Trans Mountain Deal:
The "Least Worst" Option?

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By Kevin McSweeney, June 1, 2018

On May 29, 2018, the Government of Canada announced that it is prepared to purchase a variety of assets (most notably the Trans Mountain Pipeline System, including its planned expansion) for $4.5 billion from Kinder Morgan Canada (KML), which is 70%-owned by Texas-based Kinder Morgan Inc. (KMI). Certain mutual funds managed by Signature Global Asset Management ("Signature") are shareholders of KML and KMI, and Signature has followed this saga extremely closely. This note represents big-picture thinking only, with the details being too numerous to mention here.

While the government's purchase may represent the "least worst" option, it is not – in aggregate – a good news story.

Overall, I view this result with some relief, and much disappointment as a portfolio manager* and as a Canadian. For those readers who would like further context on the subject, see my previous blog on an alternative solution for the Trans Mountain Expansion Project.

The relief comes from knowing that the Kinder Morgan entities will not be burdened with debt amid an uncompleted project, and that investors may now look at KMI as a straightforward midstream company that has a free cash flow yield of approximately 7%, a good balance sheet, and a dividend yield in the 5% range. The Trans Mountain dispute had obscured these qualities.

Our disappointment comes from (1) the necessity of the government purchase, and (2) the value loss.

Many, particularly politicians, have said that this shows Canada's commitment to getting projects built and that this should be a positive signal to international investors. We think the lesson is different: it indicates that project sponsors cannot be confident that political hurdles will be overcome in the normal course of business. If they can be overcome, it is only through extraordinary measures, which may include giving away the upside to the government. No corporation or pension/investment fund would choose to spend seven years of consultations and engineering design (along with $1.2 billion!) to donate the future cash flow from those efforts.

While $4.5 billion is undoubtedly a lot of money, it is less value than what is being acquired. Our valuation of the expansion – over and above the remaining $6.5 billion cost to complete it – was approximately $4 billion. Our valuation of the other assets that the Canadian government bought, including the existing pipeline, is ~$2.4 billion. On a per-share basis, this equates to a current valuation on the KMI stock of ~$26 per share if the expansion were to be built by 2021, and as much as $35/share when the expansion was fully up and running. In contrast, if we knew the expansion would never be built, the existing business is worth about $14/share. Many Bay Street analysts have comparable numbers. As KML was trading at a price of around $17/share, we liked the “$9 up versus $3 down” asymmetry, with a belief that the project could be completed in a reasonable amount of time.

Given the valuation metrics outlined above, the government absolutely did not “bail out” or “give away money” to Kinder, as some have suggested. Rather, the government bought $6.4 billion in value for $4.5 billion. And it appears to have been the only buyer at this discount - *which Kinder felt compelled to accept* - because of political uncertainty that the federal government was unable to resolve. (Please note that despite the discounted sale, KMI has taken the news in stride, rising 6.5% and seeing its market cap increase approximately US$2.2 billion since the announcement; KML is down about 3.4% from its pre-announcement level as of this writing).

The government’s objective in these situations is to facilitate private investment and overcome obstacles to investment formation, not to seize a deal when those objectives go unmet.

For KML, we expect a large special dividend in the fall from the proceeds (a $16 stock should have $12 of cash available for a dividend later this year) and view the stock as cheap given the cash proceeds in addition to the value of the remaining businesses. For KMI, we see an opportunity for the company to receive approximately US$2 billion in proceeds, for a balanced combination of shareholder returns, investments and debt repayment.

For the government, the path forward depends on the outcome of court decisions that may continue to constrain the development of the project and prolong the economic losses from a lack of pipelines. We know that a number of large institutional investors would have loved to invest in this pipeline if they could get certainty around the completion and timing. I will be surprised if another investor steps up in the near term given the remaining uncertainty, which may not be resolved until the Supreme Court of Canada rules on provincial powers and indigenous engagement.

As Canadians, we still get to live in the best country in the world, but it is hard to not see this as a lost opportunity and an unfortunate episode.

**Mr. McSweeney is a portfolio manager of, and investor in, certain Signature mutual funds that hold securities of KML and KMI.*

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