TransAlta Corporation: This Cheap Stock Deserves Your Attention

Description

Sometimes, companies with minor problems can become ridiculously cheap because of market sentiment. I believe such a situation is happening with **TransAlta Corporation** (TSX:TA)(NYSE:TAC), one of Canada's largest suppliers of power.

There are, admittedly, a few issues plaguing this company. Back in 2012 and 2013 the company was hampered by low power prices in Alberta, its main area. It also suffered from the advance in the Canadian dollar, which suppressed results from its U.S. operations once converted back to loonies. And finally, the company was hit by a number of unscheduled and costly repairs to some of its older plants.

These factors all culminated in early 2014 when management finally slashed the quarterly dividend from $0.29 per share to today's level of $0.18. That move sent shares reeling, falling from $15 to $12 each in just a few weeks.

Since then, although management has improved several of the issues that led to the troubles in the first place, shares have sold off considerably more to today's level of $9.70 each. The latest weakness is mostly due to the new NDP government in Alberta, which is somewhat opposed to coal-fired power.

That's a lot of bad news packed into one stock, but for value investors, there could be opportunity. Here's why I'm looking very hard at the stock for my portfolio, and why I think others should do the same.

It's very cheap

The question that should be on every investor's mind is just how much TransAlta's power plants are worth.

They're older plants, which means the company has depreciated them on the balance sheet. The current book value of the whole company is approximately $12 per share, but that's likely understated. In reality, because the plants have been depreciated so much, book value is likely closer to $15-17 per share. That represents upside of more than 50% compared with today's levels.

Improving balance sheet

The company is also taking steps to get debt off its balance sheet. It recently announced a transaction with its subsidiary **TransAlta Renewables Inc.** to get rid of Australian assets for $1.78 billion. Approximately $300 million from the transaction will go towards paying off debt.

As part of the transaction, TransAlta has increased its ownership stake of the subsidiary to 76%, meaning it'll still get the majority of dividends from the assets. That's good news for investors who count on the parent company's generous dividend for income.

Coal fears overblown

Newly elected Alberta Premier Rachel Notley is known to be somewhat anti-coal. This is one of the big factors that have caused shares to plunge lately.

Upon further inspection, I don't think this is such a big issue. TransAlta has already come up with a schedule to convert all of its remaining coal plants in the province to natural gas, starting in the early 2020s. And if some of the scheduled oil sands expansions start going ahead over the next few years, Alberta is going to need all the power capacity it can get.

Potential higher prices

Most of the company's production in Alberta is tied up in various power purchase agreements, which start coming off the books in 2018. If weakness in the energy sector is behind us by that point, the company should be able to get higher prices.

Don't underestimate just how important these higher prices are. If all other costs stay roughly the same, then getting 10-20% more in revenue flows straight to the bottom line.

Paid to wait

Thanks to the weakness in shares, TransAlta's current yield is 7.4%. That's a huge number, and many investors are saying it's unsustainable.

Upon further inspection the yield looks pretty good, at least for now. In 2014 the company earned $275 million in free cash flow, while only paying out $181 million in dividends. That's a payout ratio of just 66%.

In 2015 management is forecasting EBITDA of approximately $1 billion, which is about the same as 2014's number. This would lead to similar free cash flow and dividend sustainability.

The dividend looks to be pretty safe until 2018, when the power purchase agreements expire. If power prices go up, investors will be in pretty good shape, with a share price that's likely much higher and a few years of collecting a 7.4% dividend. In today's market, that's not a bad opportunity.

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