THE GLOBE AND MAIL

April 24, 2017

Why this utility stock is gaining appeal among longer-term investors

DAVID BERMAN

TransAlta Corp.'s withering share price and dividend cuts have demoralized investors over the past decade. But forgiving types are seeing an opportunity here.

The Calgary-based electricity generator, which fell off the S&P/TSX 60 index in 2015, is starting to attract sideways glances from some sophisticated institutional investors.

Canadian Pension Plan Investment Board and the Alberta Investment Management Corp. both doubled their respective stakes in TransAlta in the fourth quarter of 2016 – admittedly from a low level – which suggests that these savvy, long-term investors may see something here.

And analysts have been raising their target prices on the stock for the first time in about nine years, to an average of about $8, or 14 per cent higher than the current price.

"Investors willing to tolerate near-term uncertainty may benefit from longer-term upside," analysts at CIBC World Markets said in a note.

The reason: The tarnished utility is now embarking upon a plan to convert coal-producing assets to cleaner natural gas, with generous financial assistance from Alberta's government.

The new TransAlta should emerge with compelling competitive advantages, and it could appeal to a new investor base that is less concerned with dividend yields and more focused on long-term potential.

Of course, it's not easy to ignore the past. From 2008 to 2016, the shares fell about 90 per cent, reflecting quarterly losses, credit downgrades and rising debt ratios.

By early last year, the dividend yield had ballooned to 18 per cent, all but ensuring that the payout would be slashed. It was, to 4 cents a quarter from 18 cents, pushing unhappy dividend investors out of the stock once and for all.

Today, though, TransAlta is showing some promise. It made a profit in three of the past four quarters, and blew past estimates in the fourth quarter of 2016. The share price has rebounded about 85 per cent since early last year.

The worst appears to be over. But more importantly, there's a good chance the rebound can continue – and now is a good time to look at the stock because it has been drifting sideways throughout 2017.

Last week, TransAlta's board of directors approved management's decision to convert coal-fired plants to natural gas generation. This marks a huge shift in what the utility looks like: The conversions account for about 3,000 MW of generation capacity, or more than a third of TransAlta's international capacity.

Alberta's provincial government will help pay for the conversion, which investors applaud: TransAlta shares jumped 17 per cent on the day the financial assistance was announced in November.

The greener tilt may be appealing to institutional investors such as CPPIB, which has said that it is starting to take climate change into account when it makes long-term investments.

"We are undertaking an ongoing project to thoughtfully ensure that we are positioning our portfolio to perform well through the transition to a low-carbon economy," CPPIB said in March.
But the coal-to-gas conversion over the next several years also rests on a good business case: It will cost just $300-million, after factoring in $524-million in payments from Alberta.

That's a fraction of the cost of building new plants from scratch, according to ***Darryl McCoubrey***, an analyst at ***Veritas Investment Research***. What's more, he pointed out that the labour costs associated with gas plants are 65 per cent lower than coal plants. And carbon-dioxide emissions should fall by 40 per cent, reducing environmental compliance costs.

The company has been retiring some debt, and rising cash flows are now improving its debt ratios, giving TransAlta more financial flexibility.

Some uncertainty remains. For one thing, even the company acknowledges that the timetable for the coal-to-gas conversion, expected to start next year, is aggressive. For another, power pricing is still low, and no one expects TransAlta's once-mighty dividend to rise any time soon.

This turnaround is in its early stages. For early investors, that's okay.

Follow David Berman on Twitter: @dberman_ROB