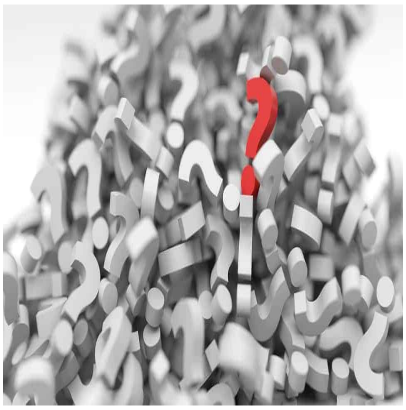

Can You Buy TransAlta Corporation Shares for Free?

Description

It would be easy to think of **TransAlta Corporation** (TSX:TA)(NYSE:TAC) as a bad investment. Since the start of 2012, the stock price has declined over 60% and the dividend has been cut over 85%. And while TransAlta has been expanding and diversifying away from coal-generated power plants (just 30% of cash flow in 2016 came from coal-generated power), the company is still seen as a generator of dirty energy and, as such, will be negatively impacted by the move towards renewable energy.

But looking closer at the numbers behind the story will illustrate why TransAlta is a great value investment.

Financials

TransAlta is generating a lot of cash. Free cash flow in the first quarter of 2017 was up 14% from $0.30 per share to $0.34. This puts the company well on track to hit its free cash flow guidance for 2017 of $1.04 to $1.26 per share. The dividend of $0.16 works out to a payout ratio of 15% even at the low end of 2017's guidance, meaning there is little chance of another dividend cut and a good chance there will be a raise in the near future.

The future of coal

The Alberta government announced that it would be phasing out all coal-fired power plants by 2030, which put a scare into TransAlta investors. At the time, TransAlta operated nine such plants, and one of the plants had an expected useful life till 2061. The announcement was seen as devastating news. But upon closer inspection of TranAlta's plants, eight were already expected to be out of commission by 2030. Two of the plants will be shut down, while six others will be converted to natural gas plants in 2020-2023.

The Alberta government will also be paying TransAlta approximately $37 million per year to help fund the conversions and closures. In the end, the phase-out of coal should have little impact on TransAlta's ability to create free cash flow, coal is still making money and will be until the plants close, and the government is providing a lot of the funding for closing/converting of the remaining plants.

Value opportunity

Here's the real opportunity: TransAlta owns 64% of **TransAlta Renewables Inc.** (TSX:RNW)—an ownership stake worth $2.25 billion. That works out to $7.80 per share of TransAlta. Right now, TransAlta shares change hands for just $7.67. This means that buying a share of TransAlta buys you a TransAlta Renewables share for a 1.6% discount; you get the entire TransAlta business for free—a profitable business that will continue to generate cash in the future.

Conclusion

TransAlta has been beaten up, but the drop in the share price has been an overreaction. Free cash flow is improving, and the dividend-payout ratio is so low that investors don't need to fear another dividend cut. TransAlata shares are so undervalued that you are buying the business for free—the stake in TransAlta Renewables is worth more than the whole market cap of TransAlta.

This situation will not last, so TransAlta Corporation is definitely a buy.

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