TransAlta Corporation: 3 Reasons to Add This 6.6% Yield to Your Portfolio

Description

Sometimes, it's tough to be a value investor.

Although there are different versions of hunting for value, it typically follows a pretty normal path. An investor identifies a stock that the market hates but has intrinsic value. The stock is purchased not during the time of maximum pessimism, but even after that, months after investors have given it up for dead.

That's sort of the vibe I'm getting from **TransAlta Corporation** (TSX:TA)(NYSE:TAC), one of Canada's largest power generators. As you probably remember, the company cut its dividend early in 2014, citing unexpected costs for its aging coal-fired power plants, as well as weaknesses in electricity prices for Alberta, its main market.

Although the stock has languished since, I think the company is making a lot of smart moves to secure its future. The dividend is now comfortably sustainable, and there are signs of Alberta's power market improving. Here's more on why you should be bullish.

Alberta's improvements

2013 was not a good year for TransAlta's operations in Alberta. Thanks to some unplanned issues, its fleet of coal-fired power plants ran at just 78% efficiency. Compare that to 2014, when the same plants ran at close to a 90% efficiency rate. That's a pretty big drop.

The last couple years haven't been good for power prices in Alberta because of new capacity coming online, but things look to improve after this year. The company estimates that an additional 3,500 megawatts in supply will be needed between 2015 and 2020, thanks to overall economic growth and the shutdown of some older coal plants. This should lead to pricing improvements going forward, which would be a welcome relief.

Plus, the company has entered into an agreement to outsource 90% of its maintenance work. Management estimates that will lead to an annual cost savings of approximately $30 million.

Balance sheet improvements

Like any power company, TransAlta has a pretty levered balance sheet. Improving it is high on management's agenda over the next few years.

Fortunately, there's a pretty easy way to do it, and that's through the company's subsidiary, **TransAlta Renewables Inc.** (TSX:RNW). The company has several assets that it's looking to drop down to its subsidiary, including 13 hydro plants in Alberta, its Australian natural gas plants, and even some of its Canadian gas-fired plants. It estimates that $700 million to $1 billion worth of assets will be dropped down, which then improves the balance sheet.

And since the parent company still owns the vast majority of the subsidiary, dividends end up flowing from TransAlta Renewables to the parent to shareholders. TransAlta can use the cash generated from the sale to pay down debt, and shareholders still share in the cash flow from the assets.

That dividend

One of the disadvantages of TransAlta cutting its dividend is now everyone doubts it can make its quarterly payment.

Through the first three quarters of 2014, the company easily generated enough cash to pay shareholders. After spending on capital improvements, TransAlta generated $203 million in free cash flow, yet paid out only $148 million in dividends. That's a payout ratio of less than 75%, which is exactly what we want to see.

As the company's future improves, so will the payout ratio. Alberta's power rates should go up, and interest paid will decrease as assets are dropped down to Renewables. This should further free up more cash for dividends, which means investors may be looking at dividend increases in 2016 or 2017 as operations continue to improve. It's not often we talk about a 6.6% yield with potential to actually go up, but I think TransAlta has that possibility.

If you like TransAlta's potential for consistent dividends, we think you're going to really love our top dividend paying stocks for 2015. Check it out below!

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

TICKERS GLOBAL

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

Category

1. Dividend Stocks

2. Energy Stocks
3. Investing

Date
2025/08/26
Date Created
2015/01/09
Author
nelsonpsmith