DSR AQN SPECIAL REPORT

AQN EARNINGS SUMMARY

- EPS of $0.11, down 27% vs last year.
- Revenue of $666M, up 26% vs last year.
- No dividend change (the dividend was increased by 6% earlier in 2022).
- Revised 2022 guidance for EPS: from $0.72-$0.77 to a range of $0.66-$0.69.
- Sale of ownerships of renewable assets.

This is your site and your exclusive newsletter. Please, feel free to share any ideas, opinions, comments, or suggestions with us via email at dividendustries@gmail.com.

ON NOV 11TH, AQN FELL 19%

Algonquin Power & Utilities Corp (AQN.TO / AQN) reported their quarterly earnings, and the stock fell by more than 19%.

Many members are concerned by AQN's dividend safety and its growth potential. This report will shed some light on what happened yesterday and answer three questions:

#1 Why AQN fell by 19%?

#2 Is AQN's dividend safe?

#3 What AQN needs to do to bounce back?

Referral

Feel free to share our ideas with your friends or associates who may benefit from this information. **We would personally consider any referrals you make on our behalf to be the ultimate compliment for our efforts.**

DIVIDEND STOCKS ROCK
INVEST WITH CONVICTION, ENJOY YOUR RETIREMENT

First know this: You MUST do your due diligence and not take this report as a financial recommendation. This is not buy or sell advice on AQN. I care about you, and I wanted to share my views on a company I hold.

WHY AQN FELL BY 19%

First, be aware that many quarterly earnings have created a commotion on the market in 2022. We have seen double-digit movements for many companies, notably Amazon and Meta. Volatility results from three factors:

#1 The market is nervous.

#2 Many margin calls are possible in a bear market.

#3 Future value projections are highly sensitive.

The third factor made the difference in AQN's drop. The company reported "okay" numbers, but EPS guidance for 2022 has been reduced by 9% at the midpoint. Following the same price-earnings ratio, the stock must already decrease by about 9%.

The rest of the drop is a combination of:

#1 Uncertainties around the acquisition of Kentucky Power (more debt, more shares)

#2 Uncertainties around future rate increase (will regulators allow AQN to increase rates as it wishes?)

#3 Uncertainties around the impact of higher interest rates.

#4 Incomprehension around the sale of renewable assets.

Let's revisit point #3 and #4.

Interest rates increase – what's the impact?

It's a tough challenge to forecast the impact of higher interest rates. Especially considering we are still determining when the FED and the Bank of Canada will stop increasing them.

However, management offered a summary of the obligations on page 43 and an estimate of the impact to interest expense from changes in interest rates on page 49 of their quarterly report.

I've reported both on the following page.

Contractual Obligations

Information concerning contractual obligations as of September 30, 2022 is shown below:

(all dollar amounts in $ millions)	Total	Due in less than 1 year	Due in 1 to 3 years	Due in 4 to 5 years	Due after 5 years
Principal repayments on debt obligations[1,2]	**$ 7,730.4**	$ 1,240.6	$ 852.6	$ 1,690.9	$ 3,946.3
Advances in aid of construction	**88.6**	1.5	—	—	87.1
Interest on long-term debt obligations[2]	**5,082.9**	244.3	471.5	392.7	3,974.4
Purchase obligations	**605.8**	605.8	—	—	—
Environmental obligations	**52.5**	26.0	5.9	1.8	18.8
Derivative financial instruments:					
Cross currency interest rate swaps	**42.7**	3.5	6.0	7.2	26.0
Interest rate swaps	**5.7**	—	—	1.8	3.9
Energy derivative and commodity contracts	**156.2**	52.8	53.8	29.5	20.1
Purchased power	**330.4**	76.7	75.5	32.5	145.7
Gas delivery, service and supply agreements	**462.1**	92.2	146.9	63.4	159.6
Service agreements	**574.1**	65.0	111.7	95.4	302.0
Capital projects	**27.1**	27.1	—	—	—
Land easements	**529.0**	13.3	26.7	27.4	461.6
Contract adjustment payments on equity units	**132.4**	76.2	56.2	—	—
Other obligations	**302.8**	64.9	5.5	5.2	227.2
Total Obligations	**$ 16,122.7**	**$ 2,589.9**	**$ 1,812.3**	**$ 2,347.8**	**$ 9,372.7**

[1] Exclusive of deferred financing costs, bond premium/discount, and fair value adjustments at the time of issuance or acquisition.

[2] The Company's subordinated unsecured notes have a maturity in 2078, 2079, and 2082 respectively. However, the Company currently anticipates repaying in 2023, 2029, and 2032 upon exercising its redemption right.

Source: AQN Q3 2022 report, page 43

Impact of an increase of 100 basis points of percentage.

$0.8M for Corporate Credit

$6.1M for Regulated Services

$0.7M for Bermuda segment

$4.5M for Regulated commercial papers

$3.8M for Renewable segment

$0.8M for BELCO and ESSAL

Total: $16.7M in interest annually.

AQN generated $324.5M in adjusted earnings for the past nine months. Considering nine months of interest impact ($16.7M / 12 * 9 months), we would have an impact of $12.5M or 3.86% of adjusted earnings.

There was a very interesting discussion in our DSR PRO private forum regarding AQN's earnings. One of our members at DSR PRO also provided a part of the transcript that could help you understand the impact of the purchase of Kentucky Power:

And then second question, in terms of your liquidity position you flagged that you have about $2.1 billion of available liquidity, is most, like -- will most of that be allocated towards the closing of the Kentucky Power Acquisition? I think, that's like about $1.4 billion, is that right?

