



3 Key Ratios to Use When Hunting for Value in Canada's Oil Patch

Description

Fellow Fool Robert Baillieul's recent article, "[What's Best of Breed in the Oil Patch?](#)" raised some interesting questions about how to value oil companies. Robert's conclusion was that the best valuation measure is return on capital employed (ROCE) — a metric he favours over the standard measures in an investor's tool kit such as the price-to-earnings or price-to-book-value ratios.

Notwithstanding that this is a useful measure of value, I believe investors must also look at a range of other industry-specific ratios — particularly those that measure an oil company's value in comparison to its oil production, profitability, and oil reserves.

The simplest of these ratios, which allows for an apples-to-apples comparison, is the enterprise value-to-EBITDA ratio. It takes into account a company's assets and debt (i.e., enterprise value) and then divides it by its earnings before interest, tax, depreciation, and amortization.

This ratio is superior to using the price-to-earnings or price-to-book-value ratios because it is capital structure neutral (because it includes debt). EBITDA is also a better measure of a company's core profitability because it measures profitability before the impact of interest and debt repayments. It also removes the distortive effects of the taxation policies of individual countries.

So the enterprise value-to-EBITDA ratio is a more appropriate measure for comparing companies that have different degrees of leverage and capital structures, with a variety of operations across different tax jurisdictions.

More considerations

Two other key measures used to evaluate oil companies: enterprise value-to-barrels of oil produced daily and enterprise value-to-oil reserves.

The first ratio allows investors to determine whether a company is trading at a discount to its peers, while the second measures how well a company's oil assets will support its operations. (In the case of both, like enterprise value-to-EBITDA, the lower the value, the cheaper the company.)

When looking at the table below, these ratios tell a far different investing story than using standard

measures such as price to earnings ratio or price to book value.

Company	Type of Company	Enterprise Value (EV)	EV-to-EBITDA	EV-to-Bbls Daily (\$'000)	EV-to-Reserves	P/E	P/ B
Suncor	Integrated O&G	\$60B	5	\$113	14	20	1
Canadian Nat Res	Integrated O&G	\$46B	7	\$72	9	25	1
Imperial Oil	Integrated O&G	\$43B	9	\$152	12	11	2
Husky Energy	Integrated O&G	\$32B	6	\$99	26	13	1
Cenovus	Large Cap Independent E&P	\$29B	7	\$168	13	37	2
Talisman	Large Cap Independent E&P	\$17B	8	\$48	16	350	1
Pacific Rubiales	S/Mid cap Independent E&P	\$9B	16	\$62	23	30	2
Athabasca Oil	S/Mid cap E&P	\$2.6B	-101	\$347	40	11	1
Whitecap Resources	S/Mid cap E&P	\$2.2B	11	\$122	36	35	2
Gran Tierra Energy	S/Mid cap E&P	\$1.7B	3	\$71	41	11	2

Sources: Yahoo Finance, Company Filings, YCharts.

As the chart illustrates, the standout performer on the basis of enterprise value-to-EBITDA is **Suncor** ([TSX:SU](#)) ([NYSE:SU](#)), indicating that the market has yet to recognize the strength of its core profitability.

But on the basis of enterprise value-to-reserves, the standout candidate is **Canadian Natural Resources** ([TSX:CNQ](#)) ([NYSE:CNQ](#)), which suggests that the market has yet to fully recognize the value of its oil reserves. **Imperial Oil** ([TSX:IMO](#))(NYSE:IMO) is also attractively valued on the basis of this ratio.

All three companies are strong contenders for investors because they have considerable oil reserves, strong core profitability, and, in comparison to their peers, they appear undervalued.

They also appear far better value for investors on the basis of their enterprise value-to-EBITDA, oil reserves, and barrels of oil produced daily than many of the smaller companies listed. This is because as integrated oil and gas majors, they are able to access greater economies of scale and utilize their downstream operations to hedge against wider price spreads.

They also have considerably larger resource bases, minimizing their exposure to the risks that come with investing a considerable portion of financial resources in exploration and development. Investors only need to look at Athabasca Oil's valuation ratios to see the impact that high capital expenditures on exploration and development with low production has on a small-cap oil explorer and producer.

Foolish final thoughts

There is no one magic ratio that allows investors to readily determine if a particular company is undervalued. Investors need to ensure that they not only consider a range of ratios but that they choose those metrics that allow for apples-to-apples comparisons.

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Disclosure: Matt Smith owns shares of any companies mentioned.

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