TransAlta: A stock that's run out of juice

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High yield stock comes with higher-than-average risk

Dividend stocks have been on a roll - but in TransAlta Corp.'s TA-T case it's been all downhill.

Even as income-starved investors pile into utilities, pipelines and anything else with a decent yield, shares of the Calgary-based power producer have tumbled about 16 per cent over the past six months.

Compounding shareholders' frustrations, TransAlta hasn't raised its dividend in more than three years, leaving many to wonder if the stock's outsized 6-per-cent yield is signalling trouble.

High yield, high risk

When a yield gets that high, there's usually a reason. In TransAlta's case, there are a few.

For starters, investors are worried about potentially hefty penalties arising from the shutdown of two units at TransAlta's Sundance generating station, a large coal-fired plant located west of Edmonton.

In December, 2010, TransAlta took Sundance 1 and 2 offline and, after inspecting the boilers, determined that the damaged units could not be "economically repaired, replaced, rebuilt or restored."

The company then moved to terminate a "power purchase arrangement" (PPA) with TransCanada Corp., which had the right to buy the power from Sundance 1 and 2 at an attractive price.

TransCanada disputed TransAlta's conclusion that the units cannot be restored economically, and an arbitration hearing is scheduled for April, with a decision expected in July. TransAlta has said it does not expect any material financial impact.

A potential shock

Should the decision go against TransAlta, however, the company could be required to pay stiff penalties to TransCanada for the lost power availability.

How stiff? In a recent report, National Bank Financial analyst Patrick Kenny estimated a maximum financial liability of $363-million, consisting of $263-million in accrued penalties and $100-million in repair costs, assuming TransAlta takes six months to fix the units.

That could slice an additional $1.50 a share from NBF's valuation of $19, said Mr. Kenny, who has an "underperform" rating on the stock. T

An unfavourable decision on Sundance could also put TransAlta's BBB credit rating at risk, he said.

Last August, Standard & Poor's revised TransAlta's outlook to negative from stable, citing high leverage; the possibility of "material penalties" from arbitration; fleet renewal costs; and weaker power prices in the Pacific Northwest affecting its major coal-fired plant near Centralia, Wash.

Questions about Centralia

In addition to the Sundance uncertainty, falling profits at its Centralia plant pose a major risk, said ***Darryl McCoubrey***, an analyst with ***Veritas Investment Research***.

In recent years, Centralia benefited by signing power sales contracts at prices that were much higher than they are today. In fact, the spread between the contracted and spot prices has been so wide that it has often been more profitable for Centralia to buy power on the open market to fulfill its obligations, instead of running the plant.

But with those favourable, short-term contracts set to expire in coming years and power prices down sharply - reflecting soft demand and competition from lower-cost hydro and gas-fired plants - Centralia won't have that option.

"While this strategy has enabled [TransAlta] to keep generating steady profits from Centralia Coal, it will eventually run through its portfolio of higher-priced sales agreements," ***Mr. McCoubrey*** said in a recent note, in which he reiterated a "sell" on TransAlta.

TransAlta is now trying to secure long-term sales contracts for the plant, but without a meaningful increase in power prices - which would require substantially higher natural gas prices - "we do not believe Centralia Coal will be able to sustain its profits for much longer," ***Mr. McCoubrey*** said.

Dividend in danger?

In an interview, ***Mr. McCoubrey*** said the issues at Sundance and Centralia could - if the outcomes are not favourable - potentially lead TransAlta to cut its dividend.

"Right now this is not an income play, because you have these two very large value issues in the very near term," he said. TransAlta "stands way above the rest, in terms of the companies I cover, as a very risky company."

For its part, TransAlta said it is not contemplating a dividend cut.

In an e-mail, Jess Nieukerk, TransAlta's director of investor relations, said "the board is committed to the dividend and to our investment grade credit ratings."

Although TransAlta has paid out more than 100 per cent of comparable earnings as dividends in each of the past three years, the board also looks at the dividend payout as a percentage of cash flow, and it is comfortable with the current ratio of about 30 per cent, Mr. Nieukerk said.

As for the Sundance arbitration, he said "we look forward to a resolution to this issue. We cannot speculate on the outcome of the hearing."

The positive case

UBS Securities analyst Chad Friess said TransAlta's cash flow is "easily sufficient" to maintain the dividend. He also said TransAlta's outlook will improve once Sundance is resolved and TransAlta completes a busy maintenance schedule at six coal plants this year.

"Beyond 2012 the skies brighten considerably as the company should have put its legal troubles behind it while maintenance spending and outages will recede," he said in a note in which he reiterated a "buy" rating.

Bottom line: TransAlta's high yield reflects above-average risk. The stock could tumble further if the arbitration ruling goes against it, or it could pop if the decision goes in TransAlta's favour.