



## What's Best of Breed in the Oil Patch?

### Description

How do you tell which companies are best of breed in the oil patch? Is it production growth, the price-to-earnings (P/E) ratio, or yield? No, the best metric in the investor toolkit is ROCE.

#### What the heck is ROCE?

One of the themes we have tried to emphasize here at Fool.ca is that growth for the sake of growth is not a desirable trait in a business. Sure, we like it when companies find new projects to grow profits — but only if they can generate a sufficient return to justify the risk. Otherwise, we shareholders would prefer if management paid us in nice dividends or share buybacks.

In the energy business, we have a very handy metric to determine how well management is allocating our capital: return on capital employed, or ROCE. I define ROCE as after-tax operating profit divided by the sum of debt plus shareholder equity.

Why is ROCE is so important? The ratio shows how much money is coming out of a business relative to how much cash is going in. This is important in industries that require a good deal of capital, such as oil and gas or semiconductor companies. In the energy business, ROCE is actually the preferred benchmark for comparing one company's performance against another.

#### So who's the best?

With that in mind, let's take a look at which large Canadian energy company has done the best job managing shareholder capital.

Company	ROCE 5-Year Average (%)
Imperial Oil	25%
Husky Energy	12%
Cenovus Energy	11%
Canadian Natural Resources	10%
Suncor Energy	8%

*Source: Company filings*

If this were a classroom, **Imperial Oil** ([TSX: IMO](#)) would be the teacher's pet. But these results shouldn't surprise anyone. Throughout the company's history, Imperial's executives have set a high bar to new investment by ensuring that only the most profitable projects receive funding. And when the company runs out of good opportunities, management has consistently returned excess capital to shareholders. While this strategy might not produce the biggest growth numbers, it's the most profitable philosophy for shareholders funding the operation.

In contrast, **Suncor** (TSX: SU, NYSE: SU) is the class clown. This might be shocking for some, given that Suncor was one of Canada's fastest-growing companies over the past decade driven by the Petro-Canada acquisition and oil sands expansion. But shareholders have paid the price for this growth. To expand, Suncor had to fund lots of low-return projects and reckless spending led to cost overruns. If that money had instead been paid out, investors might have found better opportunities elsewhere.

### **Should you bet on the teacher's pet?**

However, Suncor is getting its act together under the company's new Chief Executive Steve Williams. Since taking the helm last year, Williams has abandoned his predecessor's production targets, implemented a 15% return hurdle rate on new projects, and ramped up dividends and share buybacks. These measures should boost Suncor's ROCE in the future.

In contrast, I'm worried that Imperial is skipping class. The company's new Chief Executive Rich Kruger is talking about bold production targets rather than shareholder returns. Imperial is looking to double output to 600,000 bpd by 2020. And recent cost overruns at the company's Kearl oil sands project should be alarming.

### **Foolish bottom line**

It can't be emphasised enough — growth for the sake of growth is not a desirable quality in a company. As shareholders, we don't want to hear that executives are using our capital to build empires. Rather, management teams that deploy our capital the most efficiently should be judged as the best.

### **The Motley Fool's top two stock ideas**

The Motley Fool Canada's senior investment analyst just unveiled his [top two stock ideas](#) for new money now. And YOU can be one of the first to read his buy reports — just [click here](#) for all the details.

*Disclosure: Robert Baillieul has no positions in any of the stocks mentioned in this article.*

## **CATEGORY**

1. Investing

## **TICKERS GLOBAL**

1. NYSE:SU (Suncor Energy Inc.)
2. TSX:IMO (Imperial Oil Limited)
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