My Take on Altagas Ltd.: Why Downside Risk Remains

Description

Many analysts point to the dividend yield and growth prospects of **Altagas Ltd.'s** (TSX:ALA) proposed acquisition of **WGL Holdings Inc.** (NYSE:WGL) as catalysts that should take this company's stock price higher. I'm going to dive into a few reasons why these two factors may actually be hurting the company's long-term prospects moving forward, essentially putting it in an awkward position where it is actually destroying value for shareholders.

Let's start with Altagas's absurdly high dividend yield.

Dividend destroying value at current levels

The debate of whether Altagas's 7% dividend yield is sustainable or not is, in my opinion, the wrong discussion. Any company can maintain paying a dividend which is more than 100% of its earnings if it is willing to pile on more debt to pay such a dividend. A dividend only truly becomes unsustainable when a company's cost of debt becomes unfavourable, access to capital becomes constrained, or in situations where a company's earnings take a significant downward turn.

Most analysts estimate that Altagas's earnings will come in near 2016 levels for the remainder of 2017, meaning a stark downturn in earnings is unlikely to be the catalyst that forces the company to slash its dividend.

Putting the company's long-term earnings ability aside, at current earnings levels, the dividend is essentially destroying the equity value of Altagas's shares. Each time a dividend is paid which exceeds the company's earnings, a portion of its equity, which is not being replenished by earnings, is transferred to shareholders, destroying the company's equity value over time. This sort of negative equity effect, compounded monthly, adds up to a significant amount over time.

If Altagas continues to issue a dividend that is approximately 200% of its earnings moving forward, this sort of value destruction is one of the main catalysts that will continue to drive Altagas's share price much lower.

Proposed acquisition increases leverage, includes hefty premium

Should the WGL acquisition close on the terms proposed, the company's equity valuation will take a hit right off the bat, as the premium Altagas has agreed to pay will be one of the first catalysts to destroy value immediately. The synergies Altagas contends will provide value long term (the company asserts the synergies will be "materially accretive") will require that Altagas pay a significant premium to acquire WGL in an all-cash deal.

Given the lack of available cash as well as the fact that Altagas has been cash flow negative for the past five years, the company will need to issue a massive amount of debt to finance this transaction in addition to assuming $2.4 billion of WGL's debt, which will drive Altagas's leverage ratios completely out of whack.

Bottom line

This is a story of a company with a lack of cash flow attempting to boost cash flow by over-paying for a company which may or may not provide enough accretive CFO generation to aid the company in paying a dividend which currently hovers around 200% of earnings. Taking these value-destruction factors into account, my financial model shows a true equity value for Altagas between the $20 and $22 level.

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