Algonquin: Should You Catch the Falling Knife?

Description

Higher interest rates are making **Algonquin Power & Utilities** (TSX:AQN) an increasingly riskier investment. Investors saw their position lose 42% year to date. Utility stocks are mostly bought or held for their predictability and stability. Algonquin stock was anything but predictable and stable.

Since September, it has been a falling knife. Needless to say, it's a speculative investment now. On one hand, investors must be careful about catching falling knives that could hurt their portfolios, as such stocks could be value traps. On the other hand, if AQN stock turns out to be a deep-value stock, it could deliver outsized returns for investors that jump in now and can withstand the high volatility.

Why AQN stock fell off a cliff

Initially, the utility stock had been weaker than its peers because of its higher debt levels. Though its S&P credit rating is investment grade at BBB, it's lower than its larger peers like Fortis's credit rating of A-. Any excessive levels of debt is seen as negative in today's higher interest rate environment.

Furthermore, AQN stock tumbled more than 30% in a matter of two trading days. The fall occurred right after it reported its third-quarter (Q3) results. For the quarter, the company reported 26% higher in revenue but a 27% drop in adjusted earnings per share (EPS) to US$0.11.

This was below expectations and management lowered its 2022 EPS estimate to US$0.66-$0.69. This implies an extended 2022 payout ratio of about 107% based on the midpoint of the estimate. So, there's an elevated concern of a dividend cut.

Essentially, there are multiple factors that have increased the risk of a dividend cut, such as higher interest expenses and lower earnings. And again, the company has tonnes of debt on its balance sheet. Its debt-to-equity ratio is 1.98 times.

How big could the dividend cut be?

Yesterday, AQN stock closed at $10.61 per share and yields almost 9.1%.

Given Algonquin's balance sheet with higher debt levels, it would serve the company well to reduce its dividend to help pay off higher-interest debt. A healthier payout ratio could be 60%, which would imply a payout of US$0.405 per share based on the midpoint of management's 2022 EPS guidance. If so, it would be a dividend cut of 44%. Based on the recent closing price, it would imply a forward yield of 3.8%.

The Foolish investor takeaway: Should you catch the falling knife?

Analysts have a consensus 12-month price target of US$14 per share on the stock, which implies a discount of 43%. The market is pricing in a dividend cut.

In multiple cases, stocks have jumped after dividend cut announcements. For a more sustainable turnaround, the company would need to demonstrate improved business performance, which can come from better execution or an improved macro environment.

AQN's third-quarter financial report stated, "Given the challenging macroeconomic environment, which is expected to continue into 2023, the company is evaluating its longer-term targets and financial expectations." Investors should look for more details (and likely a dividend cut) in the Investor and Analyst Day that's expected to occur in early 2023.

Higher-risk investors might consider AQN as a total-return investment. Just ensure proper asset allocation to diversify risk in your portfolio. Additionally, it would be more prudent to wait for some consolidation in the stock before buying (more) shares.

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