This Little-Followed Stock Is Poised to Be a Dividend Machine

Description

Dividend investors like to focus on the past, telling themselves that if a stock has paid a consistent dividend in the past, then it's more likely to continue doing so. Paying a portion of profits back to shareholders becomes part of the company's culture – a commitment management takes seriously.

I prefer a different method, however. I like to look ahead to see what a dividend payment might look like three to five years in the future. As long as a company is expanding and making good capital allocation decisions, a dividend should continue heading higher.

The Holy Grail of investing, so to speak, is to find a stock with massive dividend growth potential that investors are discounting. Such a stock exists today in Canada; in fact, it's sitting right underneath your nose. Let's take a closer look.

A free cash flow machine

Polaris Infrastructure Inc. (TSX:PIF) has the vast majority of its capital tied up in a single asset — the San Jacinto geothermal power plant located in Nicaragua. This renewable energy plant generates 72 mw of energy, which makes it the tiny nation's largest power plant. All power generated by San Jacinto is sold back to Nicaragua's national power company.

This Nicaraguan exposure looked to be a liability earlier this year when protesters were upset with the nation's government over social security reforms. President Daniel Ortega attempted to shut down these protests, which only emboldened citizens. The good news is Nicaragua appears to be pretty calm today, although this could always change.

Some investors are concerned left-leaning Ortega will nationalize San Jacinto, but there's one big reason why his government is unlikely to do so. San Jacinto is the nation's finest power plant. Nationalizing it will scare off any foreign investment in the country, which is the last thing anyone in Nicaragua wants.

Anxious to diversify outside Nicaragua, Polaris' management announced an acquisition in Peru late in

2018. The company purchased one already completed hydro power plant along with the construction rights to several other projects, two of which should be completed by the end of 2019.

These projects should give 2020's bottom line a nice boost with the potential to add even more over the long-term.

Meanwhile, the company generates gobs of free cash flow. In 2018, Polaris generated US$33 million in free cash flow, which works out to approximately $3.40 per share once we convert back to Canadian Dollars. That puts shares at approximately four times free cash flow, giving Polaris one of the cheapest valuations on the entire Canadian market.

The dividend

With that much free cash flow, a company can deliver generous dividends while still maintaining ample liquidity to be used for expanding the business. That's exactly what Polaris is doing — keeping its dividend at approximately 35% of free cash flow.

The rest is going toward the Peru expansion, with longer-term plans to add renewable power plants throughout Latin America.

The current payout is US$0.25 per quarter, good enough for a 5.8% yield. Investors should be immediately attracted to that payout, especially in a world where a medium-term Canadian government bond barely pays more than 1%.

There's also potential for the dividend to head higher over time, especially after the Peruvian operations start adding to the bottom line.

Foolish takeaway

Even if Polaris decides to keep the dividend steady for a few years, investors are still getting a very generous yield while they wait for the stock to trade more in line with other power generators.

Remember, Polaris is an incredibly cheap stock. Shares could double from here and the company would only trade for eight times free cash flow. It's the type of situation where you come for the cheap valuation, but you stay for the 5.8% yield and the potential dividend growth — which I suspect comes in a big way once the company's shares climb higher.

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