Do This Simple Check Before Investing in Fortis Inc.

Description

A couple of days ago I happened to be reading an article by Fool.ca contributor Nelson Smith about the three reasons to avoid **Fortis Inc.** (TSX:FTS), one of Canada's best-performing utility stocks over the past 20 years.

Smith notes that there aren't many stocks that have delivered 15.9% annually over the past 20 years, utility or otherwise. And he's right. The TSX over the same period managed only single-digit returns.

Great stock, right? Not so fast.

He then goes on to mention three reasons to avoid Fortis stock; one being its level of debt, which has basically doubled in less than four years. With interest rates eventually set to rise, Fortis could be in a heap of trouble if it continues down this path.

However, there's a simple check you can do that will tell you more about its ability to handle any interest rate increases and other unforeseen expenses.

It's the funds-from-operations-to-debt ratio. It's used by credit rating agencies to measure a company's financial risk, including its ability to repay its debt using funds from operations.

It's one thing to have $14 billion in debt; it's another to have $14 billion in debt and no way to service the interest and principal costs on that debt. It's a surefire path to going out of business.

Now, be forewarned. Some companies' financial reports make it easier than others to find this information. Take Montreal-based utility **Valener Inc.** (TSX:VNR). It puts the information right there on page 40 of its Q3 2016 earnings report.

At the end of June Valener had $495.6 million in funds from operations over the trailing 12 months and total debt (less cash) of $3.1 billion for a ratio of 16%.

In other words, Valener generates 16 cents of funds from operations for every dollar of debt. Here, a higher percentage is definitely better.

Now, let’s take a look at Fortis. Unfortunately, it doesn’t provide this number, so we have to do a little digging.

Funds from operations are generally defined as cash flows related to operating activities less the net change in non-cash working capital items. Total debt is any bank loans, long-term debt, and the current portion of long-term debt less cash and cash equivalents.

Fortis has reported on two quarters this year, so we need to go as far back as Q3 2015 to get the 12-month number for funds from operations. That comes to $1.62 billion. Total debt less cash at the end of June was $11.3 billion.

This means Fortis generates 14 cents of funds from operations for every dollar of debt. A quick calculation of **Emera Inc** (TSX:EMA), a big rival to Fortis, shows that it’s got approximately 17 cents of funds of operations for every dollar of debt.

While a two- or three-cent difference might not seem like a lot, when you’ve got more than $11 billion in net debt compared to $3-4 billion, as is the case for Valener and Emera, you ought to at least consider the extra risk you’re taking owning its stock.

Track record and all.

CATEGORY

1. Investing

TICKERS GLOBAL

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2. TSX:FTS (Fortis Inc.)

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