Energy Regulator, or CER, rejected Enbridge's new contracting proposal in late 2021. In response, Enbridge plans to pursue either a new incentive contract structure or a cost of service contracting structure. Enbridge will submit a cost-of-service application to the CER while these discussions take place and expects a decision in 2023.

With major future pipeline projects unlikely for years at this stage on the scale of Line 3 at least, Enbridge's 5% to 7% growth profile is supported by the rest of its businesses, namely gas transmission, a significant utility based in Ontario, and a small renewables segment. Combined, Enbridge plans to invest CAD 3 billion to CAD 4 billion annually across its portfolio, with an incremental up to CAD 2 billion available for buybacks and debt reduction as well as new organic development. The utility and renewables businesses offer opportunities in renewable natural gas, hydrogen, carbon capture, and wind, placing Enbridge among the leaders in midstream in terms of being able to address long-term demand and ESG-related concerns for oil and gas.

Economic Moat | by Stephen Ellis Updated Jan 19, 2022

We award Enbridge a narrow moat rating. Our narrow moat is based on an efficient scale moat source. While we remain very confident in demand for Canadian oil (approximately 1.8% growth CAGR through 2030) and gas (9% CAGR over the same time frame) in the near to medium term, we are far more uncertain around long-term demand in the latter stages of our forecast due to the high carbon emissions intensity associated with the full cycle of oil sands production, which is a primary source for Enbridge's assets. Oil sands carbon intensity is among the highest among all the basins we cover, and it is disproportionately exposed to threats if countries and governments continue to seek ways to reduce greenhouse gas emissions. We expect material stakeholder challenges from legal, regulatory (Enbridge already pays carbon taxes, for instance), and community perspectives for any new major Enbridge project, and likely new oil sands projects from producers, challenging the investment case for new pipes and boosting costs for existing assets. Beyond stakeholder issues, we believe refineries that run a heavy crude slate that requires Canadian heavy are increasingly looking to renewable diesel (produced from food waste), raising significant questions around the maintainability of long-term demand. Finally, while the nascent hydrogen and other renewable opportunities offer ways for Enbridge to manage the energy transition, we believe at best, they could become narrow-moat businesses, further reducing our confidence in an overall wide moat rating.

Looking at each of Enbridge's businesses, we assess the liquids pipelines business as narrow (more than 50% of EBITDA), which are large pipeline projects largely protected by long-term contracts in a region that is consistently short of pipeline capacity. We continue to believe the former Spectra assets (which was a wide moat when it was acquired), now part of Enbridge's demand-driven gas transmissions business, remains wide given the quality and irreplaceable nature of the assets. The remainder of the earnings profile is mostly an Ontario-based utility, which we'd consider a narrow-moat business, and a very small (about 4% of EBITDA) no-moat renewables portfolio.

Midstream companies process, transport, and store natural gas, natural gas liquids, crude oil, and refined products. Hydrocarbons are produced and consumed in different places and in different forms from how they come out of the ground. Midstream firms transport and process hydrocarbons. Once a transport route is established, there's usually little need to build a competing route. Doing so would drive returns for both routes below the cost of capital. Thus, pipelines are generally moaty because they efficiently serve markets of limited size.

New pipelines are typically constructed to allow shippers or producers to take advantage of large price differentials (basis differentials) between two market hubs because supply and demand is out of balance in both markets. Pipeline operators will enter into long-term contracts with shippers to recover the project's construction and development costs, in exchange for a reasonable tariff that allows a shipper to capture a profitable differential, and capacity will be added until it is no longer profitable to do so.

Pipelines are approved by regulators only when there is an economic need, and pipeline development takes about three years, according to the U.S. Energy Information Administration. Regulatory oversight is provided by the Federal Energy Regulatory Commission, National Energy Board, and at the state, provincial, and local levels for cross-border Canadian pipelines. New pipelines under consideration must contend with onerous environmental and other permitting issues. Further, project economics are locked in through long-term contracts with producers before breaking ground on the project. If contracts cannot be secured, the pipeline will not be built.

A network of pipelines serving multiple end markets and supplied by multiple regions is typically more valuable than a scattered collection of assets. A pipeline network allows the midstream firm to optimize the flow of hydrocarbons across the system and capture geographic differentials, use storage facilities to capture price differentials over time, and direct more hydrocarbons through its system via storage and gathering and processing assets, ensuring security of flows and higher fees. Finally, it is typically cheaper for an incumbent pipeline to add capacity via compression, pumps, or a parallel line than it would be for a competitor to build a competing line.

The major consideration for assessing evidence of a moat for a midstream firm is asset quality, where we consider the firm's competitive strengths and assets within the efficient scale regional markets they serve. Asset quality is evaluated based on the location of the individual assets, the type of asset (for example, pipeline versus gathering and processing),

the cost-competitiveness of the basins the assets serve, capital intensity, and the overall quality of the network. Basin cost-competitiveness is important as pipelines are likely to remain relevant longer if connected to a low-cost hydrocarbon supply. Further, some of the highest-quality midstream firms have a dense network of assets that connect to key refineries, basins, and market hubs and are a reliable transportation provider for shippers. This connectivity encourages shippers to use the pipelines but also protects the midstream entity. The asset integration prevents another third party from extracting rents by owning an asset that is part of the route to the most profitable market.

