Dividend Investors: Run, Don't Walk, Away From This 29%-Yielding Energy Name

Description

Names that were once favourites of income investors are now brandishing massive yields thanks to the coronavirus-induced selling. While I'm all for a nice dividend, if it seems too good to be true, it's best to err on the side of caution. Given the deterioration of its fundamentals, the following dividend superstar is at risk of a cut.

Inter Pipeline

Even before the selling picked up steam, **Inter Pipeline** (TSX:IPL) was already paying out a yield north of 7%. Now, two months later, the stock is trading at 2008 prices with a monthly dividend of $0.1425 — an annualized yield of 29%!

History has shown that payouts this large do not last, as companies will often cut or suspend such a cumbersome use of precious cash flow. This case is no exception for three primary reasons.

Firstly, IPL is heavily exposed to commodity pricing in its natural gas business segment, translating to 13% of 2019 company-wide EBITDA. With natural gas trading in the $2 range, while propane continues to trend downward due to chronic oversupply, IPL's margins on the processing of natural gas to natural gas liquids continues to deteriorate, and with it, its free cash flow generation.

Secondly, natural gas is not the only commodity headwind the company is facing. As we all know, the bloodbath in oil continues, with Western Canadian Select trading at all-time lows of about $11 per barrel as of writing.

The reason why even a transporter like IPL will feel the strain of rock-bottom oil prices is because most the company's pipeline contracts are renewed every 30 days (or less). With oil at an unsustainable level, and Alberta's production limit to be extended to December of this year, IPL faces a very high level of counterparty risk and loss of those precious pipeline contracts.

With pipelines responsible for $168 million out of $873 million in total funds from operations, cash from this segment is critical to the viability of its dividend.

Finally, IPL’s crown jewel is its $3.5 billion Heartland Petrochemical project, which will be IPL’s hedge against the previously mentioned multi-year-low propane prices. Once buildout is complete, IPL hopes to use the facility to convert propane into polypropylene — a polymer found in clothing materials, medical products, and plastics.

For IPL, Heartland is an all-hands-on-deck project and will deliver $450-$500 million in annual EBITDA upon completion in 2021. Given the importance of Heartland on IPL’s capital budgeting decisions, it’s easy to surmise that the board will choose it over sustaining the dividend, particularly as IPL’s debt remains at a lofty six times its 2019 EBITDA.

The bottom line

Don’t be fooled by the giant yield and stay away from IPL until there is better clarity on the direction of oil prices or once the dividend has been shed. Given the current industry backdrop, it is not in the best interests of the company nor its shareholders to keep such an unsustainable cash burden. There are safer dividend names to choose.

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Date

2025/08/24
Date Created
2020/03/20
Author
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