After a Rare Drop, Hydro One Ltd (TSX:H) Stock Looks Cheap With a 4.5% Dividend Yield

Description

Hydro One Ltd (TSX:H) has been the definition of stability since its market debut in November of 2015. Since then, the company's stock has been stuck between $20 and $26, while paying out a steadily growing dividend that recently reached 4.5%.

The debt market, which largely makes decisions based on cash flow predictability, has given its blessing of stability multiple times over the past four years. For example, in 2016, Hydro One was able to sell more than $1 billion in bonds at an average interest rate of just 2.5%, which is as close to the interest rate the at which the Canadian government was borrowing money.

The past 12 months have been a surprisingly volatile time for the company, with shares down nearly 10%. Is now a rare time to buy into a stable business with a growing dividend?

Merger failure provides buying opportunity

Hydro One was privatized by the Canadian government in 2015, thereby allowing outside investors to buy into the energy utility for the first time. Nearly the entire business is regulated, so cash flows are steady and predictable, allowing the company to pay a healthy dividend every year since going public.

One huge benefit that the company holds over other utilities is that it can pass rate increases directly onto customers. Other utilities, for example, have highly variable input costs like coal or natural gas. They can typically pass these changing costs onto customers over the long term, but it's no guarantee, and short-term profits can be volatile, putting pressure on debt levels or dividend payments.

The business model of Hydro One used to be fairly straightforward: operate in a predictable and stable business, deliver a healthy dividend to investors each year, and put new assets into place to grow the dividend over the long term. Since being privatized, Hydro One has spent a few hundred million dollars annually to improve existing assets and grow the rate base.

Then, in July of 2017, Hydro One announced that it would be acquiring the assets of **Avista Corp** (
NYSE:AVA

) for $53 per share, a premium of more than 20%. Operating primarily in the Pacific Northwest of the U.S., it wasn't exactly clear where the synergies of the deal were.

Avista provides electric service to roughly 600,000 electric and natural gas customers in Washington, Idaho, and Oregon, with a small subsidiary in Juneau, Alaska. Hydro One, meanwhile, serves the Canadian province of Ontario. Because the businesses were so different, the merger plan called for Avista's board of directors and management team to be retained following the acquisition. It's tough figuring out why this merger ever made sense.

In March of 2018, the companies received regulatory approval from Washington State. In April, it received antitrust clearance from the U.S. federal government. Alaska and Montana regulators followed suit in June. Only Idaho and Oregon remained, or so it seemed. In July, things got weird.

First, Hydro One's entire board, plus its CEO, resigned. The Ontario government had recently been pushing for changes at the utility and eventually got its way, injecting the board with ten new directors, four of which were nominated by the government directly. Shortly after, the Washington state government unexpectedly nixed the merger with Avista, saying "it does not serve the best interests of the company or its customers." The decision was largely based on the Ontario government's role in forcing out Hydro One's management team.

Current troubles don't reflect a strong underlying business

Currently, the optics appear weak. A new management team is coming in, and recent merger plans had to be scrapped. But underneath, Hydro One's business is chugging along just fine. No financials or forecasts have needed to be restated, and Avista's business didn't fit well into Hydro One's anyway.

Over time, these optics should fade away, and Hydro One will trade on its fundamentals, including its predictable cash flows and strong dividend. Now is the time to scoop up shares.

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