October 19, 2012

Transalta Corporation

So what did we decide?

We have decided to buy additional shares of Transalta Corp. Using a portion of the *Sample Balanced Investment Portfolio's* cash balance, we have invested $790.92 to purchase an additional 52 shares.

Why buy more shares now?

For a couple of reasons!

1. By purchasing an additional 52 shares the market value of the portfolio's investment in Transalta common shares will be restored to the original starting amount of $2,670.00.
2. Transalta's stock market price has fallen from $22.00, 12 months ago, for a decline equal to 31%.
3. Investors continue to value the shares ignoring the current dividend yield of 7.56%, indicating they believe the company cannot or will not continue the dividend payments at the current levels. This view may or may not be correct. We do not believe the company needs to cut the dividend, but, then again, the company may simply decide to cut the dividend in acknowledgement that Investors are unwilling to properly value the high current dividend yield, just as Telus and Transcanada did in the past.

What does the future hold for the shares?

At this time, we anticipate one of three possible future outcomes:

- Transalta cuts the current dividend payment to shareholders, as the share's current market price seems to suggest. If so, then the share price might decline below it's most recent lows ($13.96), but we believe the market has already reduced the price in anticipation of a dividend cut and the downside risk is reduced.
- The dividend is not reduced and investors continue to value the shares at today's discounted price (*Manitoba Telecom Syndrome*). In which case, we are happy to hold the shares and collect the high dividend income. Or,
- The dividend is not reduced and the company's revenues and profits improve in 2013/2014 helping to lift investors' valuation for the shares. This is the *perfect world, hoped-for* outcome, but we are not counting on it. With world economies slowing down, Transalta is facing some challenges to growing their revenue above the trends of the past three years. We do, however, believe the company's has strong management and will be able to maintain its profitability.

How will each outcome affect IFM's investment approach toward Transalta?

With each possible outcome in mind, our investment response would be as follows:

- If the dividend is cut = Continue to hold the current investment and possibly add to the number of shares held.
- If there is no reduction in the dividend and investors maintain the current low share valuation = Continue to hold the current investment – no addition to the number of shares.
- The dividend is not reduced and the company's revenues and profits rise = Continue to hold the current investment with no addition to the number of shares held.

What do you think of the company's current financial heath?

Transalta is a well-established utility with long-term assets and revenue agreements in place. A number of key metrics have improved over the past three years (see chart below) helping to provide a base for our investment decision.
For example, with the common shares trading close to their 2011 book value of $12.08, rising Comparable EBITDA, a Dividend Coverage Ratio of 3.6 times, a Return On Equity at 10.6%, and a common share *Cash* Dividend Payout Ratio, after the DRIP, of 27.00%, we feel comfortable adding to the existing investment held in the Sample Balanced Investment Portfolio.

Where is the Risk?

Transalta's shares are not *guaranteed* make money for investors in the coming years. As a private business operating within 3 distinct geographical locations (Canada, Western United States and Western Australia), using 5 different input fuels (coal, natural gas, hydro, wind and renewal) to generate electricity and selling the power to both cyclical (oil, gas and steel industries) and noncyclical buyers, Transalta is subject to numerous business risks, which are beyond management's control.

For example, lower coal and natural gas prices put pressure on the market pricing for Transalta's generated power, while at the same time the company benefits from lower prices for the input fuels (coal and natural gas) it use to generate power. The company's management must manage both sides of the business to ensure their profits do not suffer.
A few potential risks the company's management may need to address in the future are:

- Energy demand in Alberta does not meet the company's projection of 3.0%, annually, due to a slow down in oil sands production and a slowdown in Alberta's economy.
- A slowing U.S. economy negatively impacts energy demand and market pricing in this market segment.
- Slowing economies in China and Asia negatively impacts energy consumption from commodity producers in Western Australia.
- Transalta appears to making good progress in reducing its carbon foot-print, thereby minimizing any negative financial impact resulting from the government's Green House Gas regulations, but should the timeline for these regulations be shortened, Transalta may see a negative financial impact.

