3 Reasons Why TransAlta Corporation Could Be a Huge Winner

Description

At first glance, it would appear that **TransAlta Corporation** (TSX:TA)(NYSE:TAC) is the perfect stock for destroying wealth, not compounding it.

Over the last five years, shares of the beleaguered power producer have fallen more than 70% as the company has dealt with a number of different problems. Back in 2010-12, the strong Canadian dollar depressed earnings from its U.S.-based power plants. Costly unexpected maintenance hit the bottom line. And increased environmental regulations didn't help either.

Even after the company cut its dividend in early 2014, shares continued to drop, this time because investors rapidly fell out of love with coal as a fuel source. Coal-fired power plants are a big part of the company's earnings.

And finally, earlier this year, Alberta shocked the world by electing an NDP provincial government for the first time in the province's history. New premier Rachel Notley has been an outspoken critic of coal in the past, and is widely rumoured to be considering a plan that will force Alberta to transition away from coal faster than everyone expected.

This is obviously bad news for the province's largest supplier of power, most of which comes from coal-fired plants. But is there actually good news in the cards? I believe so. Here's why.

Coal for nothing

I like to use enterprise-value-to-EBITDA ratio (earnings before interest, taxes, depreciation, and amortization) to value power companies.

On that metric, TransAlta is far cheaper than its competitors. The company currently has an enterprise-value-to-EBITDA ratio of just 6.5. Its competitors all trade between 10 and 11 times EBITDA using the same ratio.

Or we can look at it another way. If you take away the cash TransAlta earns from coal-fired power–which is about 40% of EBITDA–it trades at 10.9 times EBITDA. Essentially, it means that the market is valuing TransAlta's other assets at the same value as peers, and the coal assets are worth nothing.

I'm not sure what the coal assets are worth, but I do know they're worth more than nothing.

More hidden assets

There's another way to value TransAlta, and that's to look at the company's stake in **TransAlta Renewables Inc**. (TSX:RNW), a drop-down company that is more than 76% owned by the parent.

There are two ways for investors to value the stake in Renewables. Firstly, we can look at market value, which is currently at $2 billion. Or we can use the subsidiary's book value, which is $1.91 billion. To be conservative, we'll use the lower number.

A 76% ownership stake in Renewables is currently worth $1.45 billion. The market cap of TransAlta is currently $1.71 billion. That means that investors are paying just $260 million for all of TransAlta's coal assets, as well as its hydro, wind, natural gas, and solar-powered plants that it hasn't dropped down to Renewables yet.

Again, I don't need to know exactly how much these plants are worth to know they're worth more than $260 million.

A potential catalyst

Because the market has valued the coal assets at zero, there's potential for some big upside if Premier Notley announces anything that isn't a swift death to coal in Alberta.

As it stands right now, Alberta simply can't turn off the coal. Almost 40% of the province's power supply comes from the dirty fuel, capacity that takes time to replace. Notley knows this as well as anyone.

Additionally, many of TransAlta's coal plants are scheduled to already shut down or convert to natural gas in the 2020s. The transition away from coal is already happening. Legislation from the NDP could speed up the process, but something like that would likely be accompanied with incentives for the owners of coal-fired plants. It's bad for business to be known as the government that suddenly changes the rules.

If you're looking for a long-term contrarian play with some nice upside potential, TransAlta looks to me like a good pick. That's exactly the reason why I own it.

CATEGORY

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