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Why Fortis should be a core holding for dividend investors

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With dividend stocks, I like predictability. The more stable the business is, the better.

That's one of the main reasons I'm a fan of Fortis Inc.

The gas and electric utility operator – whose shares I own personally and in my model Yield Hog Dividend Growth Portfolio – isn't going to deliver massive returns. But it's not the sort of stock that will crater on bad news, either.

For investors seeking modest earnings and dividend growth – and a relatively high degree of income safety – Fortis is an attractive pick, particularly now that the share price is well off its highs. As ***Darryl McCoubrey***, a ***Veritas Investment Research*** analyst who rates Fortis a "buy," said in a recent note: "Boring can be beautiful."

Here are five reasons I view Fortis as a core holding for dividend investors.

PREDICTABLE EARNINGS

St. John's-based Fortis provides electricity and gas to 3.3 million utility customers in Canada, the United States and the Caribbean. Electricity and gas are commodities that people rely on every day, and demand is only going to grow. What's more, 97 per cent of Fortis's earnings are from regulated distribution and transmission assets, which throw off stable and predictable cash flows that increase over time. In a recent note, RBC Dominion Securities analyst Robert Kwan called Fortis "the 'go to' stock for investors seeking a Canadian utility … with a clean story and outlook."

A GROWING RATE BASE

Fortis completed three major U.S. deals in recent years, acquiring New York-based CH Energy Group Inc. in 2013, Arizona-based UNS Energy Corp. in 2014 and Michigan-based ITC Holdings Corp. in 2016. Analysts say Fortis is unlikely to make any more major deals in the near term and will focus on investing in its existing operations to grow its rate base – the value of assets on which a utility is permitted to earn a

regulated rate of return. The company forecasts that its rate base will grow by about 5.4 per cent annually, reaching $33-billion in 2022, driven by capital spending on transmission lines, natural-gas-system upgrades and expansions, clean-energy initiatives and other projects.

A RISING DIVIDEND

Thanks to steady growth in its earnings, Fortis's annual dividend has increased for 44 consecutive years. The company, which currently yields 4 per cent, aims to continue raising its dividend at an average annual rate of about 6 per cent through 2022. "We are pleased with the results we are seeing to date and remain confident that our growth efforts will support our dividend growth target," president and chief executive officer Barry Perry said on the second-quarter conference call in July. Another increase could be coming soon: Last year, Fortis hiked its dividend in October to coincide with its 2017 Investor Day. The company's next Investor Day is scheduled for Oct. 15 in Toronto, when it will update its capital-spending plan.

A SAFE PAYOUT

Fortis has "best-in-class dividend coverage," ***Mr. McCoubrey*** said. For the 12 months ended June 30, its adjusted funds from operations or AFFO – a cash flow measure – was $3.61 a share, implying a "healthy 2.1 times coverage ratio on its $1.70 annual dividend. In comparison, the peer average coverage ratio is 1.6 times," he said in a note. As for future dividend growth, ***Mr. McCoubrey*** said the 6-per-cent target is "doable." However, citing the impact of U.S. tax reform, the need for Fortis to delever its U.S. operations and the cash required to fund its capital spending plan, 5-per-cent dividend growth "might be a more prudent target," he said in an e-mail.

A REASONABLE VALUATION

Fortis's shares aren't cheap. They trade at more than 16 times estimated 2019 earnings per share, compared with about 14 times for other regulated utility stocks. But analysts say the premium is warranted given Fortis's strengths. Of the 14 analysts who follow the company, there are 10 buy recommendations, four holds and no sells, and the average 12-month price target is $48.50. Fortis closed on Tuesday at $42.69 on the Toronto Stock Exchange.

CLOSING THOUGHTS

There are risks with every stock. Adverse regulatory decisions or a continued rise in interest rates could pressure Fortis's share price. That said, the shares have already dropped more than 12 per cent from their 52-week high of $48.73 reached last November, which may offer some downside protection. Regardless of what the share price does in the short run, Fortis will almost certainly continue to grow its earnings and extend its decades-long track record of dividend increases.

Globe Unlimited subscribers can view the complete model Yield Hog Dividend Growth Portfolio at tgam.ca/dividendportfolio.