Buy This Renewable Energy Utility and Lock In a +3% Yield

Description

Trump’s repudiation of global warming and announcement that the U.S. would withdraw from the Paris Agreement on climate change has had little real impact on investment in renewable sources of energy. Global investment in clean energy for the first half of 2018 came to US$138 billion, which was a mere 1% lower than the same period in 2017. There are signs that investment will expand further during the second half of the year because many major economies continue to invest heavily in renewable sources of energy. An attractive means of gaining exposure to this important secular trend is by investing in diversified utility **Algonquin Power & Utilities** (TSX:AQN)(NYSE:AQN).

Now what?

Algonquin is a regulated utility which generates 32% of its EBITDA from clean power generation and the remainder from its U.S. electricity, natural gas, and water transmission. Its electricity generating operations have 2.3 gigawatts (GW) of net installed capacity and earnings are contractually locked in through power-purchase agreements (PPAs), which have an average life of greater than 16 years. This virtually guarantees Algonquin’s earnings and hence the sustainability of its dividend, which is currently yielding 3.66%.

Importantly, the utility’s earnings continue to grow. For the second quarter 2018, adjusted EBITDA expanded by a healthy 9% year over year, while net earnings shot up by a remarkable 86% compared to a year earlier to almost US$66 million. This notable earnings growth can be attributed to an increase in revenue created by the U.S. Great Bay Solar plant coming online in March 2018.

A key contributor was Algonquin’s utility transmission business, which experienced solid earnings growth, reporting a 9% expansion in its bottom line. Trump’s corporate tax reforms, which reduced the U.S. corporate tax rate to 21%, were also a key contributor delivering a considerable windfall by reducing tax expenses by US$10.8 million. The largest contributor, however, was a US$15 million increase in the fair value of an investment that Algonquin is currently carrying on its books.

There is every sign that the utility will continue to deliver solid earnings growth. The Canadian Amherst 75-megawatt (MW) wind facility commenced operations in the second quarter 2018, which will give second-half revenue a solid lift. Algonquin is considering investing in 201 MW of Canadian wind projects currently under development, which are expected to commence operations between 2019 and 2022. The utility is also considering other development options in the U.S. and international jurisdictions.

Algonquin anticipates that by 2022 its EBITDA mix will be significantly more diversified that it is now, reducing its reliance on wind power while significantly boosting the earnings generated by international operations. The company is also developing the Granite Bridge natural gas pipeline project, where it filed an application for approval to commence construction in December 2017 with a decision expected in early 2019.

The push by U.S. states to increase the contribution of clean energy to their overall energy mix will also act as a powerful tailwind for earnings growth. In July 2018, the Missouri Public Service Commission delivered an order for 600 MW of wind generation as part of the plan to replace coal-fired power in the state.

For these reasons, Algonquin expects EBITDA to expand at a compound annual growth rate (CAGR) of greater than 10% annually between now and 2022, which will support further dividend hikes while giving its market value a healthy boost.

So what?

The diversified nature of Algonquin's business, its wide economic moat, and the fact that a large portion of its earnings a contractually locked in combined with the relatively inelastic demand for electricity, water, and natural gas makes it an attractive investment for any portfolio. Over the past few weeks, Algonquin's stock has pulled back to see it down by 4% since the start of 2018, creating an opportunity for investors to lock in a sustainable yield of over 3%.

CATEGORY

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2. Investing

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Author
mattdsmith