THE GLOBE AND MAIL

July 31, 2018

Why Capital Power's dividend just went up – again

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Nothing brightens my day like a dividend increase.

So I was thrilled when Capital Power Corp. (CPX) – a stock I hold both personally and in my model Yield Hog Dividend Growth Portfolio – hiked its payout by 7 per cent on Monday. This was the fifth consecutive annual increase for the company, which is now paying $1.79 on an annualized basis – good for a yield of about 6.8 per cent.

In some circumstances, a yield that high might call for caution. But in Capital Power's case, the dividend is well covered and I expect that it will continue to grow.

Let's take a closer look at the company, the factors that led to the latest increase and what the future might hold for this growth-oriented power producer.

A DIVERSIFIED – AND GROWING – PORTFOLIO

Edmonton-based Capital Power operates 24 facilities in Canada and the United States that can generate 4,500 megawatts at peak output. Its growing fleet includes coal, natural-gas, wind, solar, waste-heat and solid-fuel plants, with 82 per cent of EBITDA (earnings before interest, taxes, depreciation and amortization) coming from contracted sales and 18 per cent – all in Alberta – from merchant power, which is sold at prevailing rates. Renewables represent a major source of growth for the company, which expects to add – among other projects – three contracted wind facilities in North Dakota, Alberta and Illinois within the next two years representing an additional 450 MW of generation.

RISING CASH FLOW

For the second quarter ended June 30, Capital Power's adjusted funds from operations (AFFO) – a cash-flow measure that excludes depreciation, amortization and other items – rose by 73 per cent to $76-million or 74 cents a share. For the full year, the company expects AFFO to be above the midpoint of its guidance range of $360-million to $400-million. Growth in cash flow is being driven by several factors, including new generation projects, rising demand for electricity and rebounding power prices in Alberta.

ALBERTA ON THE MEND

Having plunged when the oil market collapsed, the average spot electricity price in Alberta has nearly tripled in the past year, to about $56 a megawatt-hour during the second quarter from $19 in the same period a year earlier. The increase, which reflects demand growth in the province and the retirement of some older coal-fired facilities, appears to be sustainable considering that forward 2019 power prices are currently in the mid-$50s. This is good news for Capital Power, which can take advantage of the higher prices by selling its uncontracted power.

CONSERVATIVE PAYOUT RATIO

Even as Capital Power has been increasing its dividend, the payout ratio has averaged a conservative 46 per cent of AFFO over the past five years – at the lower end of the company's target range of 45 per cent to 55 per cent. Assuming the company hits the midpoint of its AFFO guidance range this year, the payout ratio would again be 46 per cent for 2018. With its cash flow growing steadily, Capital Power is aiming to continue raising its dividend by about 7 per cent annually through 2020. "For investors, healthier prices in Alberta are supplemented by significant contracted asset additions in other markets to provide a clear pathway for CPX to deliver upon its 7-per-cent annual average dividend guidance through 2020," ***Veritas Investment Research*** analyst ***Darryl McCoubrey***, who rates Capital Power a buy, said in a note.

ATTRACTIVE VALUATION

Raymond James analyst David Quezada said Capital Power trades at an enterprise value to EBITDA multiple of about 7.8, compared with an average of 9.9 for the Canadian renewable power industry. "We believe CPX's discount to the broader [independent power producer] peer group is excessive, particularly considering the de-risking of the Alberta power market, rising proportion of contracted cash flows, and additions to the company's development portfolio," Mr. Quezada, who rates the stock "outperform," said in a note. There are nine buy or equivalent ratings on the shares, three holds and one sell, and the average 12-month price target is $28.08, according to Thomson Reuters. Capital Power closed Tuesday at $26.42.

CLOSING THOUGHTS

I have no idea what Capital Power's share price will do in the short run. But over the long term I expect that its cash flow and dividend will continue to grow, and that its share price will also move higher. Remember to do your own due diligence before investing in any security.