Is the Pullback in Fortis Inc. a Buying Opportunity?

Description

Fortis Inc. (TSX:FTS) pulled back about 8% from its 52-week and all-time high. Is it a buying opportunity?

First, let's see if Fortis is the kind of business you want to own.

The business

Fortis has nine utility operations, which serve 3.2 million electric and gas customers across Canada, the United States, and the Caribbean.

The utility has about 96% of regulated assets, which means its returns are highly predictable. For example, the allowed return on equity (ROE) on five of its utilities was between 8.3% and 10% in 2015.

Growth and returns

Other than organic growth, Fortis has a successful track record of acquisitions and integrations, including FortisBC Holdings (formerly Terasen Inc.) in 2007. And in the last few years, Fortis has expanded into the U.S. by acquiring Central Hudson and UNS Energy with operations in the states of Arizona and New York, respectively.

In the last decade or so, Fortis has delivered average annualized shareholder returns of 7.8%, which aligns with average market returns. However, keep in mind that Fortis is a conservative stock with a lower-risk profile than the average stock.

Boost your returns

You can boost your returns and reduce the investment risk in Fortis by being value conscious and buying on pullbacks at comparatively more attractive valuations and higher yields.

In the past 10 years or so, Fortis's normal price-to-earnings ratio (P/E) was 20. At about $41.20 per share, Fortis trades at a forward P/E of 19 based on this year's estimated earnings per share. So, even after the 8% pullback, Fortis still trades within fair-valuation range.

Going forward

Between 2016 and 2020, Fortis has a $9.3 billion capital program, which it expects to drive mid-year rate-base growth of about 4.5% on average per year.

Fortis is making good progress in acquiring **ITC Holdings**, which is the largest independent electric transmission utility in the U.S. with rates regulated by FERC.

ITC's allowed ROE and rate-base growth are higher than Fortis's other utilities with allowed ROE greater than 11% and rate-base growth expected to be about 7.5% per year through 2018.

Through ITC, Fortis will add eight more states to its presence to further diversify its geographic footprint in the U.S, enhance its regulatory diversity, and lower its overall rate regulatory risk.

Moreover, the transaction allows Fortis to enter a new business segment that has no commodity exposure and complements the utility's existing businesses. ITC's management team also has a track record of strong cash flow generation and superior shareholder returns.

The transaction is expected to close late this year, at which time it will be immediately accretive to Fortis's earnings per share. Fortis will then earn 61% of its operating earnings from the U.S., and it can benefit further from a strong U.S. dollar against the Canadian dollar.

Conclusion

Fortis has increased its dividend for 42 consecutive years. Its capital program and ITC acquisition should drive stable growth. The utility guides to increase its dividend per share by 6% on average per year.

The pullback brings Fortis to a P/E of 19, which is not a screaming buy, but it's not excessively expensive either. The utility offers a solid yield of almost 3.7% for conservative investors who need income today. And investors can expect an investment in Fortis to match market returns with below-average risk.

Should Fortis yield 4% or higher, that would be an excellent time to buy.

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1. Dividend Stocks
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