We consider Enbridge's assets to be very high quality. The crown jewel of its portfolio is the Canadian Mainline crude pipeline system, but Enbridge also operates other top-tier assets, such as regional oil sands pipelines, U.S. and Canadian natural gas pipelines, and regulated utilities.

The Mainline is Canada's largest pipeline. The pipeline transports primarily heavy oil from Canada's oil sands to refineries across North America, including Canada's east coast; the U.S. Midwest; Cushing, Oklahoma; and the U.S. Gulf Coast and numerous refineries. Furthermore, the Mainline offers more access to the U.S. Midwest, where producers can maximize netbacks, compared with competing pipelines along with lower tolls to the U.S. Gulf Coast.

Canada's oil sands supply is separated from most of its refining markets by large distances and relies on pipeline transportation. Pipeline takeaway capacity from the country approximates 4 mmbl/d, with approximately 71% of the takeaway capacity residing on the Mainline system. Increasing environmental and government regulations, as well as political opposition, have made new pipeline projects increasingly difficult to sanction in recent years. Accordingly, the Canadian crude industry would crumble without the Mainline system. Enbridge also operates the Express-Platte pipeline. While the pipeline is Canada's smallest crude pipeline, it's one of the few outlets for Canadian crude producers.

The company's regional oil sands pipeline network is also top-tier. The network connects to numerous producing oil sands projects. The company's major regional pipelines provide transportation from all three of the oil sands locations, but are primarily focused on the largest region, Athabasca.

Enbridge's Canadian natural gas pipelines are in position to benefit from growing production in the Western Canadian Sedimentary Basin, highlighted by the Alliance Pipeline. The Alliance pipeline is the only rich gas export pipeline from the Western Canada Select Basin but can also export dry gas. Shipments originate from the Horn River, Montney, Duvernay, and Bakken formations and are transported to the U.S. Midwest. Canadian natural gas production is expected to increase at a 9% compound annual growth rate over the next decade, accompanied by growth in natural gas liquids.

Spectra Energy's gas transmission assets diversify Enbridge's asset base with high-quality natural gas pipelines. Enbridge's U.S. natural gas network is exceptionally well positioned to serve most of the Eastern U.S., including cities such as New York, Boston, and

Philadelphia. Enbridge's ability to connect and balance supply and demand with its pipelines and storage assets means customers are eager to pay for the opportunity to access the network. These assets are also primarily demand-driven and serve end users like utilities, which keeps utilization high and removes the risk of a basin becoming less cost competitive and stranding the pipeline asset.

Contract quality is primarily assessed by term, with long-term contracts (10-plus years) being preferred with take-or-pay provisions. Contract quality does not directly support the efficient scale moat source, but it more directly speaks to the maintainability of future excess returns. Entities that are primarily oriented around pipelines are the strongest positioned as they obtain the longest terms. Long-term contracts for pipelines tend to be made up mostly of capacity reservation fees and a more modest transportation fee. Shippers are obligated to use the pipeline but not required to do so; however, they must pay the reservation charges in any scenario, ensuring rents for the pipelines. The smaller transportation fees are only paid based on actual volumes shipped. Less well-positioned firms typically contain a large component of gathering and processing, storage, fractionation, or other business areas, where it is harder to argue that advantages will persist for two decades or more, and contract terms tend to be only a few years, reflecting the reduced barriers to entry compared with pipelines.

While the Mainline is a common carrier pipeline and doesn't have any firm commitment at the moment, it has historically been very highly utilized, typically 90%-plus, including periods of apportionment. If accepted in 2023, one possible contracting structure will essentially shift the pipeline to 90% take-or-pay contracts and 10% spot market shipments, which we'd expect to be fully utilized. The other will be a cost of service structure. The Mainline represents the best option for producers to access multiple markets and to move production. In addition, eight of the 10 largest crude producers, which represent two thirds of Canada's crude production, are investment-grade counterparties and rely on the Mainline.

Other assets also retain long-term contracts. The Express-Platte contains 20-year contracts, while regional oil sands system has average durations that range from 20 to over 30 years. In U.S. natural gas, on average, the pipelines have a remaining contract duration that exceeds 10 years, with over 95% of the capacity contracted by investment-grade counterparties, providing for stable and secured cash flows.

Material ESG exposures create additional risk for midstream investors. In this industry, the most significant exposures are greenhouse gas emissions (from upstream extraction, midstream operations, and downstream consumption), and other emissions, effluents, pipeline spills, and opposition and protests. In addition to the reputational threat, these issues could force climate-conscious consumers away from fossil fuels in greater numbers, resulting in long-term demand erosion. Climate concerns could also trigger regulatory interventions, such as production limits, and removal of existing infrastructure.

