TRANSALTA RENEWABLES INC.

RNW.TO. **SEPTEMBER 2015**

PORTLAND INVESTMENT COUNSEL™

Business Description:

TransAlta Renewables Inc. ("TransAlta Renewables") is a power producer domiciled in Canada with managed power facilities across Canada, an economic interest in a wind farm in Wyoming and structured ownership in a core set of Australian assets. Its Canadian operations are allocated into its Western Canadian wind facilities, its Eastern Canadian wind facilities and its hydro facilities. These Canadian facilities and the wind farm in Wyoming encompass 29 wind and hydro power generation facilities having an aggregate installed capacity of 1,283 megawatts ("MW"), with TransAlta Renewables holding a net ownership interest of 1,255 MW. The Australian assets are composed of 575 MW of power generation from six operating assets and the South Hedland project currently under construction as well as a recently commissioned 270 km gas pipeline. TransAlta Renewables net economic ownership in the Australian assets is 425 MW. The company is headquartered in Calgary, Alberta. Included in this business brief is information that was discussed with the management of Transalta Renewables in May 2015.

Overview and Investment Thesis:

- **Stable, Predictable Dividend.** TransAlta Renewables pays a high, stable monthly dividend that is currently yielding approximately 7%. The company's long dated power purchase agreements, its diversified portfolio of projects, its strong balance sheet, its access to future growth projects, its projected lower cost of capital and its managed counterparty credit risk all support the company's ability to provide a stable monthly dividend for shareholders. The company has flagged that it expects to grow its dividend by 6-7% once the South Hedland gas fired power station is fully commissioned in Australia in mid-2017. The South Hedland project is a part of the Australian assets acquisition, a transaction that was completed on May 7, 2015. The completion of this project is expected to increase cash available for distribution by 140%.
- **Long Dated Power Purchase Agreements (PPA).** TransAlta Renewables owns and operates quality power producing assets that allow the company to generate stable cash flows to its shareholders. TransAlta Renewables operates its facilities under PPAs which allow it to maintain the stability of its cash flows. Its PPAs have a capacity-weighted average contractual life remaining of 16 years, which allows the company the ability to finance future growth projects.
- **Diversification.** Geographically, the company owns assets in Eastern Canada, Western Canada, the United States and Australia. Operationally, the company has asset exposure in wind, hydro, gas fired power plants, gas pipelines, and transmission infrastructure. This mix of diversification both geographically and operationally reduces the asset risk within the company and will help the company support its stable cash flows.
- **Balance Sheet Receptive to Growth.** TransAlta Renewables sees its optimal capital structure as 50% debt and 50% equity. We believe the target capital structure is conservative and could be levered up if quality, stable, cash flow generating power producers become available to the company at the right price. The current capital structure of the firm is approximately 23% debt and 77% equity. A right-sizing of the firm's capital structure could cause the market to view the company in a more attractive light.
- **Dropdown of Assets.** The ownership structure of TransAlta Renewables is such that TransAlta Corporation owns 72.8% of its subsidiary, TransAlta Renewables. The term "dropdown of assets" is defined as the sale of assets owned by TransAlta Corporation to TransAlta Renewables as the purchaser of the assets. TransAlta Corporation is engaged in an ongoing debt reduction program which involves selling assets to TransAlta Renewables. Dropdowns of further assets from TransAlta Corporation should allow TransAlta Renewables to grow its cash available for distribution (CAFD) as well as issue debt and equity in the appropriate amounts to adjust the firm's capital structure. Assets that are candidates to be dropped down to TransAlta Renewables are 1,000 MW of gas fired generation facilities in Alberta and Ontario, 800 MW from 13 hydro units in Alberta, and a 99 MW contracted wind farm in Quebec as well as a 7 MW contracted hydro facility in Ontario.
- **Projected Lower Cost of Capital.** We believe the cost of debt to the firm could be lower in the near future as some of its higher interest rate unsecured corporate debt inherited from TransAlta Corporation comes due in the near term. Management of Transalta Renewables has indicated that it hopes to refinance this debt at lower interest rates and with short term credit facilities. Also, as the company takes on more debt through acquisitions, where it hopes to optimize its capital structure, management cites their intention to utilize lower interest rate project-level debt financings. Transalta Renewables may try and acquire an independent credit rating by the end of this year. The company expects it can attain an appropriate BBB mid credit rating to support future reductions in its cost of debt.
- **Managed Counterparty Credit Risk.** The company deems the counterparty credit risk assumed in its recent acquisition of the Australian assets as acceptable and the underlying assets of high operational quality.

