Is TransAlta Corporation Too Cheap to Ignore?

Description

It hasn't been a good year for **TransAlta Corporation** (TSX:TA)(NYSE:TAC).

Power prices in Alberta, its biggest market, have been weak. Approximately 80% of its production is locked into power price agreements, but 20% is subject to the whims of the market. A combination of oversupply and weaker demand from the energy sector left floating prices too low.

The company also got its fingers slapped by a regulator, which ruled it was guilty of illegally manipulating prices back in 2011. A fine of $56 million was assessed as punishment.

And most importantly, Alberta's newly elected NDP government passed legislation that would make Alberta a completely coal-power-free province by 2030. This is very bad news for TransAlta, since approximately 40% of its EBITDA comes from coal-fired power plants in the province.

All of these factors caused the company to slash its dividend for the second time in two years. The previously generous payout of $0.18 per share each quarter has dipped all the way down to $0.035. That's a current yield of 2.4%. The latest dividend cut ensures that any income investor who was previously holding the stock has now gotten out.

The stock has ventured into unloved value-stock territory. Although many investors are negative on the company, there appears to be plenty of value hidden underneath the warts. Here's why the company could be worth far more than the current $6.82 share price.

Renewables stake

In 2013 TransAlta spun off many of its renewable assets into a separate company, **TransAlta Renewables Inc.** (TSX:RNW). After a few different transactions affected the ownership stake, we're now at a point where TransAlta owns 64% of its subsidiary.

Renewables has a current market cap of $2.86 billion. That means TransAlta's stake in the company is worth $1.83 billion alone. And yet, TransAlta's market cap is only $2.07 billion. This means investors are valuing TransAlta's legacy business at just $240 million.

That's a mistake. TransAlta's guidance for 2016 is free cash flow of between $250 and $300 million, which works out to between $0.86 and $1.03 per share. Sure, some of those earnings come from the Renewables subsidiary, but it goes to show the legacy business is still generating ample free cash flow. It also puts shares at a ridiculously low multiple to free cash flow.

There's also the chance of power prices going up. The company is projecting a price of between $29 and $33 per megawatt for Alberta's spot price in 2016. Prices have averaged higher than this range every year since 2001, even hitting a recent high of $80.19 in 2013.

A potential catalyst

The Albertan government has begun to have settlement discussions with the power companies most affected by this shift to coal. Since TransAlta has the most to lose in this transition, it'll get the highest payout.

At this point, nobody has any clue what this payout will be. One estimate I've seen pegs the payment to be as high as $4.6 billion, but that's probably too ambitious. Other estimates say the government might just allow these companies to be exempt from the new carbon tax, or tax breaks may be given to help allow affected facilities to convert to natural gas.

The point is this: the chance of these plants very quickly becoming worthless is remote. They'll still be operational for years, generating cash flow the whole time. Some sort of payment from the government would only be a positive thing for the share price.

TransAlta isn't out of the woods yet. The company is still dealing with an excessive debt load, low power prices in Alberta, and other issues. But investors are getting compensated quite well for taking these risks, since the so-called toxic assets are being valued at almost nothing. I believe business will gradually improve, which will take the share price up nicely with it.

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1. Dividend Stocks
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