Looking for a High-Risk, High-Reward Play?

Description

The number of risks investors should be wary of is limited only by the imagination of said investors. With uncertainty in financial markets now at obscenely high levels, such risks are amplified.

Perhaps no better example of the market pricing of risk are pipeline stocks such as **Pembina Pipeline** (TSX:PPL)(NYSE:PBA). In this article, I'm going to delve into three key risk areas for Pembina which are being heavily priced into the stock.

At these levels, Pembina could be a great pick.

Counter-party risk

Perhaps the primary concern among investors in the energy infrastructure space is counter-party risk. This has been identified as the key driver of lower stock prices for pipelines in the early days of this pandemic. Investors are spooked by the state of finances of oil and gas producers.

Pembina doesn't have much in the way of direct exposure to commodity prices. However, this is where indirect exposure to low oil and gas prices comes into play for Pembina.

The incredibly low prices we've seen in recent weeks for oil and gas, in particular, directly affect the cash flows and financial health of the producers — Pembina's main customers. The concern around the viability of Pembina's counter-parties has grown to a significant degree, culminating in the drop witnessed through late March.

A significant percentage of Pembina's business is being handled through take or pay contracts — a significant benefit for Pembina. However, there still seems to be significant counter-party risk being presently priced in.

From a bullish perspective, in addition to Pembina's attractive contractual relationship with producers, analysts have noted that 80% of the company's counter-parties are investment grade, thereby lessening the real risks.

Furthermore, even among the non-investment grade counterparts, Pembina still has recourse to recovery, further reducing default risk.

Volume-related risk

Bears on pipelines will point out that even if we don't see catastrophic bankruptcies in the oil patch, oil and gas producers will undoubtedly be forced to lower production volumes due to low oil prices.

Most Canadian energy companies with unhedged books are losing massive amounts of money, with commodities trading at these prices.

These unsustainable low commodities prices will — or should — result in a lowering of supply overtime. Certainly, this isn't good for Pembina, particularly if this scenario plays out for a longer period.

The recent market moves are indicative of a short-term market dislocation. I don't see any real lasting, long-term damage to pipelines. Pembina should be well positioned in this regard.

Dividend risk

Pembina has typically had a relatively high dividend yield relative to its peers. However, this market turbulence has increased this yield further.

In recent weeks, we've seen Pembina's dividend yield reach the double digits, which usually indicates that the market has (at least temporarily) lost faith in the ability of a given company to maintain its distribution.

This dividend risk seems to be partly tied to the other two risk factors. As long as we don't see a truly catastrophic number of bankruptcies in this sector or a multi-year decline in shipping volumes, Pembina could turn out to be a great value and income pick for long term investors at these levels.

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Date
2025/06/29
Date Created
2020/06/14
Author
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