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Market Bulletin

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Summary

Commentary

We advise cautions on stocks with high yields and payouts – JE, LTS, EXE, PWT and TA.

Recommendation

TransAlta: Rating revised to Hold (from Buy), target lowered to $15.

Commentary – Growing number of dividend cuts cautionary sign as TSX surges

High dividend yield even after reduction may signal further cuts in store

Elvis Picardo, CFA

The TSX continues to surge, with its 1.5% gain last week extending its YTD outperformance over the S&P 500 to almost five percentage points (+4.29% vs. -0.66%). But with two more widely-held Canadian companies – Sherritt and TransAlta – slashing dividends last week, the growing number of TSX "dividend cutters" is a little disconcerting.

Table 1 lists TSX companies with a market capitalization of over $500 million that have reduced dividends over the past year. There are 15 companies that – pardon the pun – "made the cut." Two companies with market caps below $500 million – Atlantic Power and Reitmans (dividends slashed by 65% and 75% respectively) – have also done so. Some interesting points emerge from this Table –

- Almost half of the companies on this list are gold and base metal producers, with two apiece from the energy and utilities sectors.

- Some of these companies have extremely high dividend payout ratios, as shown in the last two columns of the table. The gold producers now have relatively lower payouts, after having taken a hatchet to their dividends in recent months.

- The average 12-month total return for this group is -7%, which does not seem too bad considering that the average dividend cut is -57%. Just Energy and Encana have actually posted decent returns; on the negative side, the gold producers and Sherritt have recorded the worst returns.

- In our opinion, stocks that continue to offer a high yield even after their recent dividend cut should be treated with caution, especially if they have very high payout ratios, since this may be an indication of further dividend cuts down the line. **There are five stocks in Table 1 where above-average yields and high payouts signal caution – Just Energy, Lightstream Resources, Extendicare, Penn West, and TransAlta. Sherritt, the other stock with a very high payout, does not figure on this list because of its paltry yield**. (Note that these payout ratios are computed by Bloomberg on the basis of net income, and therefore appear much more adverse than if they were calculated on the basis of cash flow).

Table 1: TSX companies (market cap >$500 million) that have cut dividends over past year

Ticker	Short Name	GICS Sector	Last Price	P/E	Ind.Dividend Yield (%)	Dividend Cut	12-month Return	12-month Div.Payout	Div.Payout Last Filing %
JE	JUST ENERGY GROU	Utilities	$8.93	63.6	**9.4%**	-32%	33.3%	153.4	N/A
LTS	LIGHTSTREAM RESO	Energy	$6.35	18.1	**7.6%**	-50%	-7.2%	249.6	92.0
EXE	EXTENDICARE INC	Health Care	$7.28	24.5	**6.6%**	-43%	0.4%	215.8	254.3
WJX	WAJAX CORP	Industrials	$37.88	12.9	**6.3%**	-26%	-9.0%	97.4	87.0
PWT	PENN WEST PETROL	Energy	$8.83	N/A	**6.3%**	-48%	-5.4%	N/A	485.2
TA	TRANSALTA CORP	Utilities	$13.53	N/A	**5.3%**	-38%	-10.4%	909.3	N/A
ECA	ENCANA CORP	Energy	$21.03	28.7	**1.5%**	-65%	18.5%	N/A	78.7
YRI	YAMANA GOLD INC	Materials	$11.61	65.3	**1.4%**	-42%	-22.8%	64.3	114.6
S	SHERRITT INTL	Materials	$2.93	2.0	**1.4%**	-77%	-43.6%	N/A	1160.6
HBC	HUDSON'S BAY CO	Cons. Disc.	$16.50	13.8	**1.2%**	-47%	9.1%	N/A	N/A
ABX	BARRICK GOLD CRP	Materials	$23.29	N/A	**1.0%**	-75%	-23.1%	N/A	N/A
AEM	AGNICO EAGLE MIN	Materials	$38.14	N/A	**0.9%**	-64%	-4.6%	85.2	80.5
SVM	SILVERCORP METAL	Materials	$3.10	16.4	**0.7%**	-80%	-14.5%	N/A	39.5
ELD	ELDORADO GOLD	Materials	$7.96	N/A	**0.3%**	-80%	-20.0%	57.6	98.2
HBM	HUDBAY MINERALS	Materials	$8.89	N/A	**0.2%**	-90%	-3.8%	N/A	N/A
					Average....	**-57%**	**-7%**		

Source: Global Securities Research, Bloomberg

Recommendation

(Update) TransAlta – revising rating to Hold (from Buy), target lowered to $15

Dividend reduction probably a prudent move, but stock will be in the penalty box for a while

TransAlta (TSX: TA, $13.53) surprised investors on February 20 by "resizing" its dividend despite repeated assertions about its sustainability in preceding months. While the company also missed analysts' estimates yet again, the stock only declined 7% on the day, although trading volume was extremely heavy at 11.5 million shares. We are revising our Buy rating to Hold, while concurrently lowering our target price to $15 (from $16).

