



The Future of Canada's Oil Sands Industry: Finding Value for Investors

Description

In recent weeks, I've examined the major challenges facing Canada's oil sands industry in depth. While [development and supply costs](#) along with [environmental impacts](#) were identified as issues, it is the lack of adequate [transportation infrastructure](#) that is shaping up as being key. This then leaves the final question for investors: Is the industry sustainable and if so, where does the real value lie for investors?

To recap

Much of the conjecture surrounding Canada's oil sands industry arises from whether it is truly sustainable. With growing environmental pressures and high development and production costs, prominent public figures have claimed that it is isn't sustainable. Jeremy Grantham claimed that oil sands assets over the next 10 years will become "stranded assets" and liabilities for the companies that own them and their investors.

Is oil sands production sustainable?

But it is clear that tremendous strides have been made across the sector to reduce development and production costs, as well as significantly reducing the environmental impacts. Canada is also located next to the key buyer of its crude production — the U.S.

Currently, the U.S. consumes 98% of the oil produced in Canada. Year to date, U.S. imports of Canadian oil have continued to grow — they are now up more than 10% year over year. Global demand for crude is also expected to continue rising, with the [U.S. Energy Information Administration](#) expecting global consumption to exceed global supply by as early as the end of March 2014.

So as long as the demand for oil continues to grow and the price of crude remains above the cost of development and production, the industry will remain sustainable. Even though the price of crude has declined from its 52-week high (hit in August), it is still above a level that gives industry participants a healthy profit margin.

This certainly makes Grantham's "stranded assets" statement appear premature. In stark contrast to Grantham, Warren Buffett and Bill Gates have recently taken the plunge into the industry, making

forays into **Suncor** ([TSX:SU](#))([NYSE:SU](#)) and **Canadian Natural Resources** ([TSX:CNQ](#)) ([NYSE:CNQ](#)), respectively. **ExxonMobil** also recently increased its exposure to Canadian oil sands projects.

Clearly, some big money players see significant opportunities in the industry, and given the long lead time for developing those assets (and therefore recouping any investment), it makes these pure long-term investments.

Where is there value for smaller investors?

When considering the issue of development and production costs, it is the large-cap integrated majors with upgraders and diverse sources of production that present the best opportunity and lowest risk.

These majors include Suncor, **Cenovus** ([NYSE:CVE](#)), **Imperial Oil** ([TSX:IMO](#)) (NYSE:IMO), and Canadian Natural Resources. All four companies generate the majority of their production from oil sands. But given their diverse operations, ability to upgrade bitumen to higher margin crude, and some significant efforts to minimize their environmental footprint, they are potentially attractive investments.

Investors seeking exposure to the industry may also consider energy majors that have a diversified portfolio of energy-producing assets, where bitumen is not the dominant portion of their production.

Opportunities along these lines include **Husky Energy** (TSX:HSE) and **Talisman Energy** (TSX:TLM) (NYSE:TLM) — where Canadian heavy crude or bitumen make up less than half of their crude production.

I'm skeptical that there is any value in the smaller players in the industry (e.g., Athabasca Oil) because of high development and startup costs, which have a significant impact on their earnings and cash flow.

A different way to play the sector is by obtaining exposure to those companies that provide critical infrastructure, particularly as this is fast-shaping up as the key issue.

Two of the key players in Canada's energy infrastructure are **Enbridge** ([TSX:ENB](#)) ([NYSE:ENB](#)) and **TransCanada** ([TSX:TRP](#)) ([NYSE:TRP](#)). But given the problems TransCanada is facing in obtaining approval for its Keystone XL pipeline in the U.S., this may be one company best avoided at this time.

Valuations

Let's have a quick look at valuation ratios of industry participants. Two key ratios that allow for an apples-to-apples comparison are enterprise value-to-EBITDA and proven oil reserves ratios.

Company	Enterprise Value (EV)	EV-to-EBITDA	EV-to-Reserves	Degree of Dependence Oil Sands**
Canadian Nat Res	\$46 billion	7	9	High
Imperial Oil	\$43 billion	9	12	High

Cenovus	\$29 billion	7	13	High
Suncor	\$60 billion	5	14	High
Talisman	\$17 billion	8	16	Low
Husky Energy	\$32 billion	6	26	Moderate
Athabasca Oil	\$2.6 billion	-101	40	High
Enbridge	\$57 billion	21	NA*	High
TransCanada	\$55 billion	16	NA*	High

Sources: Yahoo! Finance and Company Filings. *Enbridge and TransCanada do not have oil reserves. **Dependence was calculated by determining the portion of production and/or revenue derived from bitumen and Canadian heavy crude production.

Suncor and CNQ, Buffet's and Gates' go to names, stand out as potentially the most undervalued among the group when both metrics are considered.

Small-cap Athabasca looks the worst in this comparison, and is the most vulnerable to the issues affecting the entire oil sands industry. In my view, the company is a non-contender for any but the most risk-tolerant investors.

Infrastructure companies TransCanada and Enbridge appear expensive, and both are caught up with a range of issues affecting their financial performance. They're non-contenders for me as well.

Foolish final thoughts

It's too early to make the call that the industry is unsustainable. Too many dynamics are at play — world oil prices, global energy demand, environmental pressures.

Companies operating in the oil sands industry (with assistance from the Canadian government) are working hard to address their issues. Most interesting, the lack of investor interest of late has seemingly left many stocks attractively valued.

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2. NYSE:SU (Suncor Energy Inc.)
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