Now Is the Time to Add Capital Power Corporation to Your Portfolio

Description

Electric utilities offer investors who are concerned over the direction of the global economy and growing market volatility a solid defensive option for their portfolios. This is because of their stable earnings, wide economic moats, and heavily regulated operating environments.

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However, not all electric utilities are created equal. It is well known that a number have run into problems in recent years because of high degrees of debt and other emerging headwinds, including the push to cleaner sources of energy. One that is currently feeling the pinch is **Capital Power Corporation** (TSX:CPX).

Let's take a closer look to determine if it is a worthwhile investment.

Now what?

Capital Power is one of the main electric utilities servicing Alberta, and like **TransAlta Corporation** (TSX:TA)(NYSE:TAC), coal-fired power generation produces a considerable proportion of its electricity output. For the second quarter 2015, 58% of the total megawatts produced came from coal-fired plants, although this is less than the 67% reported by TransAlta for the same period.

This leaves Capital Power significantly exposed to the moves in Alberta to reduce greenhouse emissions and curb coal-fired power generation. These measures include marked increases to the provinces carbon levy and a reduction in the amount of electricity generated by coal-fired plants in the province.

As a result, Capital Power will incur considerable costs as it moves its portfolio of electricity-generating assets in the province away from coal to cleaner sources of energy. These costs will be mitigated in part by the higher wholesale electricity prices introduced as a result of the legislation, but they will still have a considerable impact on its bottom line.

As a result, the outlook for Capital Power is not particularly positive for the foreseeable future, but these risks are offset by two mitigating factors.

Firstly, Capital Power has amassed a significant inventory of low-cost carbon credits that will help to offset the costs associated with the transition away from coal-fired power generation.

Secondly, 18% of its portfolio's wide power-generating capacity comes from wind power, the majority of which is covered by long-term power purchase agreements. These agreements effectively lock in earnings for a fixed period, making those earnings virtually guaranteed.

Another tailwind for electric utilities in general is the current low interest rate environment; Canada's official interest rate is at its lowest level since 2010, and the U.S. Fed recently elected to keep rates on hold for the time being. This makes the costs associated with the tremendous amounts of debt held by electric utilities cheaper to finance, thereby reducing costs.

Then you have to consider that Capital Power's share price has dropped by almost 24% for the year to date, making this an attractive entry point for investors seeking exposure to electric utilities.

So what?

Capital Power is facing a range of headwinds at this time, the most significant being the transition away from coal to cleaner sources of electricity generation in Alberta. The compliance costs associated with adjusting its portfolio to meet these requirements will be immense, but they will be offset by higher wholesale electricity prices and its inventory of carbon credits.

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Investors should also note that as they wait for Capital Power's share price to appreciate, they will be rewarded by its very juicy and sustainable 7% dividend yield.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

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2. TSX:CPX (Capital Power Corporation)
3. TSX:TA (TransAlta Corporation)

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mattdsmith

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