Fortis Inc.: Is This the Right Dividend Stock to Buy?

Description

When choosing dividend stocks, it's important they satisfy a few key requirements. First, the company has to generate predictable cash flow to pay the dividend, which offers a semblance of security. Second, there has to be an opportunity for the dividend to grow, because, like anyone, I like pay raises. And third, my yield on cost needs to be sufficient enough for the income to be worth my consideration.

Let's look at **Fortis Inc.** (TSX:FTS)(NYSE:FTS) and determine if this stock is the right one for our income portfolios. Let's look at the three criteria.

Is cash flow predictable and safe?

Because it's a utility, Fortis has one of the most predictable business models on the planet. And thanks to its geographic and regulatory diversification, the company is in a good place from a cash flow perspective.

The United States accounts for 55% of its pro forma operating earnings ending March 2017 with 29% in FERC Transmission (thanks to the ITC acquisition) and 26% in electric and gas. Canada accounts for 35% with electricity at 21% and gas distribution at 14%. And finally, the Caribbean provides 4% in electricity and 6% in other energy infrastructure.

And with many of its sources being regulated, there is pre-determined growth in the price built right in, which ensures that cash flow consistently grows on a yearly basis irrespective of any other growth prospects.

With regard to dividend security, the payout ratio has historically fallen somewhere in the mid-60% to mid-70% range. In 2015 and 2016, it was 66%, so I don't worry about the dividend.

Can the dividend grow?

Receiving a dividend every quarter is fantastic, but what we're looking for is a dividend that is going to increase at least once a year. I have a full-time job, and I like raises; I expect the same from my investments.

Fortis doesn't disappoint. Between 2006 and 2016, the annual distribution increased from $0.67 to $1.53, which is a CAGR of 9%. Management is expecting that it will continue to grow the dividend by ~6% on average from 2017 through 2021. That means there are five more expected dividend increases should the company continue to execute.

For context, Fortis has increased the dividend for 43 consecutive years, the longest record of any public company in Canada, so you're in good hands.

Is the yield on cost sufficient?

This is where we run into a bit of a problem. Because the company has predictable cash flow and a dividend that is growing, investors are oftentimes willing to pay a premium for the dividend. Right now, investors have pushed shares up, so the yield is just shy of 3.5%.

The higher the yield, better your yield on cost, and that can have a significant impact on your earnings. Let’s say you have $25,000 to buy shares of Fortis. At its current price of $45.79, you can buy 546 (rounded up) shares of the stock.

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But what if the yield was 4% versus the 3.5%? That means shares would be $40. That gets you 625 shares. This would result in $1,000 in income without taking into consideration the 6% yearly growth.

Obviously, when you do take that growth into consideration, that initial 0.5% difference in yield can have a serious impact on your overall income.

The question you have to ask is if Fortis will ever be in a position to give you that 4% yield. If so, patience is important. It’s important not to fall in love with stocks; instead, analyze them strictly for the income. I want that extra $126.40 in income that I get from a 0.5% higher yield. Compounding can have a real impact on your long-term portfolio.

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Author
jaycodon