CUMBERLAND
Private Wealth

# Today's Landscape and Opportunities in Canadian Pipelines and Midstream Companies

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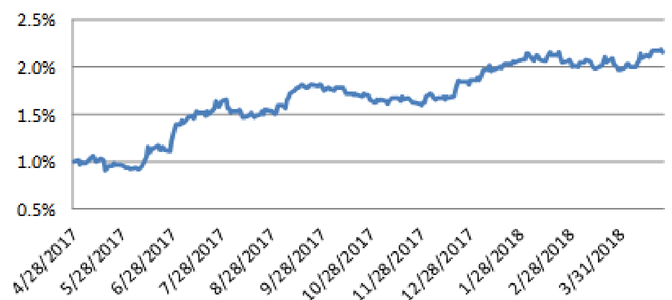
The S&P/TSX Oil & Gas Storage and Transportation Total Return Index is down approximately 14.7% year-to-date (through April 26). Rising interest rates, larger than normal discounts for western Canadian natural gas and crude oil (particularly heavier crude oil), and various delays with new projects have all given analysts, pundits, and the media plenty of material to construct a negative narrative.

We recently met with senior executives of Enbridge Inc., Gibson Energy Inc., Inter Pipeline Ltd., Keyera Corp., Pembina Pipeline Corporation, and TransCanada Corporation. Based on our meetings, we have concluded that some of this external negativity is misplaced and that the sector has been overly punished.

## The Impact of Rising Interest Rates

All things equal, rising interest rates decrease the value of most equities including pipeline company stocks. Over the past two years, S&P/TSX Oil & Gas Storage and Transportation Total Return Index and the yield on 5 year Government of Canada bond have a correlation coefficient of -0.212 when measured on a monthly basis, which does indicate that historically lower interest rates have been positive for Canadian oil and gas storage and Transportation equities.

Interest rates have generally been increasing over the last year. For example, the yield on the 5 year Government of Canada bond has increased from a recent low of approximately 0.92% in May 2017 to about 2.19% today.



Source: Bloomberg

**Government of Canada 5 Year Bond Yield**

All things equal, we expect that interest rates are more likely to rise than fall in the next 12 months. However, we do not believe than another 138% increase is likely in the next year. Furthermore, given

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the 20% + sell-off in these stocks since last May, we believe some degree of higher interest rates are already priced into their prices.

## Existing Operations Running Well

One thing that impressed us throughout the meetings was that existing operations are generally running well. Most pipeline systems originating in Western Canada are at or near full capacity. While this fact has been frustrating for oil and gas producers (as they often have to accept less attractive pricing for their product), it has led to opportunities for the pipeline companies. Increased demand for storage capacity, demand if any capacity becomes available on existing pipeline systems and producer demand for the construction of new pipelines should all be positive for the pipeline industry.

## Large, Meaningful Growth Projects to Come

While a lot of focus is placed on projects that face opposition, it is sometimes forgotten that these companies have completed a number of projects and continue to have a large backlog of potential investments. For example, Enbridge placed $12 billion of projects into service in 2017. While the Line 3 expansion is awaiting regulatory approval (a decision is expected in June), construction on projects such as the US$1.3 Billion NEXUS pipeline and the Valley Crossing pipeline in Texas continues on time and on budget. TransCanada placed $5 billion of project into service in 2017 and the US$1.6 billion Leach XPress pipeline went into service in January 2018. In 2017, Pembina Pipeline posted 43% growth in EBITDA (when compared to 2016) thanks in large part to new projects. These companies have been and continue to execute on meaningful growth projects.

## Opposition to New Projects

Almost all major infrastructure projects face opposition from at least some party. While natural gas producers may be dismayed at the price of their product in Alberta, consumers of natural gas (such as the petrochemical industry) are incented to maintain the status quo. No one has a crystal ball and can predict if and when the Trans Mountain Expansion, the Line 3 Expansion or Keystone XL get completed. As investors perhaps all we can hope for is a clear, fair regulatory process that is accepted by all parties. In the long run, it seems clear to us that transporting crude by rail is generally more costly and more dangerous than via pipeline. Furthermore, the discounts currently being endured by producers of oil and gas in Canada is currently costing the Canadian economy billions of dollars per year.

## Concluding Comments – Stay The Course

Profitably investing in pipeline companies has been difficult thus far in 2018. However, we would not advise giving up on the sector permanently. While the lack of progress on certain projects remains frustrating, in theory the value of existing pipelines should be higher if constructing new pipelines is more difficult. While much focus has been placed on these delayed "mega-projects", most pipeline/midstream companies in Canada continue to execute on smaller projects year after year. Some of these "smaller" projects are still multi-billion dollar opportunities.

In addition, the sector is currently trading at less than 17x forecast 2018 Price-to-Earnings (2018E P/E) or and a 5.9% dividend yield according to Bloomberg. In terms of 2019 forecast earnings, the sector is trading at 15.6x forecast P/E and a 6.8% dividend yield. On a forward P/E basis, this is the lowest valuation the sector has traded at in the last six years. The sector was trading over 31x forward P/E four years ago.

We believe the sector generally represents good value and approximately 10.8% of the Kipling Monthly Income Fund is currently allocated to the common equity or stocks of Canadian pipeline companies. These are also represented within the Cumberland North American and Canadian Equity mandates.

Your Portfolio Manager would be happy to review these with you.