TransAlta Corporation: Get Greedy With This 6.5% Yielder

Description

It's a rookie mistake every investor has made. I know I did.

The year was 2005, and I was still a rookie at this investing stuff. Naturally attracted to value stocks, I took a position in **General Motors**, convinced the company would recover. It was struggling against competitors who were selling smaller, more fuel efficient cars. It also had a staggering amount of debt and huge legacy costs.

I knew about those risks, but was enticed by the nearly 10% dividend yield the company offered at the time. I thought it was only a matter of time until the company returned to its former glory, and in the meantime I'd collect a very attractive dividend to wait.

A year later my hopes were dashed, as GM cut its dividend in half, to $1 per share. In early 2008 it eliminated the dividend entirely, sending shares reeling one more time. I lucked out, getting out of my position at a profit a few months later. Considering the overall market's performance during those years, it wasn't a great investment.

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My sin was chasing yield, mostly. The market was sending me a message with GM's 10% dividend, and I chose to ignore it. My story has a happy ending, but that doesn't make my mistake any better. I lucked out to not get punished chasing yield.

There are a number of stocks that are trading at elevated yields. For the most part, investors should tread very carefully with those companies. But after analyzing one, I think it looks to be a pretty good bet for greedy dividend investors. That company is **TransAlta Corporation** (TSX:TA)(NYSE:TAC), Alberta's largest producer of electricity. The company also has operations in the Western U.S., as well as an Australian subsidiary.

The skinny

Shares of TransAlta currently yield 6.5%, twice as much as its main competitor. Why exactly is the yield so high?

Mostly, it has to do with 2014, when TransAlta cut its dividend from $0.27 per share per quarter to $0.18 per share. Spurned dividend investors sold the stock off en masse, eventually driving it down to lows not seen since 2000.

Investors had one big concern. The majority of TransAlta's power generation fleet is made up of aging coal-fired power plants, which in 2015 are about as popular as Crocs and Heelys. As environmental regulations get tougher, those plants are going to be less attractive to own.

While that's a valid concern, the reality is 2013 was just a flukey bad year. The company had to do some expensive unplanned maintenance, and power rates in Alberta were disappointing. Both of these issues have been addressed, with management signing an agreement with an outside company to control maintenance costs, and the Alberta power market is expected to recover in 2015-16 as other facilities are retired.

From an earnings perspective, it doesn't look good either. TransAlta lost $0.27 per share over the last 12 months. If it's losing money, how can it afford to pay its dividend?

That's because the company is taking big chunks of depreciation from its plants. This gets recorded as an expense on the income statement, but isn't actually cash leaving the coffers. So even though the company "lost" $0.27 per share over the last year, its cash flow from operations was $1.99 per share in just the first nine months of 2014 (full-year results haven't been released yet). It spent $1.25 per share on capital improvements, meaning it had $0.74 per share available to pay to shareholders. This easily covers the $0.18 quarterly dividend.

Management also has a plan to decrease debt, which should add to the company's cash flow. By dropping down assets to its subsidiary **TransAlta Renewables Inc.** (TSX:RNW), the parent company can sell assets it has owned for years that still have value, but have been depreciated down on the balance sheet. The sale price can be immediately applied to debt, which leaves more cash flow available to pay the dividend.

Even though TransAlta's dividend looks alarming, I think the market just hasn't forgiven the company for cutting it last year. If you're looking for a dependable yield above 6%, it looks like a good bet.

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1. NYSE:GM (General Motors Company)
2. NYSE:TAC (TransAlta Corporation)
3. TSX:RNW (TransAlta Renewables)
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Date
2025/08/26
Date Created
2015/02/19
Author
nelsonpsmith

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