Investors Should Factor in This Type of Risk Today

Description

The valuation multiple that certain companies operating in the energy sector have been astounding to me. Many of these companies are now trading at multiples not seen since the financial crisis. Expectations around "lower for longer" commodity prices have ushered in absolutely zero optimism in the commodities sector. This sector has been waiting for a ray of sunshine for seemingly forever.

This oil price clash between Russia and Saudi Arabia is very real — and indeed is having catastrophic consequences for North American producers. Canadian producers of heavily oil (Western Canadian Select) have been particularly hard hit despite Canadian producers always having traded at a discount to West Texas Intermediate and Brent.

Pembina Pipeline

That said, various pipeline operators such as **Pembina Pipeline Corp.** (TSX:PPL) have also seen precipitous stock price declines, confusing many market participants. That's because these pipelines generally have contracted capacity arrangements with producers that lock in volume at essentially guaranteed pries for the pipeline companies.

If anything, these pipelines should become more valuable in times like this, given their revenue and cash flow stability, right?

Wrong. The market is now pricing counterparty risk into pipeline stocks. In essence, the market is calling into question the ability of oil producers to fulfill their agreements, both on the volume side and the ability of producers to pay.

On the volume side, it's not profitable to extract oil right now. On the ability to pay end, many producers are strapped for cash, and indeed may only have a few months' worth of liquidity via credit lines at these oil prices.

Pembina's pluses

Pembina is a great company and one of Canada's leading pipeline stocks. Pembina's 2017 acquisition of Veresen Inc. has helped the company strengthen its defensive position and bolstered its assets.

Further, Pembina's stable and diverse income stream, impressive cash flow generation and long-term cash flow all work in its favour. However, if the company doesn't get paid for its pipeline, there could be serious issues that continue to cascade downstream in the oil refining lifecycle.

Pembina has a solid balance sheet. But like all pipeline companies, Pembina holds considerable debt that could get downgraded by ratings agencies. This becomes a risk particularly if the debt loads of the oil and gas producers feeding Pembina's midstream operations continue to become increasingly unmanageable.

The trick for investors looking to trade this situation is to assess the likelihood of various scenarios taking place. This involves **a lot** of modeling and advanced analysis to pinpoint the effect that counterparty risk has on a stock like Pembina.

Bottom line

For those who, like myself, would much rather buy something with more certainty around long-term cash flows, waiting a few months should do a lot of good. Pembina will, therefore, be a company I keep on my watch list and observe from the sidelines for the time being.

Stay Foolish, my friends.

CATEGORY

1. Energy Stocks
2. Investing

POST TAG

1. counterparty risk
2. energy
3. oil
4. pipelines

TICKERS GLOBAL

1. TSX:PPL (Pembina Pipeline Corporation)

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