Can Suncor Energy Inc. and Imperial Oil Limited Endure Lower Oil Prices?

Description

The price of oil has been in a bull market for the past 14 years, only interrupted during the 2008-09 financial crisis. For the past 10 years, the Brent crude price averaged $85 per barrel, which was high enough for oil companies to make abnormal profits and spend considerable amounts on exploration and the establishment of new production capacity.

The recent sharp decline in oil prices thus poses the question: Has the bull market in oil has run its course?

Despite declines of 15%-20% from recent peaks, many analysts expect the relatively high oil prices of the past few years to continue for the foreseeable future. A recent Reuters poll of 30 analysts indicated that Brent crude oil would average $103/barrel in 2015. This compares to the average price for the past year of $105/barrel. West Texas Intermediate, or WTI, is expected to average $96/barrel next year — compared to $99 so far this year.

However, this consensus forecast may be wrong and oil companies may be faced with considerable lower prices for their products in the foreseeable future. From an investor's perspective, it is important to determine how sensitive the profits of some of the big-name oil producers could be to lower oil prices.

The profits of oil producers are highly sensitive to oil prices

Numerous factors play a role in the profitability of the Canadian integrated oil producers, including benchmark oil prices, the price differential between benchmark oil prices and the price received for locally produced oil, refining margins, and the movement in the Canadian dollar exchange rate. Despite being a complicated exercise with several moving parts, many publicly listed oil companies provide an estimate of the impact of important variables on their profitability by isolating the single most important profit drivers.

Suncor Energy Inc. (TSX: SU)(NYSE: SU) is an integrated oil producing, refining, and marketing business. The company estimates that based on the 2013 financial sensitivities, a US$1 decline in crude oil prices would detract roughly 2.5% from annual profits, assuming that all other factors including refining margins and the exchange rate remain unchanged. Based on an oil price lower by $10/barrel in 2015 compared to 2014 and assuming all other factors remain unchanged, Suncor's profits could be 25% lower in 2015.

Imperial Oil Limited (TSX: IMO)(NYSEMKT: IMO) is another of the major integrated Canadian oil and producers with major refinery and retail capabilities. The company estimates that a US$1 decline in crude oil prices would detract 1.9% from the annual profit. Based on the 2013 sensitivities and assuming all other factors remain unchanged, this implies that the companies' profits could be 19% lower in 2015, should the reference crude oil price decline by 10% compared to 2014.

Canadian Natural Resources Limited (TSX: CNQ)(NYSE: CNQ) estimates that a $1/barrel decline in crude oil prices (as measured by the WTI price) will shave 1.7% from the annual operating cash flow and 5.4% from the net profit.

A much lower oil price in 2015 will hurt the major Canadian oil companies

Consensus forecasts for crude oil prices in 2015 do not indicate major changes from the 2014 levels. However, if crude oil prices continue to decline into 2015 resulting in considerable lower average oil price realisations for producers, the impact on the profitability of the major oil producers could be substantial. The blow may to some extent be softened by increased production volumes or a weaker Canadian dollar.

Investors would do well to hold off any purchases in these shares until oil prices have stabilised.

CATEGORY

1. Energy Stocks
2. Investing

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1. NYSE:CNQ (Canadian Natural Resources)
2. NYSE:SU (Suncor Energy Inc.)
3. NYSEMKT:IMO (Imperial Oil Limited)
4. TSX:CNQ (Canadian Natural Resources Limited)
5. TSX:IMO (Imperial Oil Limited)
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Author
deonvernooy