Industry Growth Drivers/Trends: (Industry: Utilities):

- In June 2015, the G7 has committed to striving towards a low-carbon global economy by 2050 and a no-carbon economy by 2100, which highlights future anticipated growth in the renewable energy sector for the foreseeable future.
- Energy security, affordability and sustainability are issues that are expected to be touched upon in December 2015 at the Inter-Governmental Climate Change Summit in Paris where a robust climate change deal is expected amongst the developed nations. A tilt towards the development of renewable energy sources and away from fossil fuels can present significant opportunity to firms that have significant operational expertise in renewable energy.
- The 2015 Global Power & Utilities Survey by PricewaterhouseCoopers LLP cites 5 major megatrends in the industry over the next 5 years:
  - Technological Breakthroughs: Technological advances are being accompanied by price declines, especially in the cost of solar modules. A recent study completed by Deutsche Bank says that unsubsidized rooftop solar electricity costs anywhere between \$0.13 and \$0.23/kWh today, which is substantially below the retail price of electricity in many global markets.
  - Climate Change and Resource Scarcity: This has led to the global regulatory support of the development of renewable power and energy.
  - Demographic and Social Change: Africa already has over 120 cities with over half a million residents and 47 cities with over a million, spread out among 54 countries. Africa is home to seven of the world's megacities and it is expected that more than half of the global population growth until 2050 is expected to occur in Africa.
  - A Shift in Global Economic Power: The shift in global economic growth, for example, has led a number of European power companies to try to gain market share in fast-growth emerging markets such as those in Latin America and other overseas markets to offset near zero growth in Europe.
  - Rapid Urbanisation: This trend will increase the future usage of distributed energy and micro-grids.

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Competitive Advantages:

- Accretive projects from TransAlta Corporation are available to be dropped down to TransAlta Renewables. TransAlta Corporation is engaged in an initiative to de-lever its balance sheet by dropping down certain assets to TransAlta Renewables. This access to accretive projects will allow the company to sustainably grow its dividend well into the future. This is an advantage because TransAlta Renewables will not have to compete with other firms to acquire these dropped down assets.
- Experienced management team including President and Designated Chief Executive Officer Brett M. Gellner and Vice-President and Treasurer Todd J. Stack.
  - Brett M. Gellner has extensive experience in finance, valuation, economics, mergers and acquisitions, and commercial agreements. He has worked at CIBC World Markets in the Power & Utilities group and is an expert in this industry.
  - Todd J. Stack has held numerous roles in TransAlta Corporation's engineering and finance departments, serving as Assistant Treasurer and Director of Treasury. He has worked as a member of the corporate development team at TransAlta that worked towards the development of greenfield projects and acquisition opportunities.

Competitors:

- Utilities: Northland Power Inc., Innergex Renewable Energy, Inc., Brookfield Renewable Energy Partners LP, Emera Inc., Boralex Inc., Capstone Infrastructure Corporation, Pattern Energy Group Inc., Capital Power Corporation, Algonquin Power & Utilities Corporation, Fortis Inc., and Alterra Power Corporation.

Customers:

- TransAlta Renewables engages in long-term power purchase agreements with credit worthy customers. The current list of customers includes: Ontario Power Authority, BHP Billiton PLC, BC Hydro and Power Authority, Newmont Mining Corp, Energie NB Power, Fortescue Metals Group Ltd., Enmax Corp, Horizon Power, Hydro-Quebec, and TransAlta Corporation.

Barriers to Entry:

- **Initial Capital Outlays:** Greenfield power generation projects take several years to build and a substantial amount of capital to be spent in order to reach the commercial operation date of a project (COD). Entering the industry through acquisition of a portfolio of projects would entail raising a large amount of capital to acquire the properties and substantial management expertise from the new entrant to operate the portfolio efficiently.
- **Demand and Cost Uncertainty:** Entering this industry without a power purchase agreement is too risky since the price of electricity can be quite volatile over a project time horizon of 20 – 40 years for most electricity generation facilities.
- **Pricing Strategies of Competing Firms:** New firms would enter the industry through a PPA; however existing firms might be able to undercut and agree to producing power at a lower price than what a new firm could afford.
- **Regulatory Approval Barrier:** Costs and delays associated with securing regulatory approval can add to the dollar costs and lead times for a new entrant into this industry.

Officers and Directors:

- Leadership team: President and Designated Chief Executive Officer, Brett M. Gellner, Chief Operating Officer, Cynthia Johnston, Vice-President and Controller and Designated Chief Financial Officer, David J. Koch, Vice-President, Legal and Corporate Secretary, Maryse St.-Laurent, Vice-President and Treasurer, Todd J. Stack.

