What Does 2016 Hold for TransAlta Corporation and its Monster Dividend Yield?

Description

It has been a tough year for investors in electric utility **TransAlta Corporation** (TSX:TA)(NYSE:TAC). Its share price has plunged by 53% since the start of January as the company is facing a range of headwinds. Alberta's climate change policy and the historic Paris climate change accord both spell the eventual end of coal-fired electricity generation.

This certainly doesn't bode well for the outlook of TransAlta or its monster 15% dividend yield.

Now what?

The biggest problem facing TransAlta is that it derives just over half of its EBITDA from coal-fired power generation. Growing pressures to slash greenhouse gas emissions and tackle global warming have brought significant pressure to bear on coal as a source of energy.

You only need to look at Alberta, which is TransAlta's core market and the location of the majority of its coal-fired power plants, to see this.

Alberta's government has set a 15-year transition period with an ambitious target of reducing pollution from coal-fired electricity generation to zero. This will force the retirement of a number of coal-fired power plants in the province well before they are scheduled to be shut down. According to analysts, in the case of TransAlta the legislation will force the early retirement of six of the 10 coal-fired units that it either owns or has a stake in.

This doesn't bode well for TransAlta. All of its Canadian coal-fired plants are located in the province and generate 46% of its total EBITDA. It also means that TransAlta will have to engage in a costly transition program that, along with softer electricity prices in Alberta, will hit its bottom line hard.

This then brings into question the sustainability of that monster 15% dividend yield that, with a payout ratio exceeding 100%, is not sustainable over the long term. And consider that for the first nine months of 2015 TransAlta's dividend payments totaled $128 million, yet its net earnings were only $113 million.

It is difficult to see how TransAlta can sustain the dividend when it needs to invest considerable sums to transition its fleet of power plants to comply with Alberta’s new regulations. Then you have the ongoing impact of weak electricity prices on its bottom line, which also brings into question the sustainability of such a generous dividend payment.

In fact, it would make sense for TransAlta to cut the dividend in order to preserve capital that it could then use to fund the transition to the new operating environment; particularly, it could use asset sales and debt to fund any shortfalls. This would also be a good move for a company that has $4.4 billion in debt and, for the nine months ending September 30 2015, cost $182 million to service.

So what?

It is difficult to see how TransAlta can manage the costly transition away from coal-fired power generation and continue to report solid financial results when almost half of its EBITDA comes from coal-fired plants located in Alberta. This poses a threat to its very generous dividend, particularly when its existing high levels of debt are taken into account and the fact that the dividend payment continues to exceed net earnings.

For these reasons, TransAlta offers investor little upside at this time, and the looming threat of a dividend cut could just be enough to push its share price lower.

CATEGORY

1. Dividend Stocks
2. Investing

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1. NYSE:TAC (TransAlta Corporation)
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Date
2025/08/22
Date Created
2015/12/21
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