Highlights of the company's Q4 performance –

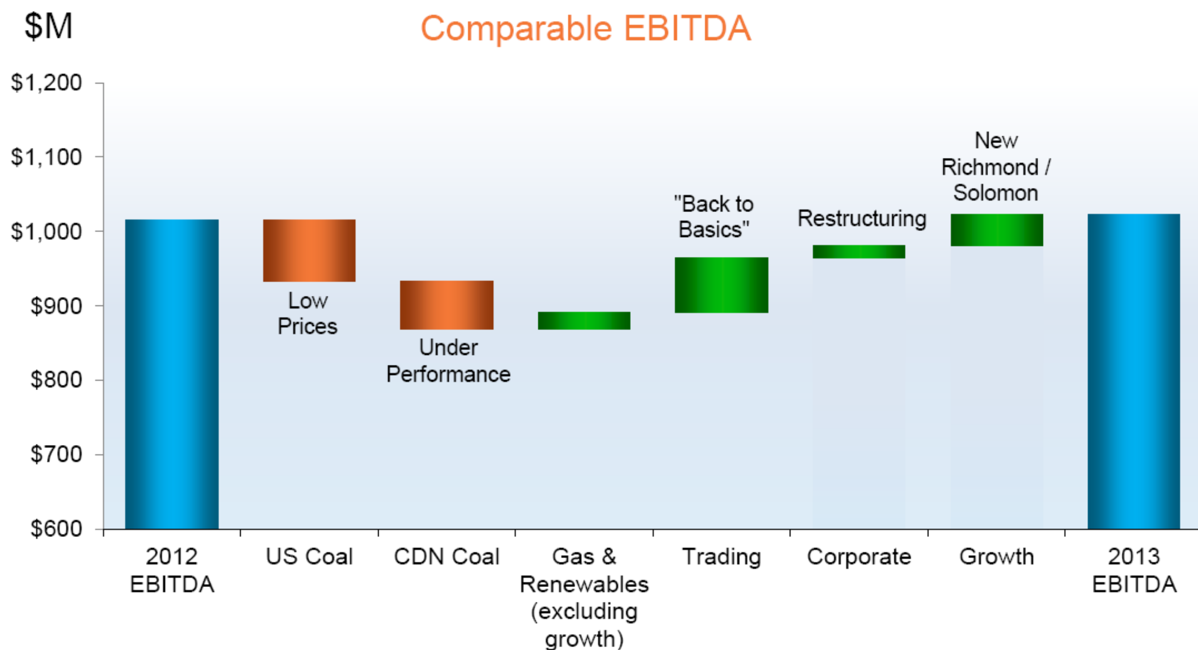
- Comparable EBITDA declined 22.4% to $242 million, from $312 million a year ago, due to lower power prices in Alberta and the Pacific Northwest, adverse weather (icing) in eastern Canada that affected wind results, and higher unplanned outages in the Canadian Coal segment.

- Although availability improved to 91.8%, from 89.4% a year earlier, revenue fell 9% to $587 million. The company reported a net loss for Q4 of $66 million or $0.25 per share, compared with year-earlier net income of $39 million or $0.15 per share.
- Comparable net income plunged to $1 million, from $55 million. Funds from operations (FFO) fell 16% to $179 million, while free cash flow declined 18% to $61 million.

Highlights of TransAlta's full-year performance –

- Comparable EBITDA for 2013 posted an incremental increase of $8 million to $1,023 million, as stronger performance in gas, renewable and trading offset the lower pricing and unplanned outages noted earlier (Figure 1).
- Availability fell to 87.8%, from 90.0% in the preceding year, largely due to *force majeure* at Keephills Unit 1. Revenue rose 4% to $2.3 billion, with a reported net loss of $71 million compared with a net loss of $615 million in the previous year, when the company booked huge impairment charges and write-downs.
- Comparable net income fell 31% to $81 million or $0.31 per share. Funds from operations registered a more modest decline of 7.5% to $729 million or $2.76 per share. Free cash flow rose 14% to $295 million or $1.12 per share.

Figure 1: TransAlta's comparable EBITDA – FY13 vs. FY12



Source: TransAlta http://www.transalta.com/

TransAlta also announced two initiatives that it said were required to enhance its ability to continue executing its growth strategy and remain competitive:

- The sale of its 50% interest in CE Generation, Blackrock development and Wailuku to MidAmerican Renewables, its partner in these holdings, for US$193.5 million.
- Reduction of its dividend to an annualized level of $0.72 per share ($0.18 per quarter) to align with its growth and financial objectives.

The company believes these initiatives will generate $120 million in free cash flow, which can be plowed back into growth. TransAlta also expects its free cash flow to be stronger and dividend payout more sustainable under a range of FFO scenarios (Figure 2).

