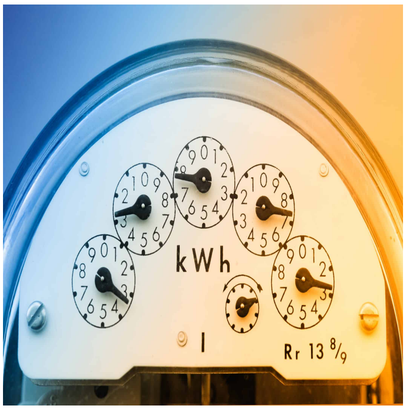

What's Next for Algonquin Power Stock as it Falls to New Lows?

Description

Utility stocks are some of the most stable, less-volatile names across broader markets. However, **Algonquin Power and Utilities** (TSX:AQN) investors have been in shock since November, as the stock has been consistently declining. It has lost 40% in the last six weeks and is currently trading at its eight-year low. It fell to new lows this week but is still holding at a $9-apiece level.

Algonquin Power and peer utility stocks

Utility companies earn stable cash flows from regulated operations and, thus, grow slowly but steadily. Sure, they are capital-intensive businesses and carry a lot of debt on their books. Algonquin shares these characteristics but a tad differently.

Like peers, it also has large, regulated operations. But at the same time, it also has massive exposure to renewable assets. As a result, it was one of the fastest-growing utilities among peers in the last decade. Its superior earnings growth created sizeable wealth for shareholders in the same period, beating peers by a big leap. However, it came with a cost.

Algonquin's weaker financials and a dividend cut

Algonquin has a relatively higher exposure to variable interest rate debt, which started biting this year as rates rose. It reported a 27% drop in profits year over year for the third quarter of 2022. While peers continued to see stable earnings growth in 2022, Algonquin's deep plunge has been quite concerning. As interest rates increase further next year, Algonquin will most likely spend higher on debt servicing, causing an even greater blow to its bottom line.

Many investors look at AQN's recent fall as an opportunity to enter. However, there is a tremendous amount of uncertainty with its bloating balance sheet and rising rates. The potential impact on its net income could be troubling, making strong grounds for a dividend cut.

Algonquin management also lowered the earnings guidance to $0.66 to $0.69 per share for 2022.

Given its current dividend rate, the payout ratio for 2022 comes out to 106%. A payout ratio beyond 100% indicates that the company is giving away more in dividends than its earnings. This situation can not persist in the long term.

So, either the company must increase its earnings or cut back on dividends. The first one does not seem to be an option for Algonquin. With the Kentucky Power acquisition soon to close, the debt burden will likely increase further. So, the interest expense will likely balloon in 2023.

Besides, Algonquin could take up equity dilution to support its finances. This could dilute existing shareholders' stake, waving another red flag for investors. At the end of 2019, AQN had 504.7 million outstanding shares. However, it increased to 683.4 million at the end of November 9, 2022.

Conclusion

AQN stock might not recover anytime soon. Instead, weaker quarterly earnings and a payout cut will likely fuel another wave of stock drop in the short term. Even if the dividend yield currently looks superior at 8%, it will likely normalize after the potential dividend cut.

There are a few other TSX utility stocks that look appealing to get the defensive exposure for 2023. As markets might continue to trade volatile, it will be prudent to offload Algonquin and enter peer utility names. Consider **Fortis** (TSX:FTS). It offers immense stability with a stable dividend yield of 4%. The stock might underperform in the short term. But if you hold it through multiple business cycles, it will create a significant reserve.

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