A High-Risk, High-Return Renewable Energy Stock Yielding 7%

Description

I last wrote on junior renewable energy utility **Polaris Infrastructure** (TSX:PIF) in early October 2018. Since then, it has lost 2%, trailing behind its larger industry peers such as **Brookfield Renewable Partners**, which gained 7% over that period. While there is a range of risks associated with Polaris's operations, its long-term outlook remains positive and this decline in value has created an opportunity for risk-tolerant investors.

Recent acquisition diversifies its portfolio

Polaris owns and operates the San Jacinto geothermal power plant located in Nicaragua, which has net installed capacity of 72 megawatts (MW). In late 2018, the utility completed the acquisition of Union Energy Group, which added that company's hydro-assets to Polaris's portfolio.

These assets were the five MW Canchayllo hydro plant, which has been in operation since 2015, as well as the Generación Andina and Karpa projects; upon completion, they will boost Polaris's installed capacity by 48 MW. The Generación Andina development is forecast to be completed by the end of 2019, whereas in the case of Karpa construction has yet to commence.

That deal reduced Polaris's dependence on its Nicaraguan business, thereby mitigating some of the risk associated with its operations.

High degree of geopolitical risk

The significant geopolitical risk connected to operating in Nicaragua has been weighing on the company's stock; the stock has been roughly handled by the market and is down by 37% over the last year. Nicaragua has been deeply embroiled in a political crisis which was sparked in April 2018 by government attempts at pension reform and led to protests that saw over 325 people lose their lives. This has tipped the Latin American nation into recession.

Economists believe that Nicaragua's gross domestic product (GDP) will contract by around 2% during

2019 and then the economy will return to growth in 2020 with it expected to expand by around 1%. That recession coupled with heightened political risk is the key reason for Polaris losing 37% over the last year.

Aside from the obvious political risks, the contraction of the economy will lead to lower demand for electricity because there is a direct correlation between GDP growth and consumption of energy.

Growing earnings

For 2018, Polaris reported solid financial results, including a 15% year-over-year increase in adjusted EBITDA to US$57.8 million and net income grew sevenfold to US$12 million. That notable increase in earnings was driven by an 11% year-over-year increase in average electricity generation.

The completion of the acquisition of Union Energy will give Polaris's earnings a further lift during 2018 because of the addition of the operational five MW Canchayllo hydro plant. That growth will continue into 2020, as the Generación Andina plants are completed and brought online by the end of this year. This — along with rising demand for electricity in Peru, where the economy is forecast by the International Monetary Fund to expand by over 4% in 2019 and 2020 — bodes well for further earnings growth.

Robust balance sheet

Polaris possesses a solid balance sheet. The company finished 2018 with almost US$38 million in cash and net debt of US$173 million, which is a very manageable three times its annual adjusted EBITDA. This means Polaris is well positioned to continue funding the construction of the Generación Andina assets and to evaluate whether it will progress development of the Karpa operation.

Is it time to buy Polaris?

Despite possessing many positive attributes, Polaris is a risky investment. The risk has been magnified by recent events in its core market of Nicaragua. It is likely that its stock will remain under pressure until there are signs that the political and economic crisis in the Latin American nation is easing.

There are, however, as discussed, a range of positive catalysts that will lift earnings and ultimately Polaris's market value. While investors wait for that to occur they will be rewarded by the utility's regular quarterly dividend yielding a very tasty 7%. That dividend, which, for 2018, had a payout ratio of 78%, appears sustainable, especially when it is considered that Polaris's earnings will continue to grow at a healthy clip.

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