Unloved and Undervalued: 6 Reasons to Be Bullish on Suncor

Description

By Matt Smith

Along with an unstable outlook, recent gyrations in the price of crude oil have created opportunities for investors among integrated oil companies. One of the most compelling is Canada's largest integrated energy company **Suncor** (TSX:SU, NYSE:SU), which recently reported its second-quarter 2013 results. Though the results were unimpressive, the company is well-positioned to improve its performance over the remainder of 2013 with a number of emerging positive catalysts.

Second-quarter results, in one word: disappointing
Suncor is an integrated energy company with both upstream (oil producing) and downstream (processing, refining, transport and infrastructure) operations. The company has a range of production operations both in Canada and internationally in conventional and unconventional oil and gas.

Suncor's second-quarter results were disappointing, particularly in light of the fact that global demand for energy is expected to continue growing significantly. Many analysts reappraised their outlook for crude and while it is still expected to fall in price, short-term demand has spiked.

For the second quarter, Suncor's bottom line was net earnings of $680 million ($0.45 per common share), a twofold increase year over year. But operating earnings and cash flow from operations declined year over year by 25% and 4%, respectively. The decline can be attributed to an 8% year-over-year decline in oil production for the quarter to an average of 500,000 barrels of oil per day, a result of both planned and unexpected maintenance outages.

The unexpected outages were caused by flooding in Alberta, as well as security issues and labor disputes in Libya. Suncor has also indefinitely suspended its Syrian operations because of the ongoing civil conflict.

Even still, I believe there are a range of catalysts that will boost Suncor's financial performance for the remainder of 2013.

1. Production will grow

The successful completion of planned maintenance events of Upgrader 1, the Edmonton refinery, and Firebag will allow normal production to resume at those facilities. In addition, a range of improvements were made to hot bitumen transport and storage infrastructure at Firebag and Suncor's Athabasca terminal, unlocking constrained capacity. These moves will increase operational flexibility and allow Suncor to optimize its sales mix going forward, all of which bodes well for increased production, margins, and profitability for the remainder of 2013.

Increases in production will also make up for any further softness in its price, allowing Suncor to generate higher revenue. But the price for crude — while appearing soft for the short-term — should start to pick up with supply-side constraints created by geopolitical tension in the Middle East.

2. The majority of production comes from lower-risk locations
More than 80% of Suncor's production comes from Canada and the U.S. alone, with the remainder coming from its international operations. Given that its primary business is in politically and economically stable countries, Suncor is less susceptible to production outages and other disruptions.

3. There's a focus on higher-margin oil production
Like many of its competitors in Canada and the U.S., Suncor is seeking to divest itself of those assets that are focused on the production of natural gas, while ramping up oil production. This move has been triggered by the uncertainty and low margins associated with producing natural gas.

Suncor divested itself of its western Canadian conventional natural gas business for approximately $1 billion. The sale excludes Suncor's natural gas properties in the Kobes region of British Columbia and its unconventional oil assets in the Wilson Creek area of central Alberta. It underscores Suncor's continued focus on its smaller unconventional oil and gas assets.

Suncor is expecting to recognize a gain on the completion of the transaction; it's expected that the proceeds will be returned to shareholders by way of a stock buyback (up to $1 billion), creating support for its share price.

4. Valuation
With Suncor trading with an enterprise value of five times EBITDA and 14 times proved reserves, the company appears quite cheap, particularly in comparison to other integrated oil companies. This includes **Chevron**, which reported some disappointing second-quarter 2013 results. Declining production and softer conditions for crude and refined products caused Chevron's net income to plunge by 26% year over year. Chevron now trades with an enterprise-value of just over five times EBITDA and 21 times its proven reserves.

For the same period, **Exxon's** bottom line also plunged because of softer conditions for crude and refined products — net income fell by 57% year over year. As a result, Exxon is trading with an enterprise value of six times EBITDA and 16 times its proven reserves, which are higher than Suncor's.

Suncor is also far better value than Canada's second-largest energy company **Enbridge**. Like its peers Enbridge delivered disappointing results for the second quarter, which has left it with an enterprise value of 21 times EBITDA. But it is difficult to make an apples-for-apples comparison with Suncor, because Enbridge is solely focused on energy transportation and distribution.

5. A healthy dividend yield

Suncor pays a healthy dividend of 20 cents per share, which equates to a yield of 2.4%. This dividend payment has been steadily appreciating in value, as the chart below illustrates.

suncor div

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Source: Suncor second-quarter 2013 report to shareholders for the period ended June 30, 2013.

While not sensational, this is certainly one of the better yields among integrated energy companies. As is the case with most dividend-paying companies, it is also essentially rewards investors for their patience, paying them to wait for the share price to appreciate.

6. Big news of the week
Finally, we should note the big news of the week: Warren Buffett, widely considered to be the world's greatest investor, has taken a bullish view on Suncor's prospects. At the end of June, Buffett's **Berkshire Hathaway** amassed almost 18 million shares, or just over 1% of Suncor, worth approximately $500 million. Berkshire Hathaway became the 16th-largest shareholder in the company.

Foolish final thoughts
In my view, it is clear that Suncor's potential is being undervalued by the market — and it seems that the world's greatest investor believes that as well.

While it may take some time for significant improvements to Suncor's performance to emerge, there's an upshot for investors willing to be patient: a steadily growing dividend and ongoing share buyback scheme.

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Matt Smith does not own shares of any companies mentioned.

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