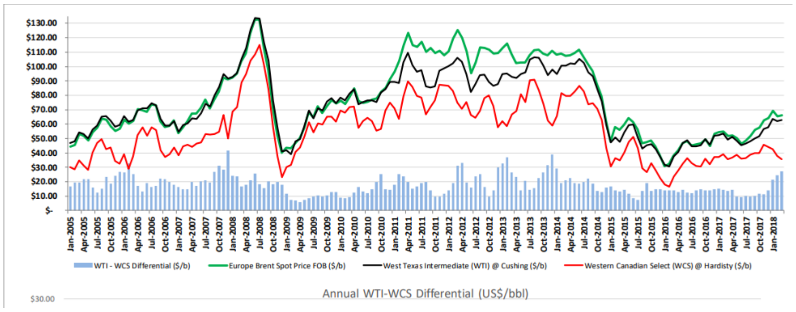
Opportunities for Growth and Stability in O&G Market

Business Overview - Pembina is a midstream oil and gas service provider located in western Canada. The business is divided in three main divisions: Pipelines, Processing facilities, and Marketing/New Ventures with the Pipelines division being the largest of the three (Last10k.com). Their strategy is to maintain the existing pipelines and facilities while also seeking to grow through acquisition of new projects that offer long-term reserves and steady cash flows (Pembina Media).

Industry - Within the oil and gas industry there are three sectors: the upstream, midstream and downstream. The upstream companies explore and extract the raw hydrocarbons who then send it to the midstream where the product is processed and transported to the downstream. The downstream consists of end-product users, refiners and distributors (Last10k.com).

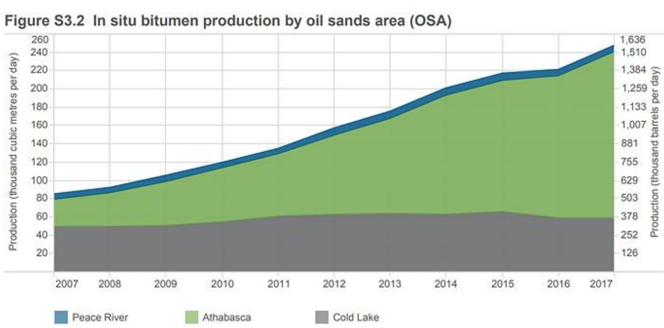
Macroeconomics - Alberta has one of the largest crude oil reserves in the world. The oil however, is locked in a substance known as bitumen, which is a mixture of oil, sand and clay. The oil also tends to be high in sulfur content which is referred to as 'sour' compared to low sulfur 'sweet' oil (CERI). Because it is sour and heavy, the oil requires significantly more processing and therefore increased costs to turn the bitumen into useful hydrocarbon products (Last10k.com). This can be illustrated in Figure 1, which shows the price differential that Albertan oil (WSI) trades at a discount compared to other blend around the world.

Figure 1



In the past two decades however, The Canadian Oil Sands have become increasingly profitable to produce because the rise in the price of oil (See Figure 2). With the development of new technologies, the extraction process is becoming more economical in recent years, which also explain the rise in production. 80% of Alberta's bitumen reserves are too deep to be mined by an open pit, which was the conventional method of recovery. If the bitumen is too deep, they can extract it by injecting steam into the reservoir. The high pressures and temperatures liquefy the bitumen and make it easier to pump and then refine (Oil Sand magazine). One of the reasons WSI trades at a discount is the lack of pipeline infrastructure in Canada. A significant portion of WSI is transported by rail, which costs twice as much compared to transporting it by pipeline (Aliakbari & Stedman). This highlights the need for more pipeline infrastructure as production of WSI continues to increase. This presents a great secular growth opportunity for pipelines companies to take advantage of in the next few years.

Figure 2



Risks

Short Term – The short-term risks to the company are regulation hurdles. The Jordan Cove project is a $10 billion USD liquefied natural gas export facility planned to be built in Oregon. In May, the project was delayed by a year as it fights to gain the necessary state permits. These regulatory hurdles present a risk to all of Pembina's projects, as there can be significant political opposition to new pipelines being constructed (BNN Bloomberg).

Long Term – In the long run, oil prices present the biggest risk. As the U.S continues to increase its production, there has been an oversupply in the oil and gas industry, which has kept prices low in the past few years. The effects of which can be seen in the market capitalization of Canadian oil and gas companies which have fallen to a 10 year low (Mittal & Slaughter).

