Fortis Inc. (TSX:FTS): Q2 2018 Earnings Review. Buy, Hold, or Sell?

Description

Fortis (TSX:FTS)(NYSE:FTS) is a core holding in many retirees' portfolios. Its dividend is one of the most secure on the Toronto Stock Exchange. However, after Fortis stock has fallen from its all-time high of about $48 per share in late 2017 and has been stuck in the low $40s, even long-term investors may be second-guessing their positions in the stock.

Fortis stock hasn't really moved much — up about 1% — since it reported its second-quarter results at the end of July, which may indicate the market was indifferent about its recent results. What should current or potential investors do? Let's start by reviewing the results.

Fortis's Q2 results

Here are some key metrics compared to the same period in 2017:

	Q2 2017	Q2 2018	Change
Net earnings	$257 million	$240 million	-6.6%
Net earnings per common share	$0.62	$0.57	-8.1%
Adjusted net earnings	$253 million	$240 million	-5.1%
Adjusted net earnings per common share	$0.61	$0.57	-6.6%

Other than the Q2 earnings being negatively impacted by the U.S. tax reform, the earnings were also negatively impacted by unrealized net losses of $14 million on mark-to-market of derivatives at the Aitken Creek natural gas storage facility. The change in the prices of the underlying assets of derivatives can lead to losses. However, if the prices change favourably, they can also lead to gains.

Taking out the impact of the $14 million unrealized net losses, Fortis's Q2 adjusted net earnings would have remained stable and would have declined only about 1% on a per-share basis.

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Dividend, valuation, and returns potential

Fortis is [a top dividend-growth stock] with more than 40 consecutive years of dividend increases. It generates stable and predictable earnings to support its growing dividend. Its quarterly dividend of $0.425 per share is 6.25% higher than it was a year ago.

As a utility, Fortis is capital intensive. In the first half of the year, Fortis's capital spending was $1.5 billion. The second half will be another $1.7 billion. However, this is all a part of its five-year $15.1 billion capital plan to help reach a rate base of about $33 billion by 2022.

Fortis's payout ratio of about 68% combined with the investments that the quality utility is making should lead to dividend growth per share of about 5-6% per year through 2022.

The analyst consensus at **Thomson Reuters** has a 12-month target of $48.50 per share on the stock, which represents about 13.5% near-term upside potential. Barring the occurrence of a market downturn, investors can expect long-term annualized returns of 9-10%.

At about $42.50 per share, Fortis trades at a price-to-earnings multiple of about 17. Fortis tends to trade at a premium multiple because of its quality, predictability, and stability. Its long-term normal multiple is about 18. However, the stock will likely continue to be pressured in the current rising interest rate environment, which is expected to continue into the foreseeable future.

As a result, cautious investors should wait for a bigger margin of safety before buying. Aiming for an entry point of under $39 per share (or an initial dividend yield of about 4.35%), a multiple of about 15.5, is a good start.

Investor takeaway

Fortis's dividend, which currently yields about 4%, is well covered. Thus, retirees and income investors can hold the stable utility for income. However, if you're thinking of buying new shares, it'd be prudent to wait for a bigger margin of safety, as rising interest rates should continue to put pressure on Fortis, which is capital intensive.

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