Can Fortis power its way through recent soft patch?

By JOHN HEINZL
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Though some analysts questions its staying power given exposure to whims of regulators

Think utilities are boring, stodgy stocks suitable only for widows and orphans?

Fortis Inc. FTS-T shareholders would beg to differ.

Over the past decade, shares of Canada's largest publicly traded gas and electricity distributor have posted an average gain of 10.3 per cent annually. Throw in dividends, which Fortis has raised every year, and the total return has been a sizzling 14.3 per cent.

How's that for boring?

As strong as Fortis's track record has been, the question now is whether it can continue to deliver such stellar gains. Not everyone is convinced.

With income-starved investors rushing into dividend-paying utilities as an antidote to anemic bond yields, many analysts say Fortis's shares are fully valued. Of the 11 analysts who follow the company, seven rate the shares a "hold", with two "buys" and two "sells", according to Bloomberg.

Such caution toward the stock reflects several factors.

For starters, Fortis is trading at a multiple of about 18.5 times estimated 2012 earnings, which isn't outrageously expensive, but not cheap, either.

The company is also facing headwinds in the form of lower allowed returns from provincial utility regulators. The Alberta Utilities Commission, for example, reduced Fortis's allowed return on equity (ROE) by 0.25 percentage points. The company is also facing reviews later this year from utilities commissions in Newfoundland and British Columbia.

Adding to the uncertainty are weak economic conditions in the Caribbean, where Fortis has electricity generating and transmission assets in the Cayman Islands and Turks and Caicos. Then there are the company's struggles in Belize, where the government expropriated Fortis's investment in the regulated electric utility earlier this year and has yet to pay any compensation. Fortis continues to own non-regulated hydroelectric assets in the country.

With Fortis's 2011 earnings up less than 3 per cent on a normalized basis, the company's "growth is at least for now not what it used to be," Scotia Capital analyst Matthew Akman said in a note. "Holding [Fortis] shares may not hurt in 2012, but we see little potential for capital appreciation."

Yet for investors with a longer-term horizon, Fortis still presents an attractive opportunity, other analysts say. Despite the recent soft patch, earnings and dividend growth should accelerate in coming years thanks to an aggressive capital spending plan of $5.5-billion through 2016. Most of the money will go to its Canadian gas and electric utilities, increasing the so-called "rate base" - or amount of invested capital - on which it earns a regulated return.

The company is also aiming to expand in the United States with the proposed $1-billion (U.S.) acquisition of CH Energy Group Inc., an electric and gas utility in New York's Central Hudson Valley.

Apart from boosting Fortis's earnings, the growth in its Canadian regulated gas and electric utilities - its most stable businesses - will lower the risk profile of the company, said analyst ***Darryl McCoubrey*** of ***Veritas Investment Research***, who has a "buy" on the shares.

Even at current valuations, the shares should appeal to risk-averse income investors, he said in an interview.

The capital spending "is all being driven by their regulated businesses, so that being the case you're getting the safety to go alongside potential earnings and dividend growth going forward," he said.

Although some analysts predict Fortis's dividend hikes will be modest for the next few years - the last increase, in December, was just 3.3 per cent - ***Mr. McCoubrey*** is more optimistic. He expects Fortis could announce an 8-per-cent increase the next time it raises its dividend, likely later this year.

Based on Tuesday's closing price of $32.33, the current annual dividend of $1.20 yields 3.7 per cent.

Is Fortis a slam dunk? No. A rise in interest rates would likely hurt all interest-sensitive utilities, including Fortis. Regulatory decisions are another wild card: RBC Dominion Securities analyst Robert Kwan estimates that a 0.5-percentage-point cut in allowed ROE for Fortis's B.C.-based utilities would shave 5 cents a share from its earnings.

Still, for investors who want a steady stream of income that will almost certainly grow, Fortis is worth considering. That's why I continue to hold the stock and may add to my position if there's a pullback.