3 Reasons to Place a Contrarian Bet on TransAlta Corporation

Description

From its 1909 origins in western Canada, **TransAlta Corporation** (TSX: TA)(NYSE: TAC) has spent the past 105 years slowly growing to become Canada's largest investor-owned wholesale power generator and marketing company.

The long road hasn't been without its bumps, and the past five years have been especially rough for this centenarian of the electrical power industry. Recently, the market has been treating TransAlta as if its lights are about to go out.

In fact, at $12.50 per share, the stock is now trading near its 15-year low.

Difficult transitions

Coal-fired plants were all the rage back in the days when nobody cared about pollution, but these legacy assets have been the albatross around TransAlta's neck for the past few years.

Expensive upgrades and low prices for the electricity generated by its coal plants finally caught up with TransAlta early in 2014, when the company slashed its beloved dividend from $1.16 to $0.72 per share.

The dividend cut was inevitable, but the high percentage of enrollment in the company's dividend reinvestment plan had many investors believing that the dividend was safe, despite the fact that the company's free cash flow couldn't justify it.

Income investors that had been hanging on for dear life finally decided to pull the plug and sent the stock into a nosedive headed for the bottom of the tailings pond. Within seven days, the stock dropped from $15 to $12.50, where it currently trades.

Why would anyone take a chance on such a messed-up company?

As a long-term investor, it is important to look down the road to see whether the future is going to be different, and I believe TransAlta is near its pivotal point.

Here are three reasons why I think now is a good time to buy TransAlta Corporation.

1. Stronger electricity markets for coal plants

Although TransAlta is slowly upgrading or retiring its coal-fired operations in the U.S. and Canada, coal plants still represent about 55% of TransAlta's electricity production, so it's important for the company to secure solid contracts.

For example, its Centralia plant in the state of Washington is set to retire in 2025. Weak power markets have meant that the company has struggled to sell enough of the plant's electricity generation.

During the Q2 2014 conference call, TransAlta's CEO, Dawn Farrell said the power market in the U.S. has been strengthening and the company only needs one or two more medium-sized deals to carry the Centralia plant through its last 11 years of operation.

If power demand in that region's electricity market continues to strengthen into 2015, the company should see buyers step up to close the required deals.

In Alberta, where TransAlta has significant operations, a number of legislated power purchase arrangements are going to expire over the next few years, and TransAlta believes the result will be significant increases to free cash flow.

2. International growth

While TransAlta continues to work its way through making its North American operations more efficient, it has been using its expertise in electricity generation to secure contracts overseas.

On July 30, 2014, TransAlta announced a $580 million deal to build, own, and operate a new gas-fired power plant in Western Australia. The company sees a lot of potential in the region and the new agreement suggests that TransAlta is well on its way to transition to new and profitable projects as it winds down or upgrades its legacy assets.

3. Dividend stability

The current dividend of $0.72 per share should be safe and is easily covered by the expected 2014 free cash flow of $1.07 to $1.26 per share.

While the cut was ugly, it could have been worse and the company needed to protect an investment-grade balance sheet. The reduced payout still provides a nice 5.7% yield at the current stock price of $12.50 per share.

The bottom line

TransAlta's work certainly isn't finished and it will take time to transition the majority of its revenue from its legacy assets to more modern and cost-efficient ones.

At this point, I think the downside risk is minimal. I'm willing to get paid to wait for the market to realize that this old electricity company has a very bright future and might reward investors for another century.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:TAC (TransAlta Corporation)
2. TSX:TA (TransAlta Corporation)

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