TransAlta Corporation: This Stock Is a Buy Even After a 78% Dividend Cut

Description

On Friday **TransAlta Corporation** (TSX:TA)(NYSE:TAC) announced its quarterly dividend would be vastly lower in 2016 with the payout being chopped from $0.18 per share all the way down to just $0.04.

Dividend investors didn't take kindly to this 78% haircut in their income and sent shares reeling. After closing at $4.36 each on Thursday, shares fell more than 13% on Friday, ending the day at just $3.76. At least the selloff didn't continue on Monday, which saw the beleaguered power producer finish the day slightly positive.

It's never good news when a company slashes a dividend, and TransAlta is no exception. Management stated that the dividend cut was needed to free up capital to repay debt or acquire cleaner assets.

Management also mentioned that the $150 million in annual savings from the dividend would be important when it comes time to pay its next debt maturity, a US$400 million note due in 2017.

Essentially, the move boils down to this: TransAlta has identified that it has too much debt and is looking to lighten the load on its balance sheet. Since it now knows it'll have to be out of the coal-fired power business in Alberta by 2030, management is doing everything it can to get rid of any liabilities from its legacy business.

This shouldn't have come as much of a surprise. TransAlta's stock has fallen so hard that the dividend yield was more than 15% prior to the announcement. There's no reason for a stock to pay out that much even if the company can afford it.

What's being ignored in all the dividend chaos is TransAlta's future as an investment. Here's why I think TransAlta is a much better opportunity than most people covering the stock think.

Rock-bottom valuation

One thing many investors have forgotten about TransAlta is that it's still profitable.

When the company released its third-quarter results, management guided that the company would earn between $990 million and $1.1 billion in EBITDA in 2016. Free cash flow is expected to be healthy as well, coming in at somewhere between $250 and $300 million for the upcoming year.

Assuming the mid-point for each of these projections, TransAlta is not only the cheapest power producer in the country, but it's also one of the cheapest stocks overall. After the recent market selloff, Canada's other power producers still trade at an enterprise value-to-EBITDA ratio of approximately 10. If TransAlta can earn $1.05 billion in EBITDA in 2016, it will trade at about 5.2 times the same ratio. That's a huge discount compared with its peers.

From a free cash flow perspective it's even cheaper. If TransAlta can generate $275 million in free cash flow in 2016, investors who buy today are getting this company for less than four times free cash flow. This is a fraction of the multiple its peers currently command.

There are still issues with TransAlta. The company's power purchase agreements in Alberta start rolling off the books in 2017 with most sticking around until 2020. These agreements are in place for a much higher price than what the company can get on the open market. If conditions don't improve in Alberta between now and then, profitability will really get hit.

Another source of value is TransAlta's big investment in its subsidiary, **TransAlta Renewables Inc**. (TSX:RNW). As I write this, TransAlta owns 65% of Renewables. At a current market cap of $2.04 billion for the subsidiary, TransAlta's stake in the company is worth $1.33 billion. Remember, TransAlta's market cap is currently just $1.08 billion. Investors aren't just getting the coal assets for free. They're being paid $250 million to take them.

Coal-fired power gets a bad rap, but these plants remain profitable. In fact, some 40% of TransAlta's EBITDA comes from the fuel, and these earnings should continue. There's still 14 more years until coal goes away completely in Alberta, and most of the plants are scheduled to close before then anyway.

At less than $4 per share, TransAlta is incredibly cheap. And investors are getting paid a yield of 4.2% to wait–a dividend that actually looks to be safe for the first time in years. It might not be a great dividend payer any longer, but there's sure a compelling argument to be made for TransAlta as a value play.

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