Should Investors Try to Catch the Falling Knife That Is TransAlta Corporation?

Description

As a value investor, I get a little excited every time a stock I'm interested in drops. The only thing I like better than cheap assets is cheaper assets.

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Of course, one huge risk in my version of investing is getting caught in the proverbial value trap. Sometimes, as we all know, cheap assets are destined to remain cheap. Perhaps they're obsolete and have been passed forever by new technology. Or maybe the company is in the middle of a market glut, like what we see happening in the commodity space right now.

Specifically, that seems to be what's happening with **TransAlta Corporation** (TSX:TA)(NYSE:TAC) right now. The market is not a fan of the company's coal-fired power plants, especially in this world of low natural gas prices. TransAlta is also sitting on quite a bit of debt and has had other issues over the years, which culminated with a dividend cut in 2014.

But there's also a lot of value there. Can TransAlta pull out of this tailspin, or is coal power doomed forever? Let's take a closer look.

Cheap assets

Although TransAlta has made a big effort to diversify away from the coal-power business over the last decade or so, the market still views it as a coal-centric power producer. Packaging up and spinning out many of its renewable assets into **TransAlta Renewables Inc.** (TSX:RNW) didn't help that perception either. That transaction, plus the market sentiment towards coal, practically gave the market an excuse to beat down TransAlta's shares.

The big question with TransAlta is, what are the coal-fired power plants worth? Remember, all these plants are currently producing electricity, and most are scheduled to be converted to natural gas power at some point over the next two decades. Yes, converting is an expensive process, but these plants still have life left in them.

Currently, the book value of the entire company is approximately $11.30 per share, which is a big premium compared with the current share price of $7.50. But it's easy to make an argument that the book value is understated, since these power plants have been depreciated so much over the years. I'd estimate the book value to be closer to $15 per share once you factor that in.

One issue remains: are these plants worth anywhere near $15 per share? That's certainly debatable, but it's not the end of the world if they're not, since TransAlta's ownership stake in Renewables is worth quite a bit. It owns 76% of its subsidiary, an ownership stake with a market value of $1.76 billion. To put that into perspective, TransAlta's market cap alone is just $2.11 billion. Essentially, the market is valuing TransAlta's coal assets at just $350 million.

A sustainable dividend

Even though TransAlta recorded disappointing second-quarter results, it has still generated $133 million in free cash flow in the first half of 2015 (excluding adjustments in working capital, and after paying out dividends for preferred shareholders). It paid out just $83 million in common share dividends during that same time. For a company with a yield of more than 9.5%, that's a very sustainable payout ratio.

Operational improvements

Finally, TransAlta's management is making some smart moves in order to improve the business going forward.

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A big cause of 2014's dividend cut was some unplanned expenses in many of TransAlta's U.S. coal power plants. The company has since signed a contract with a third-party maintenance company to ensure such surprise costs don't pop up again.

In 2018 many of its power purchase agreements in Alberta expire. One of the reasons for TransAlta's underperformance is the disappointing prices it has gotten from Alberta in recent years. If it could sign some better contracts, that would flow directly to the bottom line.

The other thing helping TransAlta now is its exposure to the U.S. earnings from south of the border look even better when converted back to Canadian dollars.

Although investors are rightfully nervous about TransAlta—especially in a world where the pro-environment NDP party is in charge of Alberta—there's a lot to like about the company too. The valuation is cheap, debt is going down, and it pays a sustainable dividend. I think value investors should be looking closely at TransAlta today.

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nelsonpsmith

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