The Bear Case for TransAlta Corporation

Description

It has been a tough year for investors in electric utility **TransAlta Corporation** (TSX:TA)(NYSE:TAC). The stock has plunged by 43% over that period because of a series of headwinds. The fact that it was fined $56 million by Alberta's energy regulator for manipulating electricity prices has also not helped how it's perceived by investors.

Despite these headwinds and other red flags, there are some analysts claiming that TransAlta is a bargain buy.

However, as I will explain, this couldn't be further from the truth.

Now what?

Electric utilities are typically considered to be solid defensive stocks because of their low volatility, smooth but gradual earnings growth, and consistent but conservative dividend payments. TransAlta couldn't be more different from this.

In early 2014 it slashed its dividend by 38%, but with its stock price in free fall, it now yields a monster 12%. It is difficult to see how TransAlta can sustain this monster yield. Not only is its payout ratio well in excess of 100%, but the company continues to face a range of headwinds that will continue to impact its financial performance for the foreseeable future.

The most significant headwind is the secular trend to cleaner renewable sources of electricity. The Alberta government, and many others in North America, is focused on regulating coal-fired power generation out of existence.

By 2030 Alberta plans to have coal-fired power plants contributing 12% of the province's total electricity, less than half of the 30% it contributes today.

Now, while some analysts claim that it will be almost impossible for Alberta to achieve this because about 55% of the province's electricity comes from coal-fired plants, what is clear is that the government has set a very clear mandate.

As part of this mandate, the government has introduced a range of measures including a cap on greenhouse emissions and an increased carbon levy. There are also plans for coal-fired plants to start operating at reduced capacity in 2016.

This is a serious matter for TransAlta.

You see, TransAlta derives 46% of its EBITDA from coal-fired electricity generation in Canada, all of which comes from Alberta.

The trend to cleaner sources of electricity will force TransAlta to undertake a costly transition from coal-fired power generation to cleaner alternatives. This comes on top of the already considerable investment the company has made in updating its aging fleet of coal-fired power plants, including placing clean-coal technology.

Another headwind that is set to stymie TransAlta's performance is declining electricity prices in Alberta, primarily because of sharply weak demand from the energy patch.

For the nine months ending September 30, 2015 Alberta spot-electricity prices were down by 34% year over year, and with signs that oil prices will remain low for a sustained period, electricity prices will remain depressed. This will have a significant impact on TransAlta because it generates a considerable portion of its revenues in Alberta.

So what?

It is clear that it will not all be clear sailing for TransAlta in the coming years. The secular trend of clean electricity generation is acting as a considerable headwind in an already difficult operating environment.

Then you have to ask yourself whether or not TransAlta can sustain its dividend with that monster 12% yield, particularly as it is set to incur considerable costs as it transitions its operations in Alberta to meet the new regulatory requirements.

While TransAlta may appear attractively priced, it is hard to see any significant upside in the stock at this time.

CATEGORY

1. Dividend Stocks
2. Investing

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