TransCanada Corporation: Solid Growth, but What About the Risks?

Description

TransCanada Corporation (TSX:TRP)(NYSE:TRP) owns critical energy infrastructure assets in Canada, the U.S., and Mexico including 68,500 km of natural gas transmission networks, 3,500km of liquid pipelines, and 19 power plants with 10,800 MW of power generating capacity.

The company reported good results and increased the dividend by 8% but investors should be aware of the risks that they will face over the next few years as the company executes on huge expansion plans, manages a substantial debt load, and attempts to deliver a growing dividend stream.

A strong final quarter and solid full-year results

TransCanada announced adjusted earnings per share of $0.72 for the fourth quarter, which was 24% better than the comparable quarter last year and better than expected. For the full financial year, the profit per share was 8% higher than the previous year. The dividend per share was also increased by 8% in line with a previous undertaking by management to increase the dividend annually by at least 8% until 2017.

Revenues increased by 12% in the quarter and by 16% for the year as $3.8 billion of new assets were placed into operation during the year. Operating and other expenses increased by 16% resulting in income before interest and tax rising by 14% for the year. The interest expense for the year jumped by 22% as a result of higher debt levels, the higher interest cost on U.S. dollar debt translated into Canadian dollars and lower capitalised interest cost with the completion of the Gulf Coast extension of the Keystone Pipeline System.

Natural Gas Pipelines, the largest of the three main divisions, increased its earnings by 25% compared the same quarter last year and 16% for the full year. The profit of this division was boosted by the U.S. pipeline component, which recorded not only higher U.S. dollar profits but also a considerable translation gain of 11% for the year as a result of the weaker Canadian dollar.

Liquids Pipelines turned in a very strong performance with earnings improving by 44% in the quarter and 40% so far this year. The Gulf Coast extension of the Keystone Pipeline System, Mexican pipelines and the weaker Canadian dollar boosted the profits for this division.

Despite the positive impact of the weaker Canadian dollar, the Energy division reported slightly lower earnings for the year as the Western Power division experienced a sharp decline in realised power prices in Alberta.

Healthy cash flows but increasing debt levels

The cash flow of the business remains strong with a high 40% of revenues converting to operatingcash flow. However, as a result of ongoing large capital expenditures, the free cash flow (operatingcash flow minus capital expenditures) was a negative $278 million for the year.

The balance sheet is somewhat stretched with net debt of $26.5 billion representing 56% of total capital. Given the considerable additional capital expenditure plans for the next few years, the already stretched balance sheet will become an additional risk to the business and its ability to pay and increase the dividends, especially in a rising interest rate environment.

TransCanada management expects to finance the planned $46 billion roster of projects and the cost of the dividend through cash flow generated by the existing operating businesses, commercial debt, project finance, equity finance and sales of assets to its master limited partnership ("MLP"), **TC Pipelines LP** (NYSE:TCP.N.) The cost of the dividend in 2014 was already $1.4 billion and should grow to more than $2.0 billion per year based on the dividend growth guidance.

The dividend is safe – for now

TransCanada declared a dividend of $0.52 per share for the first quarter of 2015 which is 8% higher than the previous year. The company has grown the dividend on average by 7% per year over the past 14 years and built up a solid dividend payment track record since it cut the dividend in 2000.

TransCanada has an enviable North American energy infrastructure and reasonable growth opportunities for the next decade. However, it will have its work cut out to finance the intended expansion plans, manage the operational and project risks, and at the same time generate a positive cash flow to support growth in the dividend payments over the next few years.

The attractive 3.6% dividend yield is not without risk.

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