This Dividend Stock Is a Cash Cow

Description

If you want big dividends, check out utility stocks.

Utility companies are in charge of getting electricity to their customers. Owning a bunch of transmission lines is a perfect example. These businesses often aren't able to grow by leaps and bounds each year given the vast majority of the country is already covered by an energy providor. Instead, utilities rely on incremental pricing and population growth to boost their bottom lines.

Because electricity demand is stable from year to year, and governments often guarantee utilities's minimum pricing, cash flow generation is very predictable. This gives utility stocks more cash each quarter that they're able to reinvest. That's why they pay such high dividends.

Algonquin Power & Utilities (TSX:AQN)(NYSE:AQN) stock is a prime example. Since 2009, shares have increased in value by 420%, all while paying a dividend of at least 3%. Looking ahead, this stock looks ready to become a cash cow for investors.

Best of both worlds

Many utility investors may balk at Algonquin's 3% dividend yield. That's reasonable considering competitors are offering yields of 5% or more. Yet there's something that those stocks are missing: capital upside.

As mentioned, over the last decade, Algonquin stock has risen by more than 400%. That sounds like a fair trade for a lightly smaller yield. **Emera**, for example, has a 4.1% dividend, but since 2009, it has only risen by 150%. I'll take quadrupling my money over a minuscule increase in yield any day.

How can Algonquin offer a steady dividend and sizable long-term growth?

Unlike other utilities, Algonquin isn't playing a single game. Most utility stocks are either regulated or unregulated. These are two very different beasts. Regulated utilities have government guarantees about their pricing and rate base. These guarantees have minimums (decreasing risk) but also ceilings (capping upside). Unregulated utilities are exposed to market volatility, increasing both risk *and* upside.

Algonquin decided that it didn't want to choose between stability and growth, opting for a two-pronged strategy. Around two-thirds of revenue come from traditional regulated sources. This segment produces a lot of cash flow, and instead of paying all of it out to shareholders, Algonquin retains some to invest in its unregulated business. Around one-third of revenue stems from its unregulated renewables business, which provides long-term growth possibilities.

And don't think that unregulated utilities are full of volatility. Algonquin's renewables portfolio is tied to long-term contracts that can span decades. So, in realty, this business is closer to the regulated segment than you'd think.

Over the next five years, Algonquin is spending $9.2 billion to expand both its regulated and unregulated businesses. Note that its market cap as of today is just $11.5 billion. Expansion should fuel capital upside, but it also comes at a cost in the form of lower near-term dividends.

As these assets are put into place, however, Algonquin should be able to reap the rewards as capital expenditures come down. The upfront cost is only over a few years, yet these projects should generate cash flow for decades. The market hasn't caught on yet, but Algonquin looks like Canada's next top dividend stock.

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