3 Big Reasons to Add TransAlta Corporation to Your Portfolio Today

Description

The past few years have not been good for **TransAlta Corporation** (TSX:TA)(NYSE:TAC) shareholders.

It started with weak power prices in its main area, Alberta. Unlike many other jurisdictions, Alberta does not regulate the price of electricity. New supply came on the market, which drove prices down.

Then the Canadian dollar strengthened against the greenback, which temporarily suppressed earnings from its U.S. operations located in the Pacific Northwest. This problem has since reversed itself, but it really hampered earnings through 2012-13.

And finally, the company had to deal with some costly and unexpected repairs to some of its aging coal-fired plants. These repairs did some major damage to the bottom line.

Because of all of these factors, TransAlta's management did the unthinkable and cut its quarterly dividend early in 2014. The payout fell from $0.29 per share to $0.16, eventually settling at $0.18. As a response, shares fell to lows not seen since Al Gore was a presidential candidate.

Even though all of this seems like a ringing endorsement to stay away from the stock, I think it represents a pretty compelling value at these levels. Here are three reasons why I'm looking hard at it for my portfolio.

Great value

Without a doubt, TransAlta is the cheapest power generator in Canada. The others don't even come close.

Shares currently trade hands at $10.88 per share, within $1 of the all-time low set late last year. The company's book value is $12.16, which is a pretty nice discount. In fact, it's extremely rare for power generators to ever get much below book value.

That's because the value of TransAlta's plants are understated on the balance sheet. Since it depreciates about 4% of the value of each plant per year, there's about $5.3 billion in accumulated depreciation on the balance sheet. At a minimum, I'd estimate the company's power plants are worth $2-4 per share more than the value on the balance sheet. Thus, the true book value of shares are closer to $15-17 per share.

The reason why the stock trades at such a discount is twofold. First, investors don't want anything to do with coal during what can be described as a clean energy revolution. And second, newly-elected Alberta Premier Rachel Notley is a known opponent to coal power. Now that she's in charge, the market speculates that TransAlta may be forced to shut down some of its larger coal plants in the province.

But TransAlta already has a schedule for converting its coal-fired plants to natural gas, which is mostly slated to happen in the mid-to-late 2020s. These are some of Alberta's largest plants, so I doubt the new Premier will want Alberta to go without that energy.

A sustainable yield

Because of the sell-off in shares, the stock currently yields 6.7%. Based on 2014 earnings, it's a pretty sustainable yield.

The company produced $225 million in free cash flow for the whole year, and only paid out $181 million in dividends. That's good enough for a payout ratio of 80%, which, arguably, is a little high, but should be sustainable, especially given some of the operational improvements the company has made.

Nice changes

In response to some of the issues that plagued the company over the last few years, management has made some changes.

The company now outsources the majority of its repair work to an outside company. This is a good move because it keeps these costs constant, even if some years it would be cheaper to keep it all in house. In business, cost certainty is very important.

The company is also dropping down its Australian pipeline assets to **TransAlta Renewables Inc.**, a publicly traded subsidiary. And since it owns approximately 76% of Renewables, most of the dividends the subsidiary pays will flow right back to the parent. Essentially, all the transaction did was transfer much of the debt accumulated to build these pipelines in the first place to Renewables, but it does help TransAlta's balance sheet.

TransAlta is a solid value in a market where many other consumer staple stocks are overvalued. Management is making smart moves, and investors are getting paid a nice dividend to wait. For those reasons, I like the stock.

CATEGORY

1. Dividend Stocks
2. Energy Stocks

TICKERS GLOBAL

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