TransAlta tempts, but risks remain

Globe and Mail, John Heinzl
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Dividend still attractive – for now – but some analysts tending to be bearish on shares amid unresolved issues

When we last wrote about TransAlta Corp. in March, the stock was trading at $19 and the dividend yield was a hefty 6 per cent.

We warned investors to be careful, because high yields often come with high risk. Well, since then the stock has plunged below $16 and the yield has climbed to more than 7 per cent.

Has the stock hit bottom? Not everyone thinks so.

Risks remain

Even after its recent drop, TransAlta remains a risky holding, some analysts say. The power producer has resolved some issues that were pressuring its shares but it still faces plenty of uncertainty. And while the dividend appears safe for the moment, some analysts say the company could have trouble sustaining it in the long run, particularly if power prices don't rebound from current weak levels.

"For low-risk, income-oriented investors I don't see a lot of appeal in this name," said ***Darryl McCoubrey***, an analyst with ***Veritas Investment Research*** who has a "sell" on TransAlta shares.

A quick recap

A lot has happened since we last looked at TransAlta.

In July, an arbitration panel ordered the company to rebuild two damaged units at its Sundance coal-fired power plant in Alberta that were at the centre of a dispute with TransCanada Corp. TransAlta faces $50-million in net penalties and $190-million in repair expenditures to bring the units back into service.

Also in July, TransAlta signed an 11-year contract to sell a portion of the electricity at its Centralia coal-fired facility in Washington state to Puget Sound Energy, beginning in December, 2014. It also wrote down the value of the plant by $347-million.

The company posted a comparable loss of $22-million or 10 cents a share for the second quarter, down from earnings of $65-million or 29 cents a year earlier. Including the Sundance penalties and writedowns on Centralia and other assets, the net loss was $797-million or $3.51 a share.

In August, TransAlta sold $225-million of preferred shares, and said it will use the net proceeds "to partially fund capital projects, for other general corporate purposes and to reduce short-term indebtedness of the corporation and its affiliates."

Dividend in the spotlight

In the second-quarter conference call, the company sought to reassure investors that the 29-cent quarterly dividend is safe.

"There's more than sufficient cash flow generated from the business to cover the dividends and sustaining capital," chief financial officer Brett Gellner said. Moreover, because TransAlta has an unusually high 70-per-cent participation rate in its dividend reinvestment plan (DRIP) – which will save it an estimated $185-million in cash annually – the company has "significant" funds available for debt repayment, growth projects and productivity improvements, he said.

Some analysts think the beaten-down shares are attractive.

After TransAlta released its results, Jeremy Rosenfield of Desjardins Securities reinstated his "buy" rating, which he had placed under review.

"Although [TransAlta] continues to lack strong near-term growth (unlike many peers in the utility and power sector), we view the dividend as relatively safe, and find the current valuation attractive for long-tern investors," he said in a note.

Others aren't so sure.

Of the 12 analysts surveyed by Bloomberg, six rate TransAlta a "sell," with three "holds" and three "buys." Target prices range from a high of $18 to a low of $14, with an average of about $16.

A closer look at the DRIP

Although ***Mr. McCoubrey*** agrees that TransAlta can sustain its dividend in the near term, he wonders if the company might make better use of the cash by reinvesting in the business or reducing debt to protect its investment grade credit rating.

He also points out that TransAlta's DRIP is unusual in that investors can choose a "premium dividend" option in which they don't receive additional shares but instead get paid cash equal to 102 per cent of the dividend. He suspects this is why TransAlta has such a high participation rate in its DRIP.

But calling it a DRIP is actually a misnomer, he said. In fact, the shares TransAlta issues under the premium dividend component are purchased at a 5-per-cent discount by a broker – currently Canaccord Genuity – which then resells them on the market, and relays cash back to the original investor. Under this arrangement, the brokers makes a profit of about 3 per cent, and the original investor gets the other 2 per cent.

But this can only continue as long as the market has an appetite for TransAlta shares, ***Mr. McCoubrey*** said.

The danger is that "as the investment dealers continue to go to market with new TransAlta equity each quarter, they'll dilute existing shareholders and push down the share price."

So if you're tempted by TransAlta's juicy yield, be mindful of the risks.