Is TransAlta Corporation’s Generous 6.2% Yield Safe?

Description

It’s been a tough five years for **TransAlta Corporation** (TSX: TA)(NYSE: TAC) shareholders, assuming any of them had the patience to hold their shares for the entire time.

Shares have decreased by nearly 50% since the end of 2009. The company has suffered from regulatory issues, unexpected repairs and maintenance, and lower cash flows. Finally, in early 2014, the company was forced to cut its quarterly dividend from 27 cents per share to 18 cents. As you can expect, this announcement sent shares sharply lower.

One look at TransAlta’s power generating assets is enough to make most long-term investors nervous. Approximately 75% of its capacity comes from coal fired plants, which have been slowly falling out of favour for years. Who wants to invest in a company so dependent on a dirty fuel?

That’s an admirable attitude, but unfortunately for environmentalists, coal power isn’t about to go away. Can we say the same about TransAlta’s 6.2% dividend? Or is it destined to be cut again? Let’s take a closer look.

Why Alberta is so important

Although TransAlta has done a good job diversifying its asset base over the years, the majority of its assets are still coal powered plants in Alberta.

During the early 2000s, this was a pretty ideal situation. Alberta’s population exploded, oil sands production ramped up, and because Alberta has deregulated power prices, TransAlta did well. The company enjoyed nice cash flows for years.

The market has a way of reacting to those kinds of situations. Starting in 2010, new supply started coming onto the market, which naturally pushed prices down. Even though Alberta’s economy is still one of Canada’s best, growth just wasn’t enough to support the high prices. As power prices weakened, so did TransAlta’s profits. Unexpected maintenance issues didn’t help either.

However, there looks to be a light at the end of the tunnel. According to the company’s projections, Alberta will need an additional 3,000 mega watts of additional supply to come to market between 2015 and 2020. To put that into perspective, that’s approximately 60% of TransAlta’s current output in the province.

And, now that prices are depressed, so too has investment in new supply. Because of these factors, TransAlta’s management predicts Alberta power prices will head higher over the medium to long-term.

The company has also taken another important step, and that's hiring an outside company to do the majority of its maintenance work. Based on what it has paid in repairs over the past few years, management expects to see an additional $30 million in EBITDA from just that one move by the end of 2016.

How about the dividend?

Although it was a painful move, cutting the dividend was smart. It was hampering the company's ability to invest in new projects and pay down debt.

So far, the new dividend looks sustainable. Over the first three quarters of 2014, the company made $546 million from operating activities. Subtract its $343 million in capital expenditures, and that leaves $203 million left over to pay shareholders. The quarterly dividend has cost approximately $138 million over that time.

At today's levels, the dividend looks to be pretty secure. There's even a nice buffer in case business weakens a touch.

TransAlta also has an interesting wild card – its 70% owned subsidiary **TransAlta Renewables Inc**. (TSX: RNW). Because Renewables has a pristine balance sheet — at least, compared to the parent company — it's expected management will drop down its remaining green energy assets to the new company, using the proceeds to help pay down debt. CFO Donald Tremblay figures these drop downs could help the parent company pay back up to $1 billion in debt by the end of 2017.

At today's levels, TransAlta looks to be a secure dividend stock. If you're looking for income, I'd consider owning it. Or, check out 3 of our top dividend stock picks below.

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1. Dividend Stocks
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1. NYSE:TAC (TransAlta Corporation)
2. TSX:RNW (TransAlta Renewables)
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Date
2025/08/27
Date Created
2014/11/27
Author

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