Are Investors Mispricing TransAlta Corporation?

Description

It's easy to look at companies like **TransAlta Corporation** (TSX:TA)(NYSE:TAC) and question whether or not investors are mispricing the stock, especially considering how beaten down the stock has been over the past year. However, TransAlta is not an immediate buy, and there are a few reasons for that.

The primary reason has to do with the fact that 20% of its total energy production is sold on the whims of the market. There has been an oversupply and lack of demand, pushing prices down, which has resulted in the company generating losses.

For example, its 2015 earnings showed that it lost $0.09/share; its EBITDA is down by 9% year over year and its cash flow from operations is down a whopping 40%. Naturally, with losses coming in, TransAlta was forced to make a move no company wants to do: it cut its dividend.

Yet it had no choice. The company used to pay out $0.185 per share a quarter. However, to ensure it could stay operational, the company cut it to only $0.035. While that still means the company yields 2.33%, it's a long way from the five times dividend it used to pay.

But here's why the company really has me concerned: 40% of TransAlta's EBITDA is generated from coal-fired power plants in Alberta. This is problematic because Alberta just elected an NDP government, which mandated that all electricity generated in the province be coal free by 2030; in other words, 40% of TransAlta's EBITDA won't be allowed to exist in 14 years.

This means the company will have no choice but to shut down power plants that might still be worth operating. For example, it has invested $3 billion along with **Capital Power Corp.** to bring Keephills-3 plant online. By 2030, it'll be forced to shut down well before the plant would have run its course, limiting any profits either company can make.

To make matters worse, TransAlta has borrowed a significant amount of money to invest in these growth projects. It has $4.3 billion in debt with $1.6 billion due in the next three years. If that weren't enough, a vast majority of the debt is in U.S. dollars, so when that currency increases, the debt becomes that much harder to pay back.

What about renewables?

There is one saving grace for TransAlta, and that's the fact that it owns a controlling interest (64%) in **TransAlta Renewables Inc.** (TSX:RNW). This is a 2013 spin off of all of TransAlta's renewable projects.

At present-day value, TransAlta Renewables has a market cap of $2.96 billion. That means that TransAlta's holding of its renewable subsidiary is worth $1.89 billion. That's significant because TransAlta itself only has a market cap of $1.98 billion. In other words, investors are only valuing the non-renewables business at $90 million.

Operating cash flow for 2016 is expected to be anywhere from $250 to $300 million, of which a percentage is expected to come from the renewables. However, the rest will still come from TransAlta's legacy operations, making the company very cheap.

Here's the thing, though…

If the dividend were still really strong, I could argue that buying this company would be worth the money. However, knowing that the government has plans to make coal obsolete, I would wait to see how TransAlta can innovate beyond coal. Frankly, I would just buy the renewables division. It's very much the future.

CATEGORY

1. Energy Stocks
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