



Why the Recent 5% Plunge in TransCanada Corporation Is a Massive Buying Opportunity

Description

On November 2, **TransCanada Corporation** ([TSX:TRP](#))([NYSE:TRP](#)) shares plunged nearly 5% in a single day—an unusually large move for a fairly stable stock. The sell-off was likely due to a combination of weakness in the TSX as well as in the price of oil (which fell about 2.25%) combined with concerns over TransCanada's recent quarterly earnings.

Why the recent earnings report may have spooked investors

TransCanada reported a net loss of \$135 million, or \$0.17 per share, for Q3 2016. Analysts were expecting \$0.62 per share, which may explain some of the weakness in TransCanada's share price. Digging deeper, however, the loss was primarily due to the fact that TransCanada is selling its U.S. Northeast Power Business for \$3.7 billion, on which it took a \$1.1 billion loss.

This loss is partially reflected in the company's earnings for the quarter, and this explains the underperformance. Excluding the loss on the asset sale and other one-time expenses, TransCanada earned \$0.78 per share—well above both the consensus of \$0.62 per share and Q3 2015's earnings of the same value.

TransCanada plans to use the proceeds of the asset sale to pay off a portion of a US\$6.9 billion loan it took out when it purchased Columbia Pipeline Group for US\$13 billion earlier in the year (the balance was paid via issuing shares).

This leads to the second factor that may have contributed to the drop in TransCanada's shares. While the asset sale should repay US\$3.7 billion of the US\$6.9 billion loan, TransCanada has decided to tap equity markets to repay the balance. This means the company is issuing \$3.2 billion in common shares.

Issuing new shares can be unpopular due to the fact it increases the share count and dilutes current shareholders, and TransCanada was originally going to pay off the balance of its loan for Columbia via additional asset sales (more specifically, selling perhaps half of its Mexican pipeline business). This decision was also unexpected by many investors.

TransCanada instead decided to maintain full ownership in its Mexican pipeline business, which consists of six pipelines and should allow TransCanada to profit fully from growth in its portfolio. Mexico is a fast-growing natural gas market and is significantly underpiped. Mexico currently has about 10% of the pipeline system that Texas has, despite having four times more people, and its natural gas pipeline system is expected to grow by 90% over the next three years.

TransCanada has a strong footprint in the region, and this incumbency gives it the ability to better capture future growth, while participating fully from the US\$3.8 billion it is currently investing in the region, which should result in TransCanada's Mexican earnings growing to US\$575 million by 2018—a 217% increase from 2015 levels.

TransCanada shares are worth more than they are today

TransCanada has an impressive US\$26 billion of growth projects till 2020. These will in turn support 8-10% annual dividend growth and free cash flow growth per share of 10% annually throughout this period (as a conservative estimate) on average

Assuming TransCanada earns \$3.8 billion in free cash flow this year and conservatively grows it to \$4.1 billion in 2018 (in line with estimates by **Bank of Nova Scotia**), TransCanada would have an impressive 2017 free cash flow yield of 8.3%. This is actually higher than **Enbridge**, which has an expected free cash flow yield of 7.1% in 2017. In fact, it is one of the highest free cash flow yields in its entire peer group of North American mid-stream names.

A high free cash flow yield basically means that TransCanada's free cash flow per share is a higher percentage of the share price than its peers because its shares are cheaper. This may be because TransCanada has a lower payout ratio than its peers, or because TransCanada has yet to outline more growth opportunities.

Investors should expect both of these factors to improve going forward, and if TransCanada were to trade at the same free cash flow yield as Enbridge, it would have a share price of about \$67.

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