



2 Big Reasons TransCanada Corporation Has Limited Upside in 2015

Description

TransCanada Corporation ([TSX:TRP](#))([NYSE:TRP](#)) performed solidly in 2014, returning a total of 21.59% to shareholders. However, with a projected 2014 EPS of \$2.35 (down from \$2.42 in 2013), TransCanada has not produced the earnings to justify its price growth, making shares seem expensive.

Despite recently announcing the doubling of its dividend growth rate (from 4% to 8-10% until 2017), likely due to pressure from activist investor Sandell Asset Management, there is still good reason to be skeptical of TransCanada's ability to repeat last year's performance.

Here are two big reasons shareholders may be in for a flat year.

1. TransCanada shares seem overvalued

If you take a look at analyst reporting for TransCanada, you will be quick to note that the majority of recommendations are rated as "Hold" or "Underperform" (eight analysts in total, compared to five recommending "Outperform" or "Buy"). This compares sharply to TransCanada's major Canadian pipeline competitor **Enbridge Inc.** ([TSX:ENB](#))([NYSE:ENB](#)), which has a total of 11 Buy or Outperform ratings and two Holds.

The reason? TransCanada seems extremely overvalued, especially when one considers the companies questionable growth rate, and enormous capital requirements going forward (\$46 billion to be exact).

Currently, TransCanada trades at a forward price-to-earnings ratio of approximately 21, which is well above the five-year historical average of 18.4, and close to the all-time high of 23 set in 2014 when TransCanada stock jumped on news of activist investors splitting the company.

The justification for this high forward P/E ratio? Analysts are anticipating a fairly aggressive growth rate of approximately 10% of the next five years, as a number of smaller expansion projects including the Canadian mainline expansions, and larger projects such as Keystone XL and Energy East start producing income.

Unfortunately, this high growth rate is questionable, with the two major projects expected to drive this growth stuck in regulatory limbo. The \$12 billion Energy East pipeline, which is facing strong opposition and has yet to be approved, will not be in service till 2018 at minimum. This assumes the project is completed on time and on budget, which is not a certainty given the complex political issues that need to be resolved.

Keystone XL is facing similar conditions. Although an approval for the pipeline from a Republican-controlled Senate is likely, there is a strong possibility the pipeline will be rejected by presidential veto, which could delay the pipeline indefinitely. In the meantime, the projected cost has nearly doubled from \$5.5 billion to nearly \$10 billion.

Even if these projects are completed on time and on budget, resulting in TransCanada's aggressive growth rate being accurate, the stock still seems expensive. TransCanada's current price/earnings-to-growth (PEG) ratio is 2.21, and studies have indicated stocks with PEG ratios of over 2 typically under perform.

2. Few catalysts for price appreciation

Not only is TransCanada's expensive valuation is likely to hold its share price back, but there is also little in the way of catalysts to propel the price higher. Activist investor Sandell Asset Management suggested several actions to help unlock value including spinning off TransCanada's power generation business, and dropping down TransCanada's U.S. pipelines to its master limited partnership, **TC Pipelines, LP** (NYSE: TCP).

These actions would afford a higher multiple for the separate entities, and enable TransCanada to boost its payout ratio and dividend yield to be in line with industry peers, which would in turn satisfy yield-hungry investors and boost share price.

It appears TransCanada has taken some of this advice, announcing a doubling of its dividend growth rate. The problem? TransCanada shares did not increase in response to the announcement, a tell-tale sign shares are fully valued. Although TransCanada spinning off its power business or accelerating the pace of asset drop-downs to its MLP would likely serve as catalysts for price growth, TransCanada appears unwilling to take these measures.

Investors should also be skeptical of such actions to increase payout ratio, due to the company's huge capital needs, and already high debt levels. TransCanada has solid long-term prospects, but investors should wait for prices to drop significantly before initiating a position.

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