Inter Pipeline Ltd.: Is the 6.7% Yield Safe?

Description

For the first half of 2015, it seemed like it was only energy producers who got crushed by the carnage in the energy market.

The damage has expanded in the second half of the year, moving to the pipeline sector. The logic goes something like this: now that it's obvious that most of Canada's oil companies will slow production in 2016, investors are concerned that pipeline revenues will suffer as well. Obviously, that's not good news for the pipelines, which are paid on volume.

Because the sector has sold off so much, dividend yields are starting to get very attractive. Take **Inter Pipeline Ltd.** (TSX:IPL) as an example. Over the past few years, shares of the pipeline have tended to yield between 4% and 5%. But thanks to a 25% sell-off over the last six months, the stock now yields an attractive 6.7%.

Can investors count on the generous payout going forward? Let's take a closer look.

Results are encouraging

Thus far in 2015, the company's free cash flow has been ample to cover the dividend.

Through the first nine months of the year, the company generated $526 million in cash from operations, while spending $265 million in capital expenditures for a free cash flow of $261 million. It paid out $280 million in dividends over the same period.

While that doesn't look terribly good at first glance, we have to keep in mind that pipelines require very little in capital expenditures once they're completed. Only $36 million of the $265 million in capital expenditures were from maintenance. The rest went towards funding growth.

Inter Pipeline tracks funds from operations, which came in at $1.68 per share through the first three quarters of 2015. Dividends during the same period came to $1.10 per share. Thus, the company's payout ratio is under 70%. That's actually a slight improvement compared with the payout ratio of 79% posted through the same period of last year.

Inter Pipeline has a history of hiking the dividend annually. It has done so since 2009, growing the dividend from $0.07 per share per month to the current level of $0.13 per share. In fact, the company just raised the dividend, hiking it from $0.1225 per share.

Generally, a company about to cut the dividend doesn't raise it. This is all very good news for folks who like big yields.

Growth potential

Over the last couple of years, Inter Pipeline has been busy expanding its network. It made big additions to its Cold Lake pipeline system, completed a $112 million expansion to its mid-Saskatchewan system, and bolstered its European operations by adding bulk liquid storage capacity in Sweden. Altogether, these upgrades cost approximately $1.6 billion.

The long-term potential for the company's oil sands assets are particularly interesting. Currently, the company's Corridor pipeline system has 335,000 barrels of oil per day in throughput, with an installed capacity of 465,000 barrels per day. The Cold Lake system has an additional 673,000 barrels per day of capacity available, and the Polaris system has 760,000 barrels per day in capacity free.

In layman's terms, it means this: currently, the company's pipelines have approximately 2.2 million barrels of oil sloshing through them per day. There's potential to expand that by more than 50% with very little in additional work.

Yes, growth potential from the oil sands doesn't look very good in a world of $40 crude. But eventually the price of oil will recover and growth from the region will resume. And when that happens, Inter Pipeline is well positioned to profit from it.

Inter Pipeline's dividend appears to be pretty safe. When oil recovers and oil sands producers start expanding again and use some of that available capacity, investors could start seeing serious dividend hikes going forward.

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