An Unloved Stock That Could Deliver Big Gains in 2019 and Beyond

Description

Contrarian investors are constantly searching for beaten-up stocks that might have finally bottomed out and offer a shot at some significant upside.

Let's take a look at **TransAlta** (TSX:TA)(NYSE:TAC) to see if it deserves to be on your contrarian buy list right now.

Rough ride

TransAlta used to be a top pick among dividend investors who valued the company for its steady and generous distributions.

Unfortunately, the business ran into a series of headwinds that included the pushback against coal-fired power generation, high debt levels, and falling power prices in Alberta. Management slashed the quarterly payout a number of times, from $0.29 per share in 2013 to the current payout of $0.04.

Long-term investors are hoping a sustainable recovery is finally on the way. The shares traded for more than $20 a decade ago and bottomed out below $4 in 2016. At the time of writing, the stock is at $7.40, gaining more than 20% in the past month.

Outlook

The ongoing difficulties in the Alberta energy patch are worth watching, but management has made good progress on its efforts to address the other issues that caused much of the grief in the past few years.

TransAlta reduced its debt by $900 million in the past two years, and the company reached an agreement with Alberta to transition its coal plants to use natural gas in exchange for annual payments of about $37 million through 2030.

Free cash flow is now expected to be $270-330 million in 2019 and $525-575 million beyond 2021.

Renewables value

TransAlta owns about 64% of **TransAlta Renewables** (TSX:RNW). The subsidiary holds the renewable energy assets that include wind, solar, hydroelectric, and some gas-fired power generation.

At the time of writing, RNW has a market capitalization of about $3 billion, making TransAlta's interest worth roughly $1.9 billion. TransAlta's current market capitalization is just $2.1 billion, so the market isn't putting much value on the assets not held by the subsidiary. This includes the Canadian and U.S. coal plants that generated $300 million of the nearly $800 million in cash inflow through the first nine months of last year.

Electricity spot prices improved significantly in 2018 compared to 2017, so there is some optimism on that front. At the same time, Alberta is moving to a system where power producers will be paid for capacity, as well as the power they produce, which should help TransAlta in the coming years. The objective is to provide an incentive for companies to invest in renewable power assets in the province.

Should you buy?

The worst might be over TransAlta, and it's possible the market isn't pricing in the upside potential. The existing distribution should be safe and investors who buy today can pick up a yield of 2%. With free cash flow expected to grow at a steady rate in the next few years, the payout could even start to increase.

If you have some cash on the sidelines and are willing to sit on the position for a few years, TransAlta might be an interesting contrarian pick today.

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