Why I’m Not Falling for Algonquin Power’s 7% Dividend Yield

Description

Algonquin Power (TSX:AQN) stock continued to drop last week, even after the chief executive tried to calm the storm. It has tumbled more than 35% since November 11 and is currently trading at its seven-year low.

Some so-called market pandits are recommending the stock to lock in a juicy dividend yield. Some excitement is warranted as Algonquin has been one of the top wealth creators among utilities in the past. However, this time, investors need to see the red flags and act accordingly.

Should you buy AQN stock?

Algonquin reported a 27% drop in profits for the third quarter of 2022 year over year. Such a decline is rare among utilities with large regulated operations. So, investors’ ire was evident, and the stock got punished in the subsequent weeks.

Apart from the earnings drop, management’s sketchy guidance also marred investor sentiment. It lowered the earnings guidance to $0.66 to $0.69 per share for 2022. Moreover, the challenges that weighed on its earnings recently are expected to remain next year as well.

Adamant inflation and rapid rate hikes notably increased Algonquin’s interest expenses and brought its earnings down. A large part of its debt is exposed to variable interest rates. As a result, as interest rates increase further, Algonquin will most likely spend higher on debt servicing, having an even higher impact on its bottom line.

More concerningly, Algonquin is buying Kentucky Power for $2.6 billion. This should balloon its debt further, making managing the bottom line more challenging.

Increasing debt and a weakening outlook

After the recent fall, AQN stock is trading at an industry-leading dividend yield of 7%. However, note that it's because of the stock fall and not because of the dividend increase.

There is, in fact, a meaningful risk of a dividend cut, given the commentary and the guidance. For 2022, Algonquin will likely earn $0.68 per share per the guidance midpoint. However, it will pay a $0.71 per share dividend this year, implying a payout ratio of 104%. A payout ratio higher than 100% means that it needs to borrow money to pay dividends or dilute shareholders' stakes. Simply, the scenario is not feasible in the long term.

Algonquin has consistently engaged in share dilution in the past, too. At the end of 2019, AQN had 504.7 million outstanding shares. However, the number swelled to 683.4 million at the end of November 9, 2022. In fact, the company sold nearly 4.8 million shares between September 30 and November 9, 2022, considering the post-earnings impact on the stock.

As the number of outstanding shares increases, existing shareholders' stakes become less valuable. Algonquin will likely dilute more, as it seems like a cheaper option for now, making the stock recovery less probable.

Algonquin was more highly valued among investors a few years back. It aggressively invested in renewables projects and showed above-average growth in the last decade. During 2010–2020, AQN stock returned 22% compounded annually, way higher than its peers. However, as supply chain issues dented the renewables sector and amid interest rate increases, the tables soon turned, hitting its operational and financial growth.

Bottom line

While AQN could continue to trade weak, investors will get more clarity on its next guidance early next year. High leverage amid rapidly rising rates makes AQN stock a risky bet right now. So, it seems like investors would be better off with other more stable, dividend-paying TSX stocks for the long term.

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