Why I Am Staying Away From TransCanada Corporation

Description

We do not worry about short term hits or misses here at Motley Fool Canada, but there are long-term challenges for **TransCanada Corporation** (NYSE: TRP)(TSX: TRP) that pose a problem, in my opinion, and warrant a deeper look.

Future profitability exposed to "mega-projects"

The company has a $38 billion capital spending program for the following decade. While this sounds good on paper, the problem is that 45% of these investments are linked to two controversial projects. Both the Keystone XL pipeline in the United States and the Energy East Pipeline project in Canada are under scrutiny by their respective governmental agencies and are at risk of additional regulatory delays.

Seeing that the market is forward-looking, any delays to both projects could bring the value of the company lower because the eventual cash flows expected will be discounted in later years. Many of the company's other projects are in the early stages of development, with the majority of the upside potential to be expected later in the decade.

While TransCanada does have many more projects in the pipeline and a well-diversified revenue stream, there is cause for concern, as over 40% of its capex is tied to government regulation.

Steep valuation

When purchasing securities, it's important not to overpay for your investment. Let's look at the valuation of TransCanada at the moment. Currently, the price to EBITDA ratio for the company is 8.38, while the 10-year historical average is closer to 6.20. That is a difference of 35% to the upside. The price-to-book value metric corroborates this thesis of overvaluation with a 10-year average of 1.96 and a current value of 2.30. The dividend has not followed this increase, standing close to its average of 3.9 at 3.5% yield.

When asked about the difference between investment and speculation, the legendary investor and father of value investing, Benjamin Graham, said this: "An investment operation is one in which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative.'"

As a value investor, I do not like those numbers as they seem to indicate a high level of optimism from investors regarding future revenue that isn't justified, in my opinion.

Better alternatives

If you *do* want exposure to the pipeline sector, there are better alternatives in Canada, like **ShawCor Ltd.** (TSX: SCL), which I wrote about earlier this week. If you prefer a pure play on energy transportation, **Enbridge Inc** (TSX: ENB) (NYSE: ENB) might be a better alternative to TransCanada. While Enbridge is not yielding the same amount of dividend — coming in at only 2.6% — its projects are much more certain than TransCanada's are. Better yet, Enbridge has managed to increase its dividend every year for the past 19 years.

Enbridge has $36 billion of commercially secured projects through to 2017 and is currently growing earnings at a 10%-12% compounded annual growth rate. Most of its projects are scheduled to be completed in the short term, putting less discounting on its share valuation.

Investors can continue to expect earnings growth of that magnitude in the future, along with the appropriate dividend increase.

Foolish takeaway

TransCanada is operating in a sector that is in full expansion at the moment, but while one can be optimistic about the prospects of the industry, there are specific risks associated with such capital-intensive sectors. Considering the valuation currently placed on TransCanada and its projects, I would much prefer owning Enbrigde for my dividend energy play. Better yet, why not get some additional growth with ShawCor instead?

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Date
2025/07/20
Date Created
2014/08/14
Author
fdenault