



Why TransCanada Corp. Is North America's Cheapest Pipeline

Description

One of the main techniques that value investors use to determine if a stock is undervalued is to compare the stock to its peer group. Since many studies have shown that stocks with lower price-to-earnings (P/E) ratio's outperform stocks with low P/E ratios by roughly 12% on average, it stands to reason that simply buying the cheapest stock in an industry can lead to big returns.

This, however, is not entirely true. Sometimes a stock is undervalued compared to its peers for a reason, or a series of reasons, and unless a company can correct these reasons, it may never trade in line with its peer group. **TransCanada Corp.** ([TSX:TRP](#))([NYSE:TRP](#)) is the perfect example of a stock like this.

Currently, TransCanada is the most undervalued pipeline in North America on a price-to-earnings basis. TransCanada's Canadian peer group trades at an average forward P/E of 33.3, whereas TransCanada's 2015 forward P/E is currently around 23. TransCanada's closest competitor, **Enbridge Inc.**, is trading at a forward P/E in the high 20s, and many large American midstream companies are trading at multiples well above 30.

Unfortunately, TransCanada trades at a discount because it has several flaws compared to its peer group. Correcting these could result in large upside.

TransCanada has an uncertain capital program

While TransCanada has an enormous, \$46 billion capital program that has the potential to produce an earnings and dividend compound annual growth rate of over 15% if fully executed, the program is subject to plenty of political risk.

Only about 25% of this capital program (the small and medium-sized projects due to be in-service between now and 2017) are actually secured, while the remainder is stuck in various stages of regulatory approval. The \$8 billion Keystone XL is awaiting a presidential permit, with many thinking this may not occur until the next U.S. administration is in power.

The \$12 billion Energy East project is attempting to locate another export port in Eastern Canada after

its proposed marine tanker terminal at Cacouna, Quebec, was cancelled due to potentially interfering with a Beluga whale habitat.

The end result is that TransCanada has uncertain future growth, and pessimism over approval of projects is weighing down the companies multiple.

TransCanada also has a low payout ratio

For midstream companies, payout ratio is one of the key things that produces a premium valuation. In fact, there is a strong relationship between P/E ratio, and payout ratio, with the companies that pay out of more of their earnings in dividends receiving higher P/E ratios.

This is because midstream investors often place a high value on companies that not only focus on paying out most of earnings as dividends (which can lead to high yields), but also companies that can provide reliable cash flows, that are steadily growing.

This is the case for many American pipeline Master Limited Partnerships (MLPs), which trade at high multiples since they consist of high cash flow assets that produce reliable, growing, high-payout dividends. The average payout for the pipeline group is around 121%, whereas TransCanada is currently paying out only 79%.

The reason for this is largely because TransCanada has such a huge growth program, and the company needs to retain cash to ensure it can fund the program. TransCanada has approximately \$34 billion in projects to fund in the 2017-2020 time frame, and the company is reluctant to reduce its available cash flow in case the cost of capital were to change between now and then. Should interest rates rise for example, the company could see the cost of both its debt, and equity increase, which could reduce profits from the major capital projects.

As a result, TransCanada will likely keep its payout ratio steady until its projects are confirmed, at which point it may increase its payout ratio if capital market conditions are the same as now.

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