Algonquin Power Stock: 3 Things to Know About the Crash

Description

Algonquin Power and Utilities (TSX:AQN) stock tumbled severely last week, as its third-quarter earnings release disappointed investors. As you can see in the chart below, the stock had been treading water until an event on November 11 sent it tumbling. Most likely, the event was the earnings release.

Evidently, Algonquin's earnings were not taken well by the markets. The question is, what was revealed in the release, and why was it so bad? In this article, I will explore that question, before revealing what I think investors should do in light of AQN's release.

Algonquin Power's release in detail

Algonquin Power put out a mixed release on November 11, revealing these metrics:

- $666 million in revenue, up 26%
- -$195 million in net income, worsened by 600%
- $73.5 million in adjusted earnings (i.e., earnings ignoring some accounting rules), down 25%
- $102 million in cash from operations (i.e., cash generated by day-to-day business activities), down 47%

It was a pretty rough showing. The revenue growth was pretty impressive, but everything else was bad. Basically, earnings and cash flows went down. The company did point out an alternative measure, "adjusted EBITDA," that went up, but adjusted EBITDA is a notoriously unreliable metric.

"EBITDA" means earnings before interest, taxes, depreciation, and amortization. Excluding these costs from profit is questionable, because interest and taxes are real cash costs, while depreciation (i.e., predictable asset value declines) is meaningful and relevant if it's calculated in an honest way. Just taking these things out of profit doesn't tell investors much, which is why Charlie Munger calls adjusted EBITDA "ridiculous."

Indeed, in Algonquin Power's case, interest is the whole problem! In the third-quarter release, Algonquin said that its earnings went down because of rising interest rates. Utilities like AQN have a lot of debt, and if it's variable rate, or if they have to increase the amount of debt, then the interest expense goes up a lot. The result of this is lower earnings.

In Algonquin's third quarter, interest costs surged from $51.7 million to $75 million — a stunning 45% increase. That's not just some accounting technicality; it's a real cost that affects its dividend-paying ability. So, some of the concern about Algonquin's earnings release was warranted.

What should investors do?

Having looked at what went wrong in Algonquin Power's third quarter, it's time to ask: what should investors do now?

It's tempting to say, "buy a utility with less debt," but I don't think that's the right answer. All utilities, even the best managed ones, have a lot of debt; operating power plants and teams of electricians or natural gas installers costs a lot of money. Interest rates are going up, and all utilities are vulnerable to rising interest expenses.

The way I'm playing higher interest rates is by holding bank stocks. **Toronto-Dominion Bank** (TSX:TD) is the single longest-standing stock in my portfolio. I bought it in 2018, and I bought it in the March 2020 market crash, and both buys have paid off.

Banks often benefit from rising interest rates, because they charge interest to their customers. When central banks raise interest rates, banks respond by raising the rates on mortgages. Assuming that the interest they pay on deposits doesn't go up too much, they collect higher interest income.

In TD's most recent quarter, adjusted earnings grew 6.6%. In **Bank of America's** most recent quarter, net interest income rose 24%! These are the kinds of companies that do well when rates rise, and I have a lot of my money in them this year.

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