Should You Buy These Beaten-Down Utilities?

Description

The market has been brutal to the stocks of **ATCO Ltd.** (TSX:ACO.X) and **Canadian Utilities Limited** (TSX:CU). Both stocks have fallen ~22% in the last 12 months. ATCO is the parent of and owns a big stake in Canadian Utilities. So, it's not surprising that their stocks have moved in lockstep.

We'll discuss why the stocks have fallen so much, but before that, here's an overview of their businesses.

ATCO

ATCO owns 52.7% of Canadian Utilities. Last year, it generated 93% of regulated earnings. ATCO has a structures and logistics segment, which operates on four continents and provides workforce housing solutions and bundled lodging and support services that allow ATCO's customers to work anywhere.

ATCO has an S&P credit rating of A- and a recent debt-to-cap ratio of 57%.

Canadian Utilities

Canadian Utilities is virtually a regulated utility. Last year, it generated 99% of regulated earnings. Its electricity segment has 88,000 km of electric power lines, 18 power plants, and 2,480 MW of power-generating capacity. Its pipelines and liquids segment has 65,000 km of pipelines, 85,200 m^3/day of water infrastructure capacity, 52 PJ of natural gas storage capacity, and 200,000 m^3 of hydrocarbon storage capacity. Canadian Utilities has an S&P credit rating of A- and a recent debt-to-cap ratio of 60%.

Why the stocks have fallen so much

Utilities are interest rate sensitive because of their debt-heavy nature. Since interest rates are generally expected to rise over time, both the stocks of ATCO and Canadian Utilities are being hit.

Moreover, both utilities are expected to experience slow growth for the next couple of years compared to other utilities, such as **Fortis** and **Emera**. Most importantly, the stocks of ATCO and Canadian Utilities were trading at historically high valuations previous to the declines. Now that they are trading at much closer to their normal valuations, the stocks look more reasonably priced.

Are their dividends safe?

The utilities have a long history of paying growing dividends. In fact, Canadian Utilities has the longest dividend-growth streak among Canadian publicly traded companies; it has increased its dividend for 46 consecutive years. Its one-, three-, and five-year dividend-growth rates are ~10%.

At about $31.60 per share, Canadian Utilities offers a safe yield of nearly 5%. Its payout ratio is estimated to be under 71% this year. So, its dividend should be intact.

ATCO has increased its dividend for 24 consecutive years with one-, three-, and five-year dividend-growth rates of ~15%. At about $38.70 per share, the utility offers a safe yield of nearly 3.9%. Its payout ratio is estimated to be under 51% this year. So, its dividend should be safe.

Investor takeaway

Under normal market conditions, an investment in ATCO or Canadian Utilities can lead to long-term total returns of 8-10% per year over the next three to five years. Their dividends should deliver roughly half of those returns.

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