As stated earlier, we believe Transalta has a strong, experienced management team in place to handle these potential challenges, should they arise.

What does the investment industry say about Transalta?

According to the most recent report prepared by the Standard and Poors rating agency, there are 11 investment analysts following and making recommendations on the investment value of Transalta's common shares. Currently, of the 11 analysts covering the company's shares - 4 recommend investors *Buy* the shares, 7 analysts rate the shares as a *Hold* and 0 recommend the shares be *Sold*.
So it appears that either some investors have ignored the analysts' recommendations and sold, pushing the share's market price down 31% in the past year, or simply stopped buying.

Note: In the past year, Transalta has been very active raising new capital by issuing bonds, preferred and common shares. The underwriting fees generate by these new issues often make investment firm analysts reluctant to rate a company's shares as a Sell. As a result, some of the analyst reports may actually read as negative only to conclude with a Hold recommendation. When looking at analyst recommendations, we are more inclined to view the Buy/Hold/Sell ratings as a type of inverse indicator – Buy when the majority of analysts say to Sell & Sell when the majority say Buy! This is kind of like a reverse Herd mentality.

More background information you may find helpful.

Investment Basics: Common Shares

Trading Symbol:	TA/TAC
Stock Exchange:	Toronto/New York
Closing Price:	$15.21
Dividends/Share:	$ 1.16
Dividend Yield:	7.56%

Current Common share dividend payout ratios:

Without DRIP	87.0%
With DRIP	26.0% - 70% participation rate in DRIP

DBRS Credit Rating: Debt = BBB (Stable Trend); Preferred Shares = Pfd-3 (Stable Trend)

Company Background:
Beginning as a small, Calgary-based company in 1909, Transalta operates electric generating facilities in Canada (70.26% of revenue), the United States (25.31%) and Australia (4.43%). The company maintains ownership interests (8,386 megawatts) in 75 facilities with a total generating capacity of 10,259 megawatts of electricity.
Transalta's generates electricity using input fuels such as Coal (53.9%), Natural Gas (19%), Wind (19.0%), Hydro (11.2%) and Geothermal (2.0%).

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Basic Data *(million$)*:	**2011**	**2010**	**2009**	**Trend**
Revenue	$2,663	$2,673	$2,770	*Deteriorating*
Cash Flow From Operations	$694	$838	$580	*Improved*
Net Earnings attributable to Common Shares	$290	$255	$181	*Improving*
Comparable EBITDA	$1,077	$955	$888	*Improving*
Long-term Debt	$3,721	$3,823	$4,411	*Improving*
Total Assets	$9,760	$9,640	$9,760	*Stable*
Ratios:				
Debt to invested capital	52.40%	53.10%	56.10%	*Improving*
Return on common equity	10.60%	9.60%	6.90%	*Improving*
Return on Capital	8.80%	6.60%	5.70%	*Improving*
Earnings Coverage *(times)*	2.7	2.2	1.9	*Improving*
Dividend Coverage *(times)*	3.6	4.0	2.6	*Improved*
Per Share:				
Net Earnings Per Share	$1.31	$1.16	$0.90	*Improving*
Dividends Per Share	$1.16	$1.16	$1.16	*Stable*
Div. Payout Ratio based on net earnings	66.90%	125.10 %	129.80%	*Improving*
Div. Payout Ratio based on funds from operations	24.00%	39.60%	N/A	*Improving*
Book Value Per Share	$12.08	$12.85	$13.41	*Deteriorating*
Common shares outstanding *(millions)*	224	220	218	
Value of $100 invested in Transalta in 2001	$159.00	$151.00	$159.00	
Value of $100 invested in S&P/TSX Comp in 2001	$155.00	$175.00	$153.00	

**assumes dividends reinvested*

Source: 2011 Annual Report Transalta Corporation

Transalta Corporation a company Snapshot.

Note: The portfolio's Transaction History has been updated to reflect this purchase and a note has been added to the bottom of the portfolio report. The purchase will be included in all of the quarterly reports as at December 31, 2012.

Read Disclaimer: