Should Investors Buy TransAlta Corporation or TransAlta Renewables Inc.?

Description

Power producers are stalwarts in many portfolios, as investors are attracted to their stable cash flows, predictable stock prices, and, perhaps most importantly, some of the best dividends the market has to offer.

TransAlta Renewables Inc. (TSX:RNW) delivers just that. The company has been one of the TSX's best performers over the last year, increasing some 37%, plus dividends. With the exception of some pressure at the end of 2015, the company has been a steady performer since its IPO.

Things couldn't be any more different for **TransAlta Corporation** (TSX:TA)(NYSE:TAC), which spun out Renewables in 2013. The company has been plagued with low power prices in Alberta for years now. Costly unexpected repairs have also hit the bottom line, as well as a fine from a regulator. Debt is also a concern.

This all led to not one, but two dividend cuts. After paying $0.29 per share each quarter for years, management cut the dividend to $0.18 per share and then all the way down to $0.04 per share, where it sits today.

Surprisingly, even though these two power producers are seemingly a very long way apart, I'm actually more bullish on the struggling one. Here's why.

The case for TransAlta

There are several arguments for buying TransAlta. The first is because shares are ridiculously cheap from a couple of different perspectives.

TransAlta owns 64% of Renewables–a stake currently worth $2.13 billion. The parent company has a market cap of $1.83 billion. Not only are investors getting TransAlta's coal, natural gas, and hydro assets for free, they're getting paid to own them.

The Albertan government is forcing a transition away from coal, passing legislation to free the province of coal-fired power by 2030. Additionally, the province is going to slap a carbon tax on producers, although that cost will mostly be passed through to customers. The point is, these coal-fired assets will continue to generate earnings until they're phased out.

Even though TransAlta is suffering from terribly low power prices in Alberta, it still continues to make money. Management estimates the company will produce between $1 and $1.1 billion in EBITDA in 2016, which translates into free cash flow between $0.86 and $1.03 per share. That puts shares between six and seven times free cash flow, making it the cheapest power producer on the market. The rest aren't even close.

TransAlta also has a big potential catalyst. It has several coal-fired power plants in Alberta that were scheduled to continue operating past the 2030 deadline. Because the government artificially shortened the lifespan of these plants, TransAlta is in line to get a cash payout. When that happens, it could be very good news for the stock.

The case for Renewables

Because its parent is dealing with debt issues, TransAlta Renewables is getting the opportunity to expand quickly.

In January, it invested $540 million to buy 611 MW of power-generation assets located in Ontario and Quebec. The deal was paid for by issuing shares and convertible debentures to Transalta, as well as with $172.5 million in cash. Renewables is also growing in Australia, acquiring assets there from its parent.

Renewables has already promised investors it will again raise its dividend in 2017 as the Australian assets start adding to the bottom line. The dividend is projected to grow to $0.94 per share annually, giving the company a potential yield of 6.3% versus 5.9% today.

In short, Renewables is a much more conventional investment. The company is in much better shape than its parent, and thus attracts a different type of investor.

Which should you own?

I own TransAlta. I'm attracted to the company's cheap valuation, its turnaround potential, and its unloved status. I think when the turnaround is complete, the patience will be worth it.

Most investors will be more comfortable with Renewables. It's in a sexy part of the sector, has a good balance sheet, will continue to get opportunities to buy TransAlta's assets at reasonable prices, and pays an attractive dividend.

CATEGORY

1. Dividend Stocks
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TICKERS GLOBAL

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