



Is it Time to Sell TransCanada Corporation?

Description

TransCanada Corporation ([TSX: TRP](#))([NYSE: TRP](#)) has been a hot stock lately amongst analysts and investors, due to news that activist investors from the United States may be launching a campaign to split TransCanada by spinning off its power business into a separate corporate entity, and placing its U.S natural gas assets into a Master Limited Partnership (MLP).

On top of this, TransCanada is also in the news due to its upcoming \$38 billion capital program, and it's difficulty attaining regulatory approval for its Energy East and Keystone XL pipelines, while costs for these projects are increasing.

Although TransCanada remains an attractive investment in the very long-term, there are numerous headwinds facing the company over the next several years that should limit growth. Here's why you should consider taking profits.

A split-up would not add value

During the summer, CitiGroup analyst Faisel Khan published a report suggesting TransCanada separate its power business from its pipeline business. Khan suggested that TransCanada's midstream assets were undervalued, and that TransCanada's diverse model was acting as a drag on the stock, and preventing the pipeline business from receiving a premium value.

In addition, the market likes "pure plays", and there is a huge appetite for yield and high payout ratio, neither of which TransCanada can offer in its current form. Activist investors are hoping they can get higher yields and payout ratios out of TransCanada, which would in turn allow the company to attract more investors and compete with other pipelines and MLPs.

In fact, analyst Andrew Kuske from Credit Suisse suggests that if TransCanada were to increase its yield to 4.5%, and raise its payout ratio to 80% of cash flows (which is closer to peer averages), it could possibly translate into a share price as high as \$94.

Most analysts seem to agree that raising TransCanada's yield and payout ratio would result in a higher valuation, but there is one simple obstacle: TransCanada is simply in no position to do so sustainably.

TransCanada currently has \$38 billion in its project pipeline, meaning it is in a limited position to increase dividends. TransCanada is currently paying out about 30% of cash flows from operations, but due to its expansive capital needs, the company had negative free cash flow in 2013, and is barely positive in 2013. Due to this, raising the payout ratio and yield to the level required to bring a premium valuation to TransCanada would need to be done through debt or equity offerings, which risks diluting shareholders.

Split-up or not, TransCanada is in no position to increase its dividend to a level that would attract the investors needed to grow share price substantially.

TransCanada's high growth rate is questionable

TransCanada shares have outperformed **Enbridge** ([TSX: ENB](#))([NYSE: ENB](#)) so far this year partly due to the fact that TransCanada has seemingly strong growth potential, with analysts providing lofty 14.75% annual growth rate.

This growth rate, however, is questionable. Currently, two of TransCanada's major projects are in regulatory limbo. The \$11 billion Energy East pipeline, if approved, is expected to be in service by 2018, which means investors cannot expect to see earnings or associated price increases from this project for many years. This is assuming the project is completed on time, and on budget, which is never certain given the numerous political and regulatory hurdles pipelines need to jump through.

The Keystone XL pipeline is facing similar delays, with regulators pondering the pipeline for over six years. In the meantime, TransCanada estimates the costs of Keystone XL will be 85% to 100% higher than previously expected, rising from the current \$5.5 billion price to nearly \$10 billion. These expenses will ultimately cost shareholders.

With TransCanada projecting growth rates of 5% to 10% for these projects, which is often less than competitors' major projects, even assuming projects proceed perfectly, the earnings growth is unlikely to be as high as projected.

Although TransCanada is a strong company over the very long-term, investors seeking returns over the next several years are best to look elsewhere.

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