Why Hydro One Is a Good Buy Amid Uncertain Outlook

Description

Although Canadian equity markets have shown strong resilience, the rising COVID-19 cases in Europe and the high unemployment rate are worrying. Further, the uncertainty over the outcome of the United States presidential elections could contribute to the volatility. So, it's better to go defensive and buy **Hydro One** (TSX:H), one of the safe companies on the **TSX**.

Operating metrics

Hydro One is the largest power transmission and distribution company in Ontario. Its transmission system, which includes 30,000 circuit kilometers of high-voltage transmission lines, accounts for 98% of Ontario's transmission capacity. Meanwhile, its distribution system consists of around 123,000 circuit kilometers of low-voltage power lines, serving 1.4 million customers, primarily in rural areas.

The company earns 99% of its revenue from regulated operations. Further, it is not involved in capital-intensive power generation operations and is immune to commodity rate fluctuations. So, the company's financials are stable.

Despite the pandemic, Hydro One reported an impressive performance in its recently announced second quarter. Its revenue, net of purchased power, grew 13.4%, while its adjusted EPS increased by 50%. The increased demand for electricity due to favorable weather, higher transmission and distribution rates, and revenue contribution from assets placed-in-service in the last four quarters drove the company's topline.

During the quarter, the company's productivity savings increased 61.7% on a year-over-year basis to $86 million due to improved labor efficiency and technological advancements in the forestry, corporate, and customer service areas.

Liquidity and dividends

Hydro One generated $375 million from its operating activities in the second quarter, representing a rise of 26% from its previous year's quarter. Its balance sheet also looks healthy, with a liquidity of $3.4 billion at the end of the second quarter. So, the company has adequate liquidity to support its expansion plans and fund its dividend payouts.

Since 2016, the company has paid quarterly dividends. It has increased its dividends at a CAGR of 4.8% during the period. Currently, its dividend yield stands at 3.4%. Also, the company targets to keep its dividend payout ratio between 70%-80% of net income.

Outlook

The company's outlook looks healthy. Its management has planned to expand its rate base from $21.7 billion in 2020 to $26 billion at a 5% CAGR by investing $9.7 billion. Meanwhile, the company has announced that these investments will be self-funded, and it has no plans of issuing new equity. The growth in rate base could drive the company's earnings and cash flows.

Meanwhile, the company has reaffirmed its earlier announced guidance, which projected its adjusted EPS to growth 4%-7% annually from 2019 to 2022.

Bottom line

Boosted by the impressive performance in the first half of 2020 and its healthy growth prospects, Hydro One has returned 18.6% for this year. It has comfortably outperformed the broader equity markets, where the **S&P/TSX Composite Index** has declined by 3.3% during the same period.

Despite the increase in its stock price, the company still trades at a reasonable valuation. Its forward price-to-earnings stands at 21, while the forward price-to-earnings multiple of its peers, **Algonquin Power & Utilities and Fortis,** stand at 22.2 and 18.2, respectively. Also, its enterprise-to-EBITDA multiple stands at 12.7, lower than 14.6 of Algonquin Power & Utilities.

So, given its recession-proof business model, stable cash flows, and healthy dividend yield, I believe Hydro One is an excellent buy amid this volatile environment.

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rnanjapla