Corporate Governance:

- 6 member board – 4 members are independent.
- The company invests in renewable energy projects which help support the people, planet and profit initiative of global sustainability.
- **Environment and Sustainable Development Policy:** The company is committed to ensuring compliance with all environmental legislation, regulations, permits and licenses and to continuously improving its environmental performance.
- The compensation of TransAlta Renewables Board and its Corporate Officers is just under 0.4% of the company's operating income.
- The company pays TransAlta Corporation a general and administrative reimbursement fee to provide the company with general administrative services, including key management personnel services, as may be required or advisable for the management of the affairs of the company.

Ownership:

- Significant investors as at August 17, 2015 include: TransAlta Generation Partnership 37.4%, TransAlta Corporation 35.4%, Nuveen Asset Management LLC 0.9%, IA Clarington Investments 0.8%, and Cohen & Steers Capital Management, Inc. 0.5%.

Capital Allocation/Uses:

- TransAlta Renewables is focused on growing the company through accretive transactions that increase funds from operations and cash available for distribution. The ability to increase these two cash flow measures should allow the company to grow its dividend well into the future.
- The company expects to grow its dividend by 6-7% in 2017/2018 when the recently acquired South Hedland project in Western Australia comes online.
- For 2014, the company generated CAD$143.4 million of cash flow from operating activities, CAD$141.2 million of funds from operations, and CAD$89.7 million of cash available for distribution.
- Current dividend of CAD$0.84 per common share is 9% higher than for 2014 (CAD$0.77 in 2014) and yields about 7.00%.
- In early 2015, the company issued bonds secured by its Pingston facility for CAD$45 million. The bonds bear interest at an annual fixed interest rate of 2.95%. The proceeds were used to repay a CAD$35 million secured debenture bearing interest at 5.28%. The excess proceeds will be used for general corporate purposes.
- TransAlta Renewables has a U.S. dollar denominated loan from TransAlta Corporation that was used to finance the purchase of the Wyoming Wind acquisition. The loan is outstanding at an interest rate of 4.00%.
- TransAlta Renewables sustaining capital expenditures are comprised of the ongoing capital costs associated with maintaining the existing generating capacity of its facilities. Total sustaining capital expenditures for 2014 amounted to CAD$9 million and are expected to be CAD$7-9 million in 2015. Growth capital expenditures may exceed this and would be expected to be financed out of cash flow from operations, loans through TransAlta Corporation, debt issuances and/or equity offerings. Growth capital expenditures would be used to acquire certain drop down assets from TransAlta Corporation or other attractive projects.

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Financial Statement Summary		
CAD$ thousands, years ended December 31	**2014**	**2013**
Income Statement		
Total Revenue	233,444	245,341
Net Income attributable to common shareholders, continuing operations	48,658	52,922
Fully Diluted EPS, continuing operations	0.42	0.46
Return on Equity attributable to common shareholders, continuing operations	4.85%	5.15%
Balance Sheet		
Net Debt	634,729	665,850
Common Equity	1,002,908	1,027,769
Net Debt: Common Equity	0.63	0.65
Cash Flow Statement		
Funds from Operations	141,180	153,957
Cash Available for Distribution	89,734	142,495
Key Ratios and Figures		
Interest Coverage	2.8	3.39
TransAlta Corporation S&P Credit Rating	BBB-	BBB-

Business Segment Analysis:								
	Gross Installed Capacity (MW)		**Production (GWh)**		**Revenues (%)**		**Gross Margin (%)**	
Business Segment	**2014**	**2013**	**2014**	**2013**	**2014**	**2013**	**2014**	**2013**
Western Canada Wind	418	418	1,024	1,090	19.3	29.5	19.3	28.9
Eastern Canada Wind	616	616	1,580	1,428	64.6	59.1	64.7	59.8
Hydro	105	105	340	367	8.6	11.0	8.3	10.9
Wyoming Wind Farm	144	144	407	24	7.5	0.4	7.7	0.4
Total	1,283	1,283	3,351	2,909	100	100	100	100

Selected Quarterly Information				
CAD$ thousands	**Q3 2014**	**Q4 2014**	**Q1 2015**	**Q2 2015**
Revenue	42,596	72,870	68,156	51,277
Net earnings (loss)	(31)	21,665	19,650	7,167
Comparable earnings per share	-	0.19	0.17	0.14
Cash available for distribution per share	0.05	0.38	0.26	0.24

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Sourced from Thomson Reuters and Company Reports

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