THE GLOBE AND MAIL

November 16, 2015

Hydro One has a remarkably safe dividend, but a stock price with hidden risks

It's been noted, here in the pages of The Globe and elsewhere, that the fact the Hydro One IPO didn't "pop" on its first day of trading means investors can fairly assess the stock's value, free from any unusual factors of marketplace demand. And this is true.

It should not mean, however, that Hydro One's shares aren't already robustly priced, despite trading just 7 per cent above the Nov. 5 offering amount.

If you'll notice, I stopped just short of slapping the strong word "overpriced" on the stock. That's probably a stretch for a slow and steady dividend performer, trading in line with other regulated utilities. Hydro One's payment, which works out to a 3.8-per-cent yield, seems remarkably safe. The company has an electricity transmission monopoly in Ontario, and seems intent on building on its 25-per-cent share of assets that distribute power to end users in homes and businesses. It's got a healthy balance sheet to assist in any sort of acquisition program.

The thing about Hydro One, however, is that it has certain risks that its peers do not. And these risks do not seem to be reflected in the stock's recent prices above $22.

Darryl McCoubrey of ***Veritas Investment Research*** was skeptical of the offering in the summer when the Province of Ontario thought it could command a market valuation of $13.5-billion to $15-billion for the company. When the company instead unveiled a pricing range of $19 to $21 per share, which worked out to $11.3-billion to $12.5-billion, he became more interested in the shares.

He issued a "buy" recommendation Oct. 13, saying he believed the stock was worth approximately $22 per share, about 10 per cent above the midpoint, and raised his fair value on the shares to $24 on Friday, after Hydro One's third-quarter earnings.

His estimate, however, does not take into account certain regulatory risks that may play out in the coming years.

One is what he calls the "abnormally high" return on equity Hydro One is allowed by regulators. The Ontario Energy Board sets a permitted rate of return on equity (ROE) for Hydro One that the utility can use to set rates. The most recent "cost of capital proceeding" in 2009 used, as part of its calculation, a forecast of long-term interest rates. That base ROE includes a 4.25-per-cent interest rate.

Mr. McCoubrey estimates that if the calculation were done today, that number would be less than 2.75 per cent – and it would cut at least a percentage point off the permitted return. And he estimates that a reduction of one percentage point in allowed ROE would reduce Hydro One's equity value by $2.35 per share. (There are annual adjustments in allowed ROE that take interest rate changes into account, but the full impact of the rate change doesn't flow through to the permitted ROE.)

The second risk ***Mr. McCoubrey*** sees is potential labour cost disallowances by the Ontario Energy board. ***Mr. McCoubrey*** notes the board "disallowed a portion of Hydro One's forecast expenditures in previous rate decisions, due to a conclusion that the requested amounts were too rich compared to the industry average."

While the board disallowing certain amounts of salary might not be significant to a company with Hydro One's earnings, if it targets Hydro One's pension plan as well, the numbers become larger. This is harder to predict, and harder to value, but ***Mr. McCoubrey*** says a 25-per-cent probability of disallowing $70-million in costs would cut another 85 cents off Hydro One's stock.

Hydro One spokesman Daffyd Roderick says it would be inappropriate to comment on potential regulatory decisions, and the company hasn't offered any guidance on these two matters as a result. (Neither was listed as a material risk in the company's IPO prospectus, he notes.)

Indeed, even ***Mr. McCoubrey*** sees these issues as longer-term; in the coming year or so, Hydro One may deliver some earnings-boosting cost savings or some acquisitions that excite the market. And the shares might rise as early as this week: Analysts from Bay Street's biggest banks are prevented by regulators from releasing research immediately after the IPO, but their recommendations, many likely to be "buys," should arrive in the coming days.

All that is good news for the current holders of Hydro One shares. Investors with a long-term view, however, should keep a careful eye toward whether the stock crosses that threshold into "overpriced."