Figure 2: TransAlta's dividend/FCF payout ratios under various FFO scenarios

Dividend and payout ratio aligned to business objectives, generating significant excess cash flow

$ millions	Range of Potential Cash Flows			
FFO Range	$ 750	$ 775	$ 800	$ 825
Sustaining Capital[1]	$ (350)	$ (350)	$ (350)	$ (350)
Pfd Share/Other Distributions	$ (100)	$ (100)	$ (100)	$ (100)
Free Cash Flow (FCF)	$ 300	$ 325	$ 350	$ 375
Common Share Dividends	$ (194)	$ (194)	$ (194)	$ (194)
Excess Cash Flow	**$ 106**	**$ 131**	**$ 156**	**$ 181**
Dividend/FCF Payout Ratio	**65%**	**60%**	**56%**	**52%**

[1] Average sustaining capital over a three year cycle

Source: TransAlta http://www.transalta.com/

TransAlta's CEO Dawn Farrell said in the post-earnings conference call that a priority for the company would be to improve the operating performance of its Canadian coal power fleet. While these assets have been underperforming due to unplanned outages, she said that the focus would be on operational discipline, rather than deployment of more capital, to drive returns back up to higher expected levels.

For 2014, TransAlta expects comparable EBITDA to be in the range of $1,015 million to 1,065 million, based on the current outlook for power prices in Alberta and the Pacific Northwest. Free cash flow is forecast to be in the range of $293 million to $343 million, based on sustaining capex of $350 million. Based on per-share FCF of $1.07-$1.26, the payout ratio (dividends/FCF) is a manageable 57% to 67%.

As noted in the previous section, TransAlta's dividend payout ratios appear totally unsustainable on the basis of net income, largely because reported net income has been affected by a number of non-cash charges. But on the basis of free cash flow – which is also a rigorous measure since it denotes the amount of cash flow available to support dividends after capital expenditures – the payout ratios appear sustainable, especially at the reduced dividend level. At the previous dividend level of $1.16 per share, the dividend burden was $310 million.

TransAlta does have growth initiatives such as its Renewables business and operations in Australia that may demand more capital. If these initiatives can provide better long-term returns to shareholders, the dividend cut by TransAlta may be justified.

DBRS said on Thursday that TransAlta's sale of its 50% interest in CE Generation and the dividend cut had mitigated the two main concerns it had highlighted in a March 2013 rating report – the company's high leverage and unsustainable payout ratio. With proceeds from the divestiture expected to be used to reduce debt, and the dividend reduction resulting in about $90 million in incremental cash flow (net of DRIP proceeds), DBRS expects TransAlta's adjusted debt-to-capital ratio (post the transactions) to be near 50%. It also expects the company's two other key metrics – cash flow to debt and EBITDA interest coverage – to be in line with TransAlta's BBB rating, at 15% - 35% and 4x-7x respectively.

In terms of valuation, TransAlta presently trades at a 2015 EV/EBITDA multiple of 8.8x, compared with an average 9.8x for the 11 other members of the TSX Utilities sub-index. This discount may persist until the company proves that it can execute on its growth plans.

Even on the basis of its lowered 5.3% dividend yield, TransAlta has the fourth-highest yield on the TSX-60. This may help support the stock, as long as investors are confident that no additional dividend cuts are forthcoming. While TransAlta stock could likely test support at the $13 level in the weeks ahead, our view is that this level should hold, given that it represents a 15-year low for the stock. In conclusion, although the dividend cut has been a nasty surprise, we believe it may have been the prudent thing to do. We are comfortable in recommending that investors hold the stock until there is concrete evidence of solid execution by management on the company's strategic initiatives. **Accordingly, we have revised our rating to Hold (from Buy), with a new target price of $15**.

Market Snapshot

At close on Friday, February 21, 2014

S&P TSX	14205.72	-4.65	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	1021.66	+6.73	Canadian $ (US cents)	90.02	-0.06	90 Day T-Bill	0.86	0.04
DJIA	16103.30	-29.93	Gold (Spot)-US$	1324.28	+1.34	2-Year Bond	1.01	0.31
S&P 500	1836.25	-3.53	Oil (WTI-April)	102.20	-0.55	10-Yr.Bond	2.51	2.73
NASDAQ	4263.41	-4.13	CRB Index	301.58	+0.33	30-Yr. Bond	3.01	3.69

Thought for the Day

"The difference between ordinary and extraordinary is that little extra." – Jimmy Johnson

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(1) The analyst and/or a member of the analyst's household have a long position in the following stocks discussed in this report –**TransAlta**

Research Rating System
Strong Buy: Expected total returns of 20% or more over the next 6 – 12 months.
Buy: Expected total returns of 10% to 20% over the next 6 – 12 months.
Speculative Buy: Significant gains expected over the next 6 – 12 months, but entire investment may be at risk.
Hold: Expected total returns of 0% to 10% over the next 6 – 12 months.
Reduce: Expected total returns of up to -10% over the next 6 – 12 months.
Sell: Expected total returns of over -10% over the next 6 – 12 months.

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