



Should Investors Buy the New Hydro One IPO Over Fortis Inc.?

Description

Over the last four decades, there hasn't been many dividend-growth investments better than **Fortis Inc.** ([TSX:FTS](#)).

The company has come a long way from its Newfoundland roots. It now owns utilities across Canada, including natural gas assets in B.C., and electric generation in both Alberta and Atlantic Canada. It also owns regulated utilities in the United States and the Caribbean.

Its dividend growth has been remarkably consistent. It has raised the payout for 42 consecutive years, which makes it the current leader in a category followed very closely by dividend enthusiasts.

But perhaps the company isn't as healthy as history would indicate.

The balance sheet is getting steadily worse. At the end of 2011 it owed \$6.3 billion in total debt along with \$912 million in preferred shares. As of the most recent quarter, the total debt has more than doubled; it owes \$12.2 billion in debt and \$1.8 billion in preferred shares.

Additionally, the company hasn't earned enough in free cash flow to service the dividend in years. Over the last 12 months it posted \$1.3 billion in cash from operations, while spending \$2.3 billion on capital expenditures. The cash used to pay the dividend was part of the \$3.3 billion it borrowed.

Those kinds of numbers make me nervous. Plus, shares of the company trade at a P/E ratio of nearly 19, which is a little expensive.

I think there are better options for dividend investors out there. Is one the upcoming Hydro One IPO? Let's take a closer look at what could be Canada's largest IPO in years.

The positives for Hydro One

There are a few big things Hydro One has going for it.

Firstly, the company is essentially a monopoly with guaranteed revenues. It sells electricity at

guaranteed prices to customers who have no other choice than to use its services. That's the kind of business any capitalist can get behind.

Hydro One is the largest electricity distributor in Ontario, but it's hardly the only one. There are dozens of smaller operators in the province and hundreds more across North America. Additionally, the days of large-scale coal plants are largely behind us, meaning Hydro One can also start acquiring smaller power-generation facilities.

As it stands now, Hydro One only serves about 1.3 million customers. That leaves it with the potential to add millions more in just its home province alone.

The valuation

Growth stories are only interesting if investors are getting the potential at a reasonable price.

According to reports, the IPO will be between \$19 and \$21 per share with a total of 15% of the company being sold off. At \$19 per share, Hydro One would be worth about \$11.3 billion, which is about equivalent to Fortis in terms of market cap.

In 2014, Hydro One reported revenue of \$6.5 billion with a net income of \$747 million. This compares with Fortis's revenue of \$5.4 billion and net income of \$379 million. Keep in mind, however, that analysts expect Fortis to post a net income between \$550 and \$600 million in 2015.

Still, at a value of \$19 per share, Hydro One checks in at about 15 times trailing earnings. At \$21 per share, it has a P/E ratio of 16.7. Both of these numbers are better than Fortis's trailing and forward P/E ratios, and we're not giving Hydro One any potential for earnings growth.

Additionally, Hydro One plans to pay investors an annual dividend of \$0.84 per share, which works out to an even 4% yield if the shares are priced at \$21. That's a better dividend than Fortis offers currently, and with power prices expected to grow by 4.2% per year through 2019, there's ample potential for dividend growth.

Before investors rush out and buy Hydro One at the IPO, let me say these words of caution: IPOs have been known to spike on their first day of trading. If shares of Hydro One spike up to \$25 or so in early trading, suddenly the reasonable valuation goes away.

Fortis has a great history of dividend growth behind it. But Hydro One looks to trade at a cheaper valuation and has the benefit of operating 100% in a regulated environment. At this point, it looks to be a better choice.

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1. TSX:FTS (Fortis Inc.)

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