Is Canadian Oil Sands Worth the Risk?

Description

It has been a tough year in the patch for oil sands operators, with rising costs eating into their bottom lines and the pipeline crunch continuing to affect their ability to get their product to crucial U.S. refining markets. This has seen a number of oil sands projects halted or put on the back burner, with analysts and operators in the patch casting doubts over the profitability of a number of projects.

This increasingly negative outlook, coupled with a range of internal issues, has seen one of the patch's biggest producers of synthetic crude, **Canadian Oil Sands** (TSX: COS), cut its 2014 guidance, with forecast production revised downwards. Such a move doesn't signal well for the company's profitability or dividend growth, leading some analysts to downgrade their outlook for the stock from a sector perform to underperform.

This is despite stronger fundamentals, including higher crude prices and narrowing price differentials for Canadian crude blends to WTI, which should result in stronger financial performances in the patch.

What does the revised full-year guidance mean for investors?

Already over the last year, Canadian Oil Sands' share price has performed strongly, spiking a healthy 12% for that period. This, coupled with a dividend yield touching 6%, makes it a promising growth investment. However, the jury is out about whether the company can continue to maintain that momentum for a variety of reasons, the most troubling being the downward revision of its 2014 guidance.

At the end of the first quarter of 2014, the company's production had fallen by 6% compared to the previous quarter but grown a healthy 10% when compared to the equivalent period in the previous year. The key drivers of this worse-than-expected performance were a series of production outages caused by interruptions in the extraction and secondary operations units of its upgrader.

As a result of these outages and unforeseen maintenance requirements, as well as scheduled maintenance, Canadian Oil Sands has been forced to downgrade its production forecast for 2014.

The updated forecast sees full-year 2014 Syncrude production revised downwards by 5% to 100,000 barrels daily and operating expenses rising 6% to $1.7 billion, or $46.08 per barrel. As a result, despite realized Syncrude prices being expected to jump a healthy 9% compared to the previous guidance issued in January 2014 because of stronger fundamentals, cash flow from operations will grow only a modest 3%.

These maintenance problems and production outages can be primarily attributed to the highly complex nature of the process required to turn bitumen into light sweet crude. Furthermore, this is a costly process that requires significant capital expenditures in order to maintain its sustainability and operations.

On a positive note, Syncrude typically trades at a premium to WTI, meaning Canadian Oil Sands is not seeing its earnings affected by the significant discount at which Canadian heavy crude trades at compared to WTI. At the end of May 2014, despite the price differential narrowing significantly over the last year, this discount was almost 23%.

Will the dividend continue to grow?

Canadian Oil Sands also pays one of the highest dividend yields in the patch. It’s touching 6%, making it a compelling investment for income-hungry investors. However, the lower-than-expected guidance, coupled with cash flow remaining relatively flat, does not bode well any dividend increase and perhaps even hints at unsustainability.

The last dividend increase was way back in the first quarter of 2012, when the dividend increased a healthy $0.05 per share, or by almost 17%, to the current $0.35 per share. Since then it has remained unchanged, and given the revised production guidance and flat cash flow growth, it will remain so for the rest of this year.

Despite first-quarter net income dropping 13% quarter-over-quarter and 5% year-over-year, the dividend has an average payout ratio over the last eight quarters of 81%, indicating that the dividend is sustainable. It also indicates that there is some room to accommodate a further decline in net income caused by the revised production guidance.

While Canadian Oil Sands’ juicy dividend yield may be particularly attractive for investors, ongoing production outages, maintenance issues, and rising costs leave it poorly positioned to take advantage of the stronger fundamentals we are now seeing. Thus, I do not believe it to be the best investment opportunity in the patch at this time.

CATEGORY

1. Investing

Category

1. Investing

Date
2025/10/02
Date Created
2014/06/13
Author

mattdsmith