



Canada's Oil Patch: What Happened in 2013 and What to Expect in 2014

Description

2013 will go down as a mixed year for Canada's oil patch. On one hand, higher oil prices and depressed share prices among the main players in Canada's oil patch generated considerable interest among institutional investors (including none other than Warren Buffett).

There was also a flurry of activity in the space as integrated international energy majors sought to boost their exposure to the patch by buying up unconventional Canadian oil sands and shale assets.

And yet, infrastructure and transportation issues and growing U.S. domestic production continue to pose a threat to the profitability of oil patch producers. It's imperative that investors reflect on what happened in 2013 to try to understand how things might unfold in 2014.

2013: The year M&A activity plunged

One of the biggest deals in Canada's oil patch in 2013 was the **ExxonMobil/Imperial Oil** ([TSX:IMO](#)) acquisition of **ConocoPhillips'** Clyden oil sands assets for \$720 million. **Chevron** also joined the fray, acquiring all of **Alta Energy's** interests in the Duvernay shale formation for just under \$1 billion.

Despite this activity, mergers and acquisitions in the patch plunged by 80% in comparison to 2012, according to IHS Herold transaction research. I find it unlikely that the patch will see the same degree of activity in 2014 as in 2012. Many oil majors are reticent to open their checkbooks and acquire oil sands assets with other unconventional assets — in some cases, higher-quality, lower-development-cost assets — becoming available.

Valuations still appear cheap

Despite renowned investment manager Jeremy Grantham, co-founder of \$106 billion Boston-based investment manager GMO, calling oil sands assets "stranded assets" in February 2013, institutional investment activity continued throughout the year.

With many companies operating in the sector trading at low valuation multiples, and with rising crude prices and narrowing discounts between West Canada Select and the benchmark West Texas Intermediate, the patch appeared increasingly attractive. One of the biggest investments was Warren Buffett's foray into **Suncor** ([TSX:SU](#)); Buffett's **Berkshire Hathaway** acquired just over 1% of the

company, a stake worth around \$500 million.

My preferred valuation metrics for oil patch participants are enterprise value-to-reserves and EBITDA, and these metrics show that some of the major players are undervalued.

Company	EV-to-Reserves	EV-to-EBITDA
ExxonMobil	18	7
Chevron	21	5
Suncor	14	5
Cenovus	13	7
Imperial Oil	12	9
Canadian Natural Resources	9	7

Source data: Company reports.

They look especially attractive when compared with the multiples of international integrated energy majors ExxonMobil and Chevron.

The market doesn't seem to be factoring in the value of the oil reserves of Canada's major oil sands producers. From the table above, **Canadian Natural Resources** ([TSX:CNQ](#)) appears to be the best value on the basis of its enterprise value-to-reserves followed by Exxon Mobil controlled Imperial Oil.

But to an extent this is driven by the high development costs associated with developing oil sands assets and the high historical discount in the price of Canadian crude against West Texas Intermediate.

Lack of transportation infrastructure will continue to be a key hurdle

A major issue affecting the sector is transportation bottlenecks. There's simply insufficient pipeline available to meet transportation demand. This came to a head in 2013 as approval of **TransCanada's** Keystone pipeline remained mired in political deadlock. The Keystone pipeline would provide the key southern segment that would allow Canada's oil producers to access U.S. Gulf Coast refineries.

But with **Enbridge's** Northern Gateway pipeline now [recommended for federal approval](#), there is certainly light at the end of the tunnel in 2014. Not only will the Northern Gateway pipeline boost transportation capacity, it will also give producers increased access to lucrative Asian energy markets.

This will reduce dependence on the U.S. as a key export market — particularly important considering

that the U.S. is experiencing its own shale oil boom, with domestic production growing rapidly. Many market analysts predict a decline in the demand for Canadian crude from the U.S.

Transportation of crude by rail is also set to increase in 2014. Last year, the volume of crude transported by rail had exploded — it was up 220 times the levels transported in 2009. With a number of new crude rail terminals under construction across Western Canada, the volume of crude transported by rail will continue to grow in 2014.

While this certainly helps to boost transportation capacity and alleviate the transportation bottlenecks, it is also becoming increasingly attractive for oil sands producers. While rail transportation is more expensive than pipelines, it does not require the addition of costly diluents, reducing costs by up to 30%. As such, until more pipeline capacity becomes available, the rail transportation of Canadian crude will continue to be an attractive option in 2014 and beyond.

Higher oil prices + lower price differentials = a boost in profitability

With mounting concerns over the crisis in Syria and supply shortages caused by production disruptions in Iraq and Libya, the price of crude spiked to new 12-month highs in 2013. Add to that the decreasing price differential between West Canada Select heavy crude and West Texas Intermediate, and 2013 brought growing profitability to producers in the oil patch.

The price of crude has softened since August, but it still remains above \$90 per barrel. The price differential between West Canada Select and the benchmark West Texas Intermediate should continue to close, so I expect the profitability of major operators in the patch to continue to grow through 2014.

But the greatest threat to the patch is growing U.S. oil production. The International Energy Agency expects the U.S. to become energy self-sufficient by 2035, boosted by our neighbor's shale oil boom and increasing energy efficiency. Obviously, that would have a significant impact on U.S. demand for Canadian oil and underscores the need for Canada's producers to access crucial Asian energy markets.

The Foolish bottom line

Canada's oil patch continues to face a number of hurdles as it seeks to outgrow its environmentally tarnished image, boost transportation capacity, and access key emerging energy markets. While 2013 was a particularly volatile year, 2014 is shaping up to hold considerable promise for many of the patch's major players and investors.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:CNQ (Canadian Natural Resources Limited)
2. TSX:IMO (Imperial Oil Limited)
3. TSX:SU (Suncor Energy Inc.)

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