TransAlta Corporation: A Sustainable Double-Digit Yield?

Description

TransAlta Corporation (TSX:TA)(NYSE:TAC) was one of the TSX Composite's worst performers in 2015, falling more than 50%. The generous dividend lifted investors' total returns a bit, but still–that's a terrible result.

TransAlta is dealing with owning coal-fired power plants in an era where the dirty fuel is about as popular as the Ebola virus. Plus, the company is dealing with a new government order from Alberta, its main operating jurisdiction, which banned all coal-fired plants in the province by 2030. There will also be a carbon tax on power plant emissions, further cutting into the bottom line.

TransAlta is also dealing with low power prices in Alberta. Although it signs power purchase agreements (PPAs) that lock in a price for about 80% of its production, the price obtained for the 20% that isn't locked in has been weak. The market is concerned that PPAs expiring in 2018 won't be renewed at previous prices, further adding to the weakness.

Investors have also been focusing on TransAlta's balance sheet. Even though the company is trading at a mere fraction of book value, the market believes TransAlta's assets aren't worth nearly what the carrying value is on the balance sheet. So even though the debt-to-asset ratio is officially around 41%, in reality it's much higher.

TransAlta has made it a priority to reduce debt. It has sold off some of its greener assets to its subsidiary, **TransAlta Renewables Inc.** (TSX:RNW), such as its Australian gas projects. The problem is that much of its debt is denominated in U.S. dollars, so even though the face amount is going down, it appears to be heading higher when converted back to Canuck bucks. TransAlta has nearly $1 billion in preferred shares outstanding as well. Much of this debt is relatively short term in nature with nearly $1 billion due by the end of 2018.

Because of these issues, I believe TransAlta's very generous 14.8% yield will be cut sooner rather than later. The approximately $170 million paid to shareholders annually could be put towards paying down the debt. TransAlta is likely to keep a small dividend in place, so it doesn't get booted by portfolio managers who exclusively buy dividend payers, but it won't be much.

Fortunately for income investors, there's still a way to get generous dividends from TransAlta. Just buy the preferred shares.

Prefer the preferreds

TransAlta has four series of preferred shares outstanding. We'll focus our attention on the Series A preferreds, which trade under the ticker symbol TSX:TA.PR.D. These shares have a current yield of 11.7%.

These are rate-reset preferred shares, which means that in March 2016, the rate will reset at whatever the Canadian government five-year bond yields, plus 2.03%. Based on the original $25 par price for these securities, that's a yield of 2.78%.

That's not very exciting. Fortunately for income seekers, these preferred shares trade at a huge discount to par. Based on the current share price of $9.78, you're looking at a yield of 7.14% from 2016 to 2021. If you held these shares until the next rate reset in 2021, you'd be looking at a yield of about 7.8% for the life of the investment. In today's low interest rate world, that's not bad.

Buying the TransAlta preferred shares at this point is essentially a bet on TransAlta as a going concern. The company does have the right to suspend dividend payments on the preferred shares if necessary, but if it does that, bankruptcy likely isn't far behind.

TransAlta's common share dividend looks to be finished. There's still a compelling argument to buy the common shares from a value perspective, but not if you're looking for income. The preferred shares look to be a pretty good bet for income seekers. Just realize there's some risk to this investment.

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1. Dividend Stocks
2. Investing

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2. TSX:RNW (TransAlta Renewables)
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