TransAlta Corporation: This Troubled Stock Has Huge Upside Potential

Description

When I tell many of my peers I'm long on **TransAlta Corporation** (TSX:TA)(NYSE:TAC), the responses I get aren't very positive.

The company has major issues; that much is obvious. The big one is the phasing out of its coal-fired power plants in Alberta by the province's government. Premier Rachel Notley has vowed that Alberta will go coal free by 2030. In the meantime, large polluters such as TransAlta's coal-fired plants will be subject to a tax of $30 per tonne on carbon emissions.

Investors are concerned TransAlta spent billions on plants that will soon be declared worthless. They're also worried about the debt level associated with these plants. At the end of 2015, TransAlta had nearly $5.5 billion in long-term debt (including preferred shares) compared to assets of $10.9 billion. A 50% debt-to-assets level is acceptable when the business is stable. It's not acceptable when some 40% of the company's assets are at risk.

Investor sentiment becomes a huge factor as well. Why invest in TransAlta, the refrain goes, when there are dozens of utilities in Canada and the United States without these problems?

The reason is simple. TransAlta is a very cheap stock with upside potential of between 100% and 300% per share. There's also the chance TransAlta drowns under its debt and goes to zero, as is usual with a stock like this.

I think the first situation is more likely. Here's why I'm holding on to my shares for the long term.

Valuation

TransAlta is cheap from both an assets and earnings perspective.

Let's look at earnings first. In 2015 the company managed to eke out a free cash flow of $172 million. The company has a current market cap of $1.67 billion, putting it at less than 10 times free cash flow. TransAlta's more stable peers tend to trade between 15 and 20 times free cash flow.

And 2016 looks to be even better. The company projects free cash flow to come in between $0.86 and $1.03 per share. Even assuming the low end of that range, shares will still trade at less than seven times forward free cash flow.

I use a simple way to value TransAlta from an assets perspective. TransAlta owns a 64% interest in its subsidiary, **TransAlta Renewables Inc.** (TSX:RNW). Since Renewables is publicly traded with a current market cap of $2.68 billion, it's easy to value the ownership stake, which is worth $1.67 billion at today's prices.

Meanwhile, the parent company has a market cap of $1.67 billion. Investors are only paying for the stake in Renewables while getting the rest of the company for free. Investors are valuing TransAlta's coal assets at zero, even though the company generated nearly $400 million in EBITDA in 2015.

The silver lining

When you look closer at TransAlta's coal portfolio, a trend emerges. The company never planned to have the majority of its coal-fired plants operational past 2030 anyway. According to the latest investor presentation, just 650 MW out of 2,931 MW in capacity would have been operational past 2030, even if the government did nothing.

TransAlta will also negotiate with the province to ensure some sort of settlement for the loss of economic life of the four plants that would have remained operational past 2030. We have no idea how much it'll be at this point, but a generous payout would really help the company with the real problem: its debt.

True contrarian stocks like TransAlta tend to follow a similar pattern. Once the unknown becomes known, the price shoots up. That's because the market prices in the most pessimistic assumptions. When news comes out that surpasses those low expectations, it's a good thing for a very cheap stock.

I believe shares of TransAlta will be much higher five years from now than they are today. It's a matter of patience and giving the company time to work through its troubles. In the meantime, shares pay a sustainable 2.7% dividend as a reward for waiting for what could very well be a big turnaround.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:TAC (TransAlta Corporation)
2. TSX:RNW (TransAlta Renewables)
3. TSX:TA (TransAlta Corporation)

Category

1. Dividend Stocks
2. Energy Stocks
3. Investing

Tags

1. Editor's Choice

Date
2025/08/22
Date Created
2016/03/22
Author
nelsonpsmith