Investment Thesis

Growth & Stability – In the past ten years, Pembina's stock price grew from $16 to $46.24, which is a 189% gain. Their solid track record comes from constant acquisition of new projects. This is illustrated in the fact that Pembina has not engaged in a stock repurchase program in 10 years as they have always found more lucrative investments to generate value for shareholders (Investors Day Presentation). They have also increased their dividend 4% per year on average without ever cutting it (Investors Day Presentation).

Experienced Management – A company could have great physical assets and yet it would mean very little if management cannot provide the experience, personal connections and vision required to maximize shareholder value. Michael Dilger, the CEO of Pembina has two decades worth of experience working in the Midstream of oil and gas industry. He founded Vista Midstream Solutions, which was subsequently sold for $130 million (OGJ Editors). Prior to becoming CFO Scott Burrows worked as an investment banker focusing on energy related acquisitions (Pembina). In these two brief examples, we can see Pembina's management is staffed with highly experienced individuals who have shown they can optimize its resources.
Future Growth – Pembina is engaged in multiple new projects, which will be coming online in the next few years. The Peace Pipeline development is currently in Phase 5 with planned expansions into phase 6, 7 and 8. These subsequent phases will increase the number and size of the pipes, increasing capacity for their customers which is planned to be in service by 2021. The Hythe Development is a joint venture, gas gathering and processing facility, which will be operational in 2020. The Duvernay developments are a series of infrastructure projects, which will process oil, separate water and treat sulfur. These will be operational by 2020 as well. These three projects will help Pembina continue its growth trajectory as they become operational in the next three years (Investors Day Presentation).

Figure 3

Exposure without the Volatility – Pipeline companies in general offer the opportunity for investors to have exposure to the Canadian oil sands with less risk from the constant fluctuation in oil/gas prices. A major part of Pembina's revenue comes from handling; gathering and processing liquids, which is a business, based on the volume a customer uses and is charged a fee. This fixed-fee-for-service model insulates Pembina from market fluctuations as it provides a steady cash flow (Last10k.com). To illustrate this point, see Figure 3. The XEG is an ETF comprised of Canadian oil companies. HOG is an ETF comprised of Canadian Midstreams, which we see, have outperformed the general energy companies because of their lower exposure to the price of oil. We can also see Pembina has outperformed the midstream ETF.
Valuation - In order to understand Pembina's value, a discounted cash flow model was created to project the company's cash flows for the next ten years. Equity makes up 69.2% of Pembina's financing at a cost of 10.2%. Debt makes up 24.1% at a cost of 2.9%. The other 6.7% of financing is in the form of preferred shares at a cost of 5.1%. This results in a WACC of 8.1%. The nature of Pembina's business: acquiring projects and building pipelines, makes their growth highly dependant on the success of future projects. Unlike, for example a consumer staple company, Pembina's future cash flows are much less predictable. Using the mean forecast of Credit Suisse, Scotiabank, and TD Securities, Pembina's free cash flow will be approximately $2.48 billion CAD in 2021 (Bloomberg). If we use this figure, then assume Pembina will grow its free cash flows at a conservative rate of 3.5% per year in which case its free cash flow will be $3.165 billion CAD in 2028. Based on this assumption, we can derive an enterprise value of $43,323 billion CAD and an enterprise value per share of $84.68 CAD. Are these numbers reasonable? Based on the forecast, the company will grow its free cash flow 171% in the next ten years. In the last 10 years, their cash flow has grown 175% (Investors Day Presentation). As a larger company, it will be harder to maintain the growth they have experienced in the past therefore the prediction might be slightly optimistic. It is not far fetched however, to assume they will experience similar/slightly lower growth experienced in the past.

Conclusion – Pembina remains a strong midstream company, well positioned to take advantage of the opportunities in the growing Albertan oil and gas market. Political hurdles and low oil prices pose a threat to their future earnings. These risks are mitigated however, as they have strong cash flows from existing projects, which are insulated from fluctuating oil prices. As oil production continues to increase, there will be a greater need for pipeline infrastructure, which is both a safer and cheaper option to transport oil. Pembina has numerous projects, which will be coming in service in the next three years, which will serve as a sort term catalyst for their growth. These project will be overseen by an experienced management team. Based on these factors, an $84.68 price target in ten years is achievable.

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<u>Figure 1</u>

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<u>Figure 2</u>

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<u>Figure 3</u>

Yahoo Finance

<u>Logo:</u>

Pembina Pipeline Logo - Pembina Pipeline Corporation PNG Image: Transparent PNG Free Download on SeekPNG. (n.d.). Retrieved from https://www.seekpng.com/ipng/u2w7o0a9q8t4q8u2_pembina-pipeline-logo-pembina-pipeline-corporation/.