3 Big Reasons Why I'm Avoiding Fortis Inc.

Description

Fortis Inc. (TSX:FTS) has been one of the best investments someone could have made over the last four decades.

Anyone looking for proof just has to look at the company's dividend history. It has raised payouts each year since going public back in 1972, a streak unmatched by any other Canadian-based publicly traded company. The company has accomplished this because the utility business is a slow but steady grower, and because it has made dozens of smart acquisitions over the years, all which bolstered the bottom line.

But will the next 40 years be as good as the last 40? I don't think I can answer that without consulting my crystal ball, but I will say that Fortis isn't a stock I'm particularly excited to own for the next little while. Here are the three main reasons why I'm avoiding the stock.

Deteriorating balance sheet

In today's world of low interest rates, many companies are loading up on cheap debt.

Fortis has been especially aggressive in leveraging up its balance sheet. The company's total debt load has increased from $6.4 billion at the end of 2011 to $12.2 billion as of the end of June. If you add in the amount of preferred shares outstanding, the debt looks even worse, coming in at a total of $14 billion.

For a company with just over $9 billion in total shareholder's equity, that's a lot of debt that will eventually have to be repaid. Yes, the utility business generally offers pretty steady cash flow, but I can't see any scenario where Fortis can continue to expand at a fast rate or take on another big acquisition. It simply doesn't have the ability to borrow much more.

Negative free cash flow

For a company that's been lauded for having such a consistent dividend, it surprised me to realize that Fortis not only has negative free cash flow, but hasn't posted positive free cash flow in years.

In 2014 Fortis generated $982 million in cash from operating activities. But it spent more than $1.7 billion in capital expenditures, and paid out $256 million in dividends. That's a shortfall of more than $1 billion, which it financed by a combination of issuing new shares and by adding to the debt pile.

In the years 2013, 2012, and 2011 the company posted similar results. The shortfall during those years wasn't nearly as bad as it was in 2014, but the free cash flow was still negative for each of those years. Cumulatively, Fortis paid out more than $600 million in dividends during that time while posting a negative free cash flow. No wonder why the debt skyrocketed higher during that time.

And 2015 isn't looking much better. Thanks to its big acquisition in 2014, Fortis has increased its earning power, posting $916 million in cash from operations through the first half of the year. But capital expenditures have also gone up, totaling $1.2 billion during the same time. That's still a shortfall of nearly $300 million.

A better alternative

As a value investor, I'm constantly on the search for companies that trade at a discount to what I believe is their true value. Since everyone gives Fortis such huge praise for its dividend history, Fortis isn't any better than fairly valued.

But one of Fortis's power generation peers is pretty attractively valued. **TransAlta Corporation** (TSX:TA)(NYSE:TAC) trades at just a fraction of book value because of its dependence on coal-fired power, a part of the sector the market is currently shunning. But unlike Fortis, TransAlta has enough free cash flow to easily cover its 9.8% dividend. That's a dividend nearly three times higher than Fortis's 3.6% yield.

TransAlta is also making moves to improve its balance sheet, and has implemented operational changes to ensure it doesn't get any nasty surprise repair bills, which is what happened to the company back in 2013 and 2014. And management is confident it'll be able to secure some better rates once its power purchase agreements expire in 2018.

TransAlta is definitely more risky than Fortis, but it's taking steps to improve its balance sheet, while Fortis isn't. For my style of investing, it's definitely the more attractive option. Either way, I think investors should tread carefully with Fortis, at least until it gets serious about cleaning up the balance sheet.

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