Inter Pipeline Stock: $0 or $20?

Description

It's been a wild ride for oil stocks. Just take a look at **Inter Pipeline Ltd** (TSX:IPL). In February, shares were priced at $22. By April, they plummeted to $8. Just as suddenly, shares rocketed higher, reaching today's $14 valuation.

Investing in energy stocks will continue to be a rollercoaster. Macroeconomic trends naturally create boom-bust cycles over time, but the short-term challenges of today are particularly volatile. Trade wars, deadly pandemics, and the threat of over-supply are just a few of the factors at play.

Stocks like Inter Pipeline have a cloudy future. In some instances, shares could reach $0, wiping out equity holders entirely. In other scenarios, shares could rise by 40% or more, retesting their former highs.

So which is it? Will IPL stock move toward $20 or $0?

Know the facts

The precipitous decline in Inter Pipeline was a multivariate phenomenon. Some would call it a double-whammy.

The first issue was oil *demand*, which suddenly plunged in the wake of the COVID-19 crisis. Planes were grounded, streets were emptied of vehicles, and overall energy usage tumbled. This resulted in one of the quickest reductions in oil demand in history.

As a pipeline operator, Inter Pipeline was on the front lines of the pain. The company makes most of its money transporting fossil fuels. If demand for those fuels drops, the company's revenues are directly impacted. And because pipelines have high fixed costs, even a small dip in sales can disproportionately impact profits.

The second issue dealt with oil *supply*. In the last decade, new sources of Canadian and American oil flooded the market, keeping oil prices depressed. Saudi Arabia attempted to balance the market with a production cut, but major producers like Russia dissented.

To show its power, Saudi Arabia cranked output higher, adding huge swaths of new supply. Oil prices were instantly cut in half.

Much of Inter Pipeline's customer base includes oil sands operators. These projects produce high-cost oil. Shale plays in the U.S. can break even with prices as low as US$20 per barrel. Oil sands mega-projects, however, often need oil to stay above US$40 per barrel to turn a profit.

With pricing far below its customer's breakeven levels, the market suddenly worried if the company would lose its biggest revenue sources.

Trust Inter Pipeline stock?

Recent weeks have brought reprieve. Oil prices have doubled after Saudi Arabia ended its pricing war. Now close to US$40 per barrel, IPL shareholders can rest easy that most of its customers won't go bankrupt in 2020.

The demand side is also improving. Most countries are in a stage of reopening. Even air travel is picking up. Shrinking supply and rising demand is a bullish equation for Inter Pipeline.

Yet the company isn't out of the woods. Last quarter, it slashed its dividend by 72% to free up $525 million in annual savings. It also suspended the sale process of its European bulk liquid storage business due to the steep drop in global energy prices. The company noted that potential buyers were significantly affected due to the coronavirus pandemic.

The company is clearly in a cash crunch. It now has more than $4 billion in debt versus a market cap of just $6 billion. Much of its customer base is still in money-losing territory. If conditions deteriorate again, it's not difficult to see Inter Pipeline going insolvent. Given the debt load, equity holders would lose everything.

What will it take for IPL stock to continue its recent rise? Higher oil prices. Only when pricing sustainably exceeds US$50 per barrel will shares surpass the $20 mark.

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