Why Higher Interest Rates Shouldn’t Turn Investors Away From Pembina Pipeline Corp. (TSX:PPL)

Description

The recent surge in oil that sees the North American benchmark West Texas Intermediate (WTI) trading at over US$65 a barrel has breathed life into Canada’s beaten down energy patch. While many oil producers have surged, the companies providing critical infrastructure including pipelines and storage facilities to the patch have lagged behind.

Since the start of 2018, pipeline and midstream services company **Pembina Pipeline Corp.** (TSX:PPL)(NYSE:PBA) has fallen by over 1% in value, primarily because of concerns over the impact of higher interest rates on its operations. This has created an opportunity for investors seeking an energy company with a unique mix of growth potential, defensive characteristics, and steadily growing income.

Now what?

The greatest concern weighing on the market perception of infrastructure and utility companies is the recent rate hike by the federal government, which sees the headline rate now at 2% or double that of March 2017. The government also indicated that there would be two more rate hikes during 2018 as it seeks to normalise monetary policy.

Higher interest rates make the cost of finance more expensive, which eats into the profitability of energy infrastructure companies because of the massive amounts of capital required to develop, sustain, and expand their operations. However, the risk is significantly overbaked when Pembina is considered.

While the 2017 needle moving $9.7 billion acquisition of Canadian pipeline firm Veresen Inc. created one of North America’s leading energy infrastructure companies, it also saw Pembina’s debt almost double from $4.2 billion at the end of 2016 to $7.8 billion at the end of the first quarter 2018. On first appearances, that is a large increase, but Pembina’s debt is far lower than many of its peers, including **Enbridge Inc.**’s $61 billion of long-term debt or the $31 billion on **TransCanada Corporation’s** balance sheet.

Another important point to consider is that during times of economic growth, which is primarily responsible for higher interest rates, demand for energy grows, leading to higher commodities and greater demand for the utilization of Pembina’s pipeline network, which will give earnings a healthy bump, thereby helping offset higher finance costs.

The likelihood of a significant surge in the volumes of oil, other petroleum liquids and natural gas being produced and hence transported is extremely likely. Oil's last rally, which sees West Texas Intermediate (WTI) trading at around US$65 a barrel even after its latest decline, has created a considerable incentive for Canadian oil producers to ramp up activity and materially boost production. Only a week ago, Canada's rig count grew by a remarkable 27 rigs compared to a week earlier to see 139 active rigs operating in the energy patch, which is also almost double that of a month earlier.

After reporting a strong first quarter 2018, Pembina upgraded its 2018 guidance, lifting adjusted EBITDA for the year to $2.65 billion to $2.75 billion, or $100 million greater than the bottom end of the company's original guidance. This new forecast at its bottom range is almost $1 billion greater than 2017, thereby indicating that Pembina can easily absorb any additional financing costs sparked by higher interest rates.

So what?

When these factors are considered in conjunction with the robust portfolio of projects valued at $1.9 billion under development as well as growing demand for the utilization of Pembina's storage and pipeline network, it's easy to see earnings growing at a healthy clip. This will go a long way toward mitigating rising finance expenses sparked by higher interest rates. When these factors are coupled with Pembina's growing yet sustainable dividend yielding almost 5% and the fact that its stock has failed to keep pace with crude, it's a very attractive play on higher oil.

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