Can Investors Count On Inter Pipeline Ltd. and its 7.7% Yield?

Description

Ever since **Kinder Morgan Inc.** cut its dividend back in December, holders of many of the other pipeline stocks are convinced such a fate could happen to them as well. Since most investors view the pipelines as yield plays, a dividend cut is pretty much the worst-case scenario.

One pipeline company that's been particularly attractive to dividend investors over the years is **Inter Pipeline Ltd.** (TSX:IPL). Inter Pipeline has consistently paid a higher yield than most of its peers and has done a nice job growing that dividend at a pace that exceeds inflation. The current yield is an attractive 7.7%.

But with oil currently sitting below $30 per barrel and seemingly everyone bearish on crude, can Inter Pipeline continue to pay out that sweet dividend? I think it can.

Outlook for 2016

Recently, Inter Pipeline gave investors a preview of what it expects to spend in 2016 for capital expenditures. In total, $250 million is expected to be spent this year with $190 million going towards new growth and $60 million going towards sustaining capital. Of that $60 million, nearly half will be spent on new office space in Calgary.

As long as production from the oil sands doesn't fall off a cliff, it shouldn't be a big problem for the company to at least match the cash it generated in 2015. Some 60% of its EBITDA comes from the region. It's the big story.

Although we don't have full year 2015 results yet, we can make the assumption that the amount of cash from operations reported by Inter Pipeline over the first nine months will be continued for the rest of the year. This puts the company on pace to generate approximately $750 million in cash from operations for the year.

Subtract $250 in planned capital expenditures in 2016, and we can assume the company will generate approximately $500 million in free cash for 2016. Inter Pipeline has already committed to increasing its dividend in 2016, raising the payout from $0.1225 per share monthly to $0.13 per share back in

November. Based on this new dividend, Inter Pipeline looks to be on the hook for about $400 million in dividends for 2016. That’s a payout ratio in the 80% range, which is a little high, but manageable.

Long-term growth

What’s interesting is the amount of excess capacity the company’s oil sands operations have. Between its three major pipelines in the area, Inter Pipeline has the ability to transport up to 4.6 million barrels of crude per day. Only approximately half of that capacity is currently being utilized, mostly with contracts that are intentionally not linked to the price of crude.

This positions Inter Pipeline nicely for the next crude bull market. Although there are a real lack of oil sands projects coming on to market now, oil will eventually recover. It might take years, but I’m convinced the value of oil a decade from now is going to be higher than it is today.

One of the other advantages to owning Inter Pipeline over some of its competitors is the company’s reluctance to expand outside of Alberta. By keeping most of its pipelines inside the province, it doesn’t have to go through different governments to get projects approved. And Alberta’s government is known to be pipeline friendly. It’s a competitive advantage which constantly gets understated.

From 2009 to 2014, Inter Pipeline managed to grow EBITDA by nearly 11% annually. This growth rate will slow going forward as the company digests the big growth projects of the last few years. While investors wait for that next big growth phase, they’re getting paid 7.7% to wait with a dividend that looks to be pretty safe. That dividend plus the potential for nice capital gains in the future looks to be a pretty attractive combination.

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