How Raising Rates Have Made Shares of Inter Pipeline Ltd. More Attractive

Description

Since the Bank of Canada increased interest rates, there have been a number of ramifications for both people and companies. The most obvious is the increase in interest costs on variable rate loans made to Canadian consumers. Following that, many companies that have variable loans based on the prime rate of interest have also started to pay a higher interest costs, and that has not yet been felt by the investors.

The difference between an individual borrowing money and a company borrowing money is, the increase in rates will be felt by the consumer almost right away. For companies however, shareholders have to wait up to three months (one entire quarter) to feel the effects of higher rates. **Inter Pipeline Ltd.** (TSX:IPL) recently reported earnings for the quarter ending June 30, but the effects of higher interest rates will not be felt for at least another three months.

As investors have started to realize the burden of higher rates, shares of the pipeline company have declined by more than 6% over the past month, which, strangely enough, coincided with an increase in the price per barrel of oil. Oil increased by approximately 6% over the same period. This clear negative correlation may be setting the stage for a major comeback for shares of Inter Pipeline.

As the risk-free rate of return has increased by 25 basis points, the share price of Inter Pipeline has declined from $25 to a current price near $23.50, which, in turn, moved the dividend yield higher. Many investors are treating this stock as a pure income play and no more.

Although the spread between the risk-free rate of return and the company's dividend yield has remained the same, the catalyst for investors to make a significant profit from this name could come in one of two ways. First, the company has the opportunity to take excess capital and conduct a share buyback, thereby reducing the total number of shares outstanding and clearing the way for capital appreciation of the potential for dividend growth down the road. The second opportunity is to simply increase the total dividend paid to investors.

Although a dividend increase on a stock, which already offers a dividend yield close to 7%, may not seem possible, investors must stop and take notice of the long-term nature of the company's operations and cash flow from operations (CFO). The percentage of CFO which was paid out in dividends over the past four years was 19.5% (2013), 27.7% (2014), 53% (2015), and 58.3% (2016). Although the payout ratio is clearly increasing, investors who have done their homework will know that the payout ratio for the first half of fiscal 2017 is no more than 30.8%. Clearly, the company has excess cash flows as the price of oil has finally stabilized between US$45 and US$50 per barrel over the past few months.

As rates increase and investors become more pessimistic, shares of Inter Pipeline may just be ready for the biggest breakout yet!

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