Algonquin Power Stock: Time to Buy or Buyer Beware?

Description

It has been a painful year for **Algonquin Power and Utilities** (TSX:AQN) stock. It is down 32% in the past month and 44.6% since the start of the year. Algonquin is a diversified utility and renewable power operator.

Utility stocks are generally considered very stable and dependable. So, it is pretty amazing for Algonquin stock to drop so precipitously.

Today, Algonquin stock has a huge dividend yield of 9.6%. While that may look very appetizing for income investors, you need to be cautious.

What happened to Algonquin stock?

On November 11, Algonquin announced third-quarter results that significantly disappointed investors. Revenues and adjusted EBITDA (earnings before interest, taxes, depreciation, and amortization) were up 26% and 10%, respectively, year over year. However, net earnings collapsed 600% and adjusted net earnings fell 25%.

Algonquin faced cost pressures due to increased operating costs, project delays, and, most significantly, rising interest rates. Algonquin revealed that 22% of its debt was variable rate. Fast-rising interest rates are having a significant impact on the bottom line.

In response, the company reduced its 2022 earnings guidance and noted that it is re-assessing its longer-term growth outlook. Algonquin has long touted its stock for its above-average growth plan (7-9% compounded annual earnings growth over the coming five years). The consideration that this may not be achievable caused the rapid selloff in the stock.

Why should investors be cautious with Algonquin's stock?

Despite its attractive dividend yield today, the market is rating Algonquin stock with serious concern.

The high yield is a signal alone to be very cautious. It is very rare that a stock with a high +9% dividend yield actually sustains its dividend over longer periods.

Algonquin has a lot of debt, even for a utility. Its net debt-to-adjusted EBITDA ratio is 8.4. For context, other pure-play utilities (like **Fortis**) are closer to 6.5. Interest rates are likely to continue to rise, so floating rate debt expenses will likely rise into the new year.

Likewise, Algonquin will be drawing on its variable rate credit facilities to pay for the anticipated Kentucky Power acquisition. It will also assume over $1 billion of debt in the transaction.

This fast-rising debt expense is quickly eating up earnings, leaving little room to pay the dividend, let alone grow it. Given its elevated financial and operational execution risk, income investors need to be very cautious of buying Algonquin stock.

Is Algonquin a buy here?

The one positive for Algonquin is that its stock is cheap today. After its swift decline, it trades with a huge yield, an enterprise value-to-EBITDA ratio of 10, and a price-to-earnings ratio of 10.6. This is significantly below peers.

The company does have a high-quality portfolio of regulated utilities and renewable projects that should do well in the long term. After the massive stock decline, Algonquin's chief executive officer noted in a recent letter that he had purchased over $1 million worth of stock. This can often be a bullish signal.

The Foolish takeaway

Unfortunately, management's actions are "too little and too late." The company has sacrificed financial discretion and sustainability (a hallmark for utilities) for aggressive, yet-to-be accretive growth.

Given the uncertainty in the business, this is one dividend stock I would monitor but not buy today. The company needs to prove a prudent strategy for the future. Until then, investors should be cautious investing their hard-earned dollars into Algonquin stock.

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