Darren Myers

Yes. So we would expect with the proceeds of our sell downs to have liquidity probably in the range of $2.5 billion as we exit this year. And yes, we would look to use the credit facilities to fund the transaction as we close it.

Nelson Ng

And then just a follow up on that. In terms of your interest rate exposure, you flagged that 22% is subject to floating, but obviously when you draw on the -- when you draw to close the Kentucky Power Deal, I guess all of that would be subject to floating as well?

Darren Myers

Yes. At the outset, until we do other things through next year, so yes. And that's part of the reason obviously, interest rates have changed dramatically over the last 90 days, which is part of the reason we've given the color on next year with the pressure that the interest rate is causing." (edited)

From my understanding, interest rates will continue to pressure AQN's earnings in 2023. AQN has 78% of its debt under fixed-rate agreements spread over many years. It gives additional flexibility and time to raise rates to absorb future rate increases.

Sale of ownerships of renewable assets?

AQN also announced the sale of part ownership of operating wind facilities in the U.S. and Canada for $354M USD. It's part of the management asset recycling strategy (selling assets to unlock profit and use proceeds to invest in additional growth).

This new asset recycling strategy is explained on pages 9 and 10 of the quarterly report. The company is selling part ownerships to a business operated by Sun Life as follows:

49% ownership interest in three operating wind facilities in the U.S.

80% ownership interest in the 175 MW Blue Hill Wind Facility in Saskatchewan.

The Company will continue to oversee day-to-day operations and provide management services to the facilities. In other words, it will continue generating revenue from those assets. Sun Life likely has no interest in operating those facilities and instead has someone with experience in place.

This strategy will help generate immediate cash flow ($227.5M USD and $107.3M CAD) to ease debt pressure. We see many companies doing asset recycling to generate profit from previous investments.

IS AQN'S DIVIDEND SAFE?

Short answer: yes.

Here's the long answer:

Understanding the dividend payment for utilities

First, you can't really use the classic payout ratio as earnings are calculated using GAAP, including amortization and other non-cash factors. Since the company invests massively in assets yearly, it complicates understanding the payout ratio.

Second, the cash flow payout ratio is even worst since it's calculated based on free cash flow, which deducts CAPEX (huge for utilities), but ignores financing.

In general, utilities will finance their CAPEX based on the principle that borrowing money at 6% and generating an investment return of 10% is an intelligent way to allocate cash.

Now, let's take a look at the numbers.

Dividends in 2022: $0.1706 for the first quarter + 3 quarters at $0.1808/share = $0.713/share

2022 adjusted EPS guidance: $0.66 to $0.69

Expected payout ratio: between 103% and 108%

So far this year (9 months): EPS of $0.43, dividend of $0.53, payout ratio of 113%.

Last year, the first nine months' payout ratio was 100% ($0.50 EPS, $0.50 dividend paid), and yet, AQN increased the dividend by 6% (on top of issuing more shares). Why would they do that?

Let's look at Adjusted funds from operations.

In millions $	2022	2021	Variation
Adjusted FFO	$ 601.60	$ 535.80	112%
Dividend	$ 361.90	$ 307.66	118%
Payout ratio	60%	57%	

Considering the adjusted funds from operations and the higher EPS expected with the acquisition of Kentucky Power, **we believe the dividend is safe. However, we expect a low single-digit dividend increase in 2023.** It's smart management to keep a solid balance sheet first. AQN's Dividend Safety Score is currently 4 at DSR. **It will be reassessed in 2023 following the next dividend increase announcement expected at mid 2023.**

WHAT AQN NEEDS TO DO TO BOUNCE BACK?

If you bought AQN over the past two years, you are probably not a happy camper. Once you know the dividend is safe, you probably want to know when you will see your money back. In other words:

What must AQN do to bounce back and trade at ~$18 again?

First step: successfully integrating Kentucky Power. The company already has the financing to complete the transaction, but we'll have a clear picture once the deal closes. The transaction is expected to close in January 2023. Management is known for its expertise in integrating acquisitions, greening assets (including renewable utilities in new territories), and generating more earnings. Let's trust them to do it one more time.

Second step: proving it can raise rates to compensate for interest rates. Since the business can't control how much interest rates will increase, it's crucial to show it can adapt and generate higher revenue to compensate.

Third step: increasing its dividend. That's the ultimate sign of conviction. So far, management has stuck to pre-written answers such as "we target an 80-90% dividend payout ratio". We need more than that.

Fourth step: Improving AQN's balance sheet. Using its new recycling asset strategy, AQN could generate additional profits, strengthen its balance sheet and keep a part of revenue in managing utility assets instead of bearing the risk alone.

Fifth step: announcing strong guidance. This step will not likely happen in 2023, considering there is already a lot of work in progress (Kentucky, rate increase, dividend increase). However, if we see improvements in step 1 to 4, stronger guidance will come.

I'm a long-term investor and I don't care about short-term fluctuations. I built my investment thesis about Algonquin around the next 10 years, not the past 10 months. However, there is a clear risk attached to AQN. The company may fail to integrate Kentucky and manage its vast debt. The dividend may not be increased next year (but I don't fear a dividend cut).

You MUST do your due diligence and not take this report as a financial recommendation. This is not buy or sell advice on AQN. This is simply my views on a company I hold.