Midstream emissions are relatively low in the lifecycle of oil and gas, and midstream firms have relatively lower risk than upstream and downstream firms from carbon taxes.

Canadian firms already pay carbon taxes on their carbon emissions, most of which are generally passed to their shippers and other customers. Spills represent a major threat and have created great resistance from environmentalists, Indigenous groups, and other climate-conscious persons. Examples of the opposition are seen in President Biden's revocation of the Keystone XL presidential permit, legal battles over the Dakota Access Pipeline system, and Enbridge's own challenges with its Line 3 and 5 pipelines.

Enbridge has outlined two major ESG-related targets. It plans to be zero net carbon by 2050 on Scope 1 and 2 emissions, and it plans to reduce its carbon emissions intensity by 30% by 2030 from 2020 levels.

Fair Value and Profit Drivers | by Stephen Ellis Updated Feb 17, 2022

Our fair value estimate for Enbridge is $42 (CAD $53) per share after updating for fourth-quarter results and rolling our model. While our Canadian fair value estimate remains unchanged, our U.S. fair value declined modestly due to updated exchange rates. Our fair value estimate corresponds to 2022 enterprise value/EBITDA multiples of 12.3 times. Our cash flow forecasts incorporate the addition of the Line 3 replacement pipeline as well as the Moda deal, and we assume Line 5 remains operational while Enbridge and Michigan engage in mediation. Our 2022 adjusted EBITDA forecast is CAD 15.4 billion, and we expect distributable cash flow to reach CAD 11.5 billion in the same period. Our 2023 estimates for EBITDA and distributable cash flow are CAD 15.5 billion and CAD 12.8 billion. We assume growth capital investment of about CAD 4 billion annually over the next few years. Our assumptions result in a 7% annual average EBITDA growth, at the top-end of management's guidance, and 3% annual dividend growth.

Risk and Uncertainty | by Stephen Ellis Updated Jan 19, 2022

Enbridge's biggest challenges are primarily regulatory, legal, and other stakeholder risks related to identifying and executing on projects within its growth portfolio. Challenges over Line 3, 5, and its small stake in the Dakota Access Pipeline offer clear examples of the potentially higher costs and lost earnings involved.

Material ESG exposures create additional risk for midstream investors. In this industry, the most significant exposures are greenhouse gas emissions (from upstream extraction, midstream operations, and downstream consumption), and other emissions, effluents, pipeline spills, and opposition and protests. In addition to the reputational threat, these issues could force climate-conscious consumers away from fossil fuels in greater numbers, resulting in long-term demand erosion. Climate concerns could also trigger regulatory interventions, such as production limits, removal of existing infrastructure, and perhaps even direct taxes on carbon emissions, which already exists in Canada. Notably, Enbridge recently entered a $1 billion sustainability-linked credit facility and $1 billion bond, which links its ESG performance to borrowing costs.

Capital Allocation | by Stephen Ellis Updated Jan 19, 2022

Our capital allocation rating for Enbridge is Standard. In our view, the company maintains a sound balance sheet, with leverage in the target range of 4.5-5.0 times EBITDA. We expect the balance sheet to improve, as the company's growth portfolio is poised to generate incremental cash flow that will be directed toward paying down debt, increasing the dividend, investing in high-return projects, and possibly buy back shares if conditions warrant.

Over the past few years, management sold off over CAD 10 billion in generally lower-quality assets, including gathering and processing businesses in a shift that has improved the overall quality of the business. The focus has been on secured projects with utility-like return profiles and limited to no sensitivity to commodity prices. Broadly, we think the shift makes sense. However, the positive implications of this shift are offset by our concerns over regulatory and other stakeholder legal and environmental issues that will continue to beset any new major Enbridge pipeline project it chooses to undertake. This has undoubtedly increased the cost of capital for new pipeline efforts as Enbridge acknowledges. We also note that many asset sales involved substantial write-downs of goodwill or fair values, making the shift a more expensive proposition.

As a result, going forward, Enbridge likely faces a tougher path finding large organic pipeline projects that will move the needle on its already large asset base. We expect management will be able to find solid projects in its gas transmission, utility, and renewable portfolios, but this will be smaller singles and doubles versus the home runs of the past, which tends to reaffirm our Standard capital allocation rating. Still, we think with the Moda deal, Enbridge is effectively adding a high-quality asset that should provide solid earnings contributions for years, so we consider this a low-risk purchase that is a reasonable use of shareholder capital.

With the balance sheet on a positive path, and investments likely more restrained going forward, Enbridge has taken an appropriate stance on its prized dividend. The company has been prudent with dividend increases and has identified up to CAD 2 billion annually under its current capital spending program that can be allocated toward increased capital returns to shareholders, providing a very healthy margin of dividend support and safety.

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