



Double Your Dividend With This Gem

Description

In the span of only a couple of months, the dividend yield of one of Canada's best pipeline companies, **Pembina Pipeline** ([TSX:PPL](#)), has doubled. Pembina has been on my watch list for quite some time. This company has always traded at a fair price. Recent prices are now factoring in some pretty bearish scenarios that may or may not materialize.

Here's why I think some of the assumptions that priced into Pembina's stock price are potentially overreactions.

Utility-like exposure to the energy sector

The energy sector globally feels like some sort of economic hot potato no one wants to touch. In Canada, this feeling is amplified. Many investors will tell you that selling heavy Western Canadian Select crude for sub-\$5 per barrel speaks for itself in terms of supply/demand economics for the sector.

That said, energy infrastructure/pipeline companies like Pembina have very different economics than the broader energy sector. This fact should work in their favour in times like these. Right now, counterparty risk is the real downside that is priced into companies like Pembina. This is the ability (or lack thereof) of producers, or counterparts, to continue paying their volume fees for their contracts with pipelines.

I've [argued in the past](#) that this producer-pipeline relationship is among the strongest in the sector. Producers will undoubtedly cut back on capital expenditures, dividends, buybacks, and any other non-essential spending to stay alive. However, getting crude into the hands of refineries and buyers downstream has become very important due to rising storage costs. It's getting more costly to store the oil as contango takes effect. It's true that barrels of oil are being sold at a discount. However, the alternative is storing oil which is both difficult and expensive.

Cash flow impairments may be coming

The cash flow for pipelines like Pembina really relies on two key factors: volume shipped and timely payment by counterparties. We've already discussed the counterparty risk assumption that's being baked into Pembina's stock prices. Let's discuss the volume/contractual issues Pembina may have in this environment.

Of the counterparties Pembina deals with, 80% with are investment-grade producers. This is a fact many investors will likely already know. However, what many investors may not know is that a similar percentage of the company's contracts are of a "take or pay" nature rather than a variable "fee for service" contract.

In other words, producers pay an agreed upon amount to Pembina every month. For this fee, they gain access to volume on Pembina's pipelines. Whether the oil is shipped or not doesn't matter to Pembina. The counterparties take the risk of such contracts. Many pipelines have large "take or pay" contracts with large producers. This has the benefit of adding another layer of cash flow stability to pipeline companies.

This additional layer of cash flow is an important valuable asset for such companies, particularly when they're going to lenders trying to finance a new multibillion dollar pipeline. If they can show cash flow stability up front, it allows for more transparency with cash flow projections over the long term. This allows for confidence among both equity and debt investors.

Pembina's management team is strong

For energy infrastructure companies like Pembina, the strength of the company's management team may not seem all that important, due to its intangible nature. That said, in times like these, having a great management team to steer the company through the chaos could turn out to be one of Pembina's best assets.

Stay Foolish my friends.

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