TransAlta Corporation: Why Investors Should Avoid This Falling Knife

Description

In recent months I have taken a particularly harsh view of the outlook for electric utility **TransAlta Corporation** (TSX:TA)(NYSE:TAC). This is predominantly because of its reliance on coal-fired power generation in an operating environment where coal-fired power generation has fallen into disfavour and is being gradually regulated out of existence.

The costs involved in transitioning its power-generating assets to cleaner sources of energy are considerable and will have a significant impact on its bottom line for some time.

Despite this, there are claims that TransAlta is attractively priced, particularly when its massive 12% dividend yield is accounted for.

Let's take a closer look to determine whether it is really a worthwhile investment.

Now what?

Electric utilities have traditionally been perceived as a defensive hedge against economic uncertainty and market volatility because of the non-cyclical nature of their business and steadily growing earnings. Despite this, TransAlta's earnings have been quite volatile, gyrating wildly in recent years as it has battled a range of headwinds.

Among the most serious of these headwinds is the plan in Alberta to phase out coal-fired power generation as the government puts in place a range of ambitious targets to reduce greenhouse emissions.

This is a significant headwind for TransAlta because it generates almost 40% of its EBITDA from five coal-fired plants located in the province. It also mean that it potentially will be unable to receive the full benefit of its investment in the Keephills-3 coal-fired plant that cost it and partner **Capital Power Corporation** $3 billion to construct.

The sharp collapse in oil prices is also having an impact on TransAlta's earnings. The decline in activity in the energy patch has triggered a significant decline in the demand for electricity.

On top of these headwinds is the finding by Alberta's electricity regulator that TransAlta manipulated the province's electricity market, which generated a $16 million windfall for the company. As a result, this the regulator is considering what penalties to impose; it is estimated that the clawing back of any profits made from this manipulation could total up to $30 million.

These headwinds certainly don't bode well for TransAlta's outlook and make it an unattractive investment.

Then you have to consider that it has been bleeding red ink for some time. It reported large net losses for two out of the last five years.

All of these factors certainly don't bode well for the sustainability of TransAlta's dividend. With a yield of over 12%, it is the largest yield in the S&P TSX 60 Index.

You see, not only does its dividend payout ratio exceed 100%, indicating that its dividend is higher than net earnings, but it has used asset sales and other fundraising activities to generate additional cash flow in order to meet its costs, including the dividend. While this has allowed the dividend to remain sustainable over the short term, it is not a strategy that TransAlta can employ indefinitely.

When you consider these factors along with the headwinds the company is currently facing, it isn't hard to envisage a dividend cut some time in the foreseeable future.

So what?

While TransAlta may be trading at its lowest level in decades, it still appears quite unattractive as an investment. The headwinds TransAlta is facing will continue to stymie its performance and earnings, while causing it to incur considerable costs as it transitions away from coal-fired power generation.

For all of these reasons, TransAlta is a falling knife that investors should avoid.

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