Is TransAlta Renewables Inc.'s Dividend Safe?

Description

When investors look for dividend stocks, the immediate temptation is often to look at the overall yield, since that is ultimately what you expect you will be earning. However, if a company runs into cash issues, then cutting a dividend is usually the easiest course of action. It is for this reason that investors should always consider how feasible the current payout is for the company, especially if the dividend is yielding more than 5%.

TransAlta Renewables Inc. (TSX:RNW) currently pays a dividend yield of ~6.8%, and that high of a payout would certainly suggest that a second look at the financials is in order. The company recently hiked its monthly payout to $0.0783, which amounts to a payment of a little less than $0.94 per year.

Evaluating the payout ratio by looking at earnings

One way to evaluate a company's payouts is to look at its earnings per share (EPS). In the trailing 12 months, the company's EPS of 0.44 falls well short of the dividend payments that TransAlta would need to pay shareholders. In 2016, the company posted a loss, but the year before that, EPS was at a high of $1.18. If we look at the short term, then we can see that there are some concerns about the company's ability to meet dividend payments. However, one of the disadvantages of just looking at EPS is that a company's earnings include non-cash items that aren't going to impact dividend payments.

Using free cash flow to assess payouts

Looking at a company's cash flow is often a more appropriate way of evaluating its ability to make dividend payments. With this approach, we see that TransAlta has been generating and growing positive free cash flow in each of the past four years. In the last 12 months, free cash has totalled $282 million, which is up from $267 million that was accumulated in 2016. Dividend payments of ~$200 million a year mean that the company's payout ratio is about 70% of its free cash flow, suggesting that the company can continue to pay its dividend and that it is sustainable.

Can the company grow its dividend?

Now that we've assessed that the current dividend is manageable, the next question is whether or not the company can expect to grow this dividend. TransAlta recently hiked its dividend by 6.8% and payouts have increased in three of the past four years. If the company's payments were to increase by another 7%, then the total cash dividends paid out would be about $212 million, or 75% of the most recent free cash totals.

Certainly, 75% is still a manageable payout ratio, but the company would need to see earnings improve in order for investors to have realistic expectations of the dividend continuing to grow in the future. Unfortunately, the company has failed to see any consistent growth in its earnings or sales numbers, and this presents some uncertainty going forward.

What does this mean for investors?

The dividend looks to be manageable for the near future, and if you're looking for a good stock to park your money into, TransAlta could be a good choice. However, I wouldn't suggest investing long term in this stock until the company can demonstrate it can consistently grow its top and bottom lines.

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