Is Fortis Inc. a Good Buy as Canada Enters a Recession?

Description

The Bank of Canada is not bullish on our country, at least in the short term.

As part of its decision to cut its overnight borrowing rate to 0.5%, the Bank issued a statement about the Canadian economy, calling for negative growth in the second quarter. That, combined with the negative number posted by the Canadian economy in the first quarter, officially puts us into a recession.

At least there's a bit of a silver lining as growth is expected to resume in both the third and fourth quarters, leading to a positive year overall. I'm a little skeptical that this will actually happen without a significant improvement in the crude market, but I'll take the Bank's word for it.

Because of a bleak economic picture, investors have been heading into stocks that tend to be less economically sensitive, like utilities and consumer staples. This makes sense, since most people will cut their discretionary spending before they stop buying groceries and paying for electricity.

Let's take a closer look at **Fortis Inc.** (TSX:FTS), and see whether it's the right choice for investors looking for a defensive name in their portfolio.

The bull case

In terms of market cap, Fortis is Canada's largest utility. It owns natural gas and electric assets in Canada, the United States, Central America, and in the Caribbean, with a demonstrated history of operational excellence. Limiting operations into largely regulated areas has been a pretty smart move, with more than 90% of its assets being held in markets where governments regulate utility rates.

Because of acquisitions in the U.S. market and the decline in the Canadian dollar, Fortis actually looks to be in better shape the weaker the economy gets. A weak loonie means average U.S. results look fantastic when converted back to Canadian dollars. It's a way to get earnings growth without doing anything.

Fortis has also recommitted to focusing on its core business. It recently announced sales of both its Atlantic Canadian real estate and its hotel portfolio. Together, sale of the two assets are expected to bring in $800 million, while earnings per share suffer slightly. Management did take some of the proceeds and invest them in **Slate Office REIT**.

Fortis has had years of consistent, rising earnings, which translates into a streak of more than 40 years of consecutive dividend increases. That’s the longest such streak in Canada, which is very reassuring for dividend investors who are looking for steady growth.

The bear case

There are a couple of things that concern me about Fortis, particularly the valuation and the deteriorating balance sheet.

Let’s start with the P/E ratio, which looks pretty high on the surface, coming in at 25.8 times earnings. But those earnings were affected by costs from the latest acquisition to the tune of $0.40 per share. Thus, normalized earnings were much better, coming in at $1.81 per share in 2014.

But even still, that puts the trailing P/E ratio at more than 20, which is relatively expensive for a utility stock. Yes, earnings are expected to rise to $2.07 in 2015 and to $2.18 in 2016, but that’s largely on the back of a weak Canadian dollar. In reality, there’s not much organic growth there.

The other issue is with the balance sheet. To pay for its recent acquisitions, Fortis has binged on debt over the past few years. Including preferred shares, the company owed $7.3 billion at the end of 2011. That number has ballooned to approximately $14 billion currently. Yes, that debt has paid for assets that are producing income, but remember, they were bought during an era of low interest rates. If rates go up and the debt becomes more expensive to service, it could mean trouble.

There’s also the case of Fortis’s free cash flow. Since 2011, it has posted negative free cash flow each year, which means these increased dividends have been funded by debt. The company has the ability to scale back on the capital expenditures, but it still should be concerning for investors.

I think Fortis will offer a nice place for investors to hide from the economic storm brewing over the short term. But over the long term, I need to see improvements to the balance sheet and free cash flow before I’ll put the company into my portfolio.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:FTS (Fortis Inc.)

Category

1. Dividend Stocks
2. Investing

Date
2025/07/17
Date Created

2015/07/16
Author
nelsonpsmith