Why Now Is the Best Opportunity to Buy TransCanada Corporation

Description

TransCanada Corporation (TSX:TRP)(NYSE:TRP) has had no shortage of problems recently. The company is subject to frequent high-profile political delays, the most recent being the continued lack of a presidential permit for the Keystone XL, and the announcement that its Energy East pipeline in-service date will likely be pushed back to 2020 from 2018 due to a proposed oil-export terminal in Cacouna, Quebec being scrapped.

Prior to this, TransCanada was subject to a split-up attempt by an activist investor who argued that TransCanada was significantly undervalued relative to nearly all its peers, and that by spinning off its energy segment and dropping down all of its U.S. assets to its TCP Pipelines MLP, TransCanada could better fund its growth program, be valued higher due to it being a “pure-play” pipeline, and hike its payout ratio.

TransCanada fended off the split-up attempt, but much of the initial criticisms are accurate—TransCanada does trade at nearly the lowest multiple of earnings in its peer group and has one of the lowest payout ratios. Fortunately, there is good reason to believe this is poised to change, and the recent 16% drop in TransCanada’s share price provides a huge opportunity to benefit from discounted shares, and huge upside potential if TransCanada can close its valuation gap. Here’s why.

TransCanada has huge earnings growth potential

Currently, TransCanada has a $46 billion capital growth program, and this is the source of its growth potential. The opportunity lies in the fact that TransCanada’s growth program is basically divided into two components. The first is TransCanada’s secured, small- to medium-sized project portfolio.

These comprise approximately $12 billion of secured projects that are due to be in service before 2017. These projects, in turn, are expected to produce a decent 8% compound annual growth rate (CAGR) between now and 2017.

The second component is TransCanada’s larger projects, which represent the remaining $34 billion of the capital program. These projects include the Keystone XL pipeline, the Energy East pipeline, and TransCanada’s Liquid Natural Gas (LNG) pipelines, and are subject to varying degrees of regulatory and political approval. If they are approved, however, TransCanada estimates they will experience an impressive 16% CAGR between 2017 and 2020. Not to mention there is significant growth beyond 2020 as TransCanada positions itself as a key supplier of LNG to British Columbia's growing LNG industry, which will in turn supply an estimated doubling of LNG demand by 2030.

Currently, TransCanada is not pricing in the approval of the majority of these projects, even though many are likely to be approved, which means there is large upside potential.

Why TransCanada is undervalued

TransCanada shares have fallen 16% since late April, and current levels are the lowest seen yet in 2015. This is despite the fact that nothing in the company has fundamentally changed to warrant the price decline, and it is largely due to a broader sell off in the energy space.

As a result, TransCanada is currently trading at a price-to-earnings (P/E) ratio of 21. This is well below the peer average.

However, looking forward to 2016's earnings, TransCanada is trading an extremely low forward P/E of 18.5. This is compared with the group average of 24. This is despite the fact that TransCanada has a potential 16% CAGR between 2017 and 2020, should its projects get approved. This is better visibility, and higher growth than most its peers. The conclusion is that TransCanada is currently not pricing in the approval of its projects, and it is likely that at least some, if not all, of the projects will be approved.

In addition, once TransCanada gains the approval of its projects, it is likely that the company will increase its payout ratio, which should further boost its valuation.

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