Is TransAlta Corporation Canada’s Cheapest Stock?

Description

As a value investor, seeing stocks hit new all-time highs is a little bittersweet.

I’m happy my existing stocks are doing well, of course. It’s nice to be richer, even if it’s just on paper. But I’m decades away from retirement. I’m going to buy many different stocks between now and then. And it’s much tougher to buy aggressively when valuations are, at best, a little stretched.

Fortunately, not every stock is expensive. There are a few select companies out there that are not only cheap, but also have the ability to shoot much higher. The last thing any investor wants is to be stuck in the purgatory that is a value trap.

I think one of the best opportunities in today’s market is **TransAlta Corporation** (TSX:TA)(NYSE:TAC), which is incredibly cheap using a couple of different metrics. Let’s take a closer look.

Assets

TransAlta has a book value of $11.83 per share compared to a current market value of $7.63. That puts shares at just 64.5% of book value, which is a huge discount, especially when compared to most of its peers in the power-generation space.

Many investors are somewhat skeptical of book value, saying it illustrates what a company paid for assets — less depreciation — and not the actual value. In other words, if the value of TransAlta’s coal-fired power plants is less than the value depicted on the balance sheet, the company has no incentive to adjust those numbers accordingly.

But there is another way to value TransAlta’s assets that’s also quite flattering, suggesting book value may not be so bad after all.

TransAlta has been slowly selling assets to its subsidiary **TransAlta Renewables Inc.** (TSX:RNW), which has been paying using a combination of cash and newly issued stock. After numerous transactions, the result is that the parent company owns 64% of Renewables.

Currently, the subsidiary has a market cap of $3.26 billion. This implies that TransAlta's 64% interest is worth $2.07 billion. Yet TransAlta only has a market cap of $2.14 billion.

TransAlta investors are paying market value for its stake in Renewables while getting the rest of the company for free. And, as I'll show you, the rest of TransAlta is worth much more than $70 million.

Cash flow

TransAlta isn't just cheap from a book-value basis. It's also cheap on a price-to-cash flow perspective.

The company continues to forecast it'll post free cash flow in between $0.86 and $1.03 per share for 2016 once results are officially released. The company is certainly on pace to do so; in the first three quarters of 2016, it generated $0.75 per share in free cash flow, and Alberta had some nasty weather in December. This tells me fourth-quarter results may be strong.

If we take the mid-range of those projections, TransAlta shares trade at just 8.1 times trailing free cash flow. That is incredibly cheap.

And remember, free cash flow should go up in 2017 as power prices improve, and the company starts getting $37 million per year from the Albertan government.

I should also point out that after two dividend cuts, TransAlta's 2.1% yield is secure. The company's payout ratio will be approximately 20% of 2016's free cash flow.

But what about coal?

There's one thing that scares off many potential TransAlta investors. About a third of TransAlta's 2016 earnings came from coal-fired power. Those earnings will go away by 2030.

TransAlta's management has already come up with a plan to convert up to 3,000 MW of coal-fired plants — or about 60% of today's capacity — to natural gas at a cost I estimate to be approximately $500 million. This should extend the life of those plants an average of 15 years each. And if the price of natural gas stays the same as today, those plants will have cheaper operating costs too.

The bottom line

TransAlta's management is doing a nice job during this difficult time. The company is also quite cheap on a number of metrics, including price-to-book value, price-to-cash flow, and the value of its underlying TransAlta Renewables stake. Yes, there is uncertainty surrounding the stock, but it's hard to find a company this cheap without some warts.

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