Why Did Suncor Energy Inc. Shares Rise on Weak Earnings?

Description

On Oct. 29, **Suncor Energy Inc.** (TSX: SU)(NYSE: SU) released its third-quarter earnings report. Earnings were generally considered weak, largely due to a 46% decrease in net earnings from the third quarter of 2013, with total production also falling 12%, from 595,000 bpd to the current 519,000 bpd.

Much to Suncor shareholders' surprise, though, Suncor shares did not decline, but rather rose steadily about 3% over the following two days, from $38.84 to around $40 at close on Friday.

When share price does not decline in response to weak earnings, it can often say something about a stock's valuation. Here's what it means for investors.

The earnings release

What were the key takeaways from the earnings release? As mentioned earlier, the key headline was the 46% drop in net earnings and 12% decline in total production.

On a more positive note, though, Suncor reported operating earnings of $1,306 million, or $0.86 per share, which exceeded analyst estimates for Q3 2014 of $0.78 per share by 10%. Operating earnings can be a more useful measure than net earnings, since the former excludes non-operating expenses, and gives a good sense of a company's true earning power minus any once-off, non-operating expenses.

Although total production did decrease due to several planned maintenance activities at Suncor's Buzzard and Terra Nova projects, this decrease was offset to a degree by record production from Suncor's oil sands operations.

Why did the shares rise?

Despite weak results in the net-income area, shares rose. This is very likely due to the fact that the market has already priced in weaker earnings as a result of poor oil prices. The almost 20% drop in Suncor shares during September and early October, following a similar decline in WTI prices, was the market reacting early to coming weak earnings.

This means that there is likely little downside left for Suncor shareholders, especially if oil prices have stabilized. There is even evidence to suggest that the market has over-reacted to the oil price decline. For example, energy stocks are the cheapest relative to the TSX since 2004, and valuations are even lower than they were when oil was trading at half of its current price during the financial crisis.

Should you buy?

With energy stocks trading at historically cheap valuations, and much of the downside from oil prices for Suncor already being priced in, the rationale to buy seems strong. Taking a deeper look at Suncor's Q3 earnings release, however, reveals an even better rationale: Suncor demonstrated the ability to maximize its integrated model to produce solid earnings and control costs.

It is important to look beyond the net-income result to get a true sense for Suncor's performance. In Q3, Suncor's net income of $919 million was largely the result of $394 million foreign-exchange charge on its U.S. debt. Using the operating earnings result of $1,306 (which beat analyst estimates) is better for this reason.

Suncor was able to offset lower upstream pricing and show quarter-over-quarter growth in operating earnings thanks to excellent results from Suncor's refining segment, which showed 35% earnings growth over last year.

Suncor has been increasing its rail capacity to its Montreal refinery in Q3, which allows the refinery to use cheaper inland crudes, rather than the more expensive, internationally priced crudes. This is part of Suncor's goal to convert its Montreal refinery into a 100% inland refinery by mid-2015.

In addition, Suncor also managed to reduce its oil sands operating costs to $31.10 bbl in Q3, down from $32.60 in the prior year's Q3. This was due to record oil sands production and Suncor's ability to spread its fixed oil sands costs over a large number of barrels. According to Suncor CEO Steve Williams, this should continue to decrease.

With Suncor showing strong free cash flow and a healthy balance sheet, the company is capable of delivering strong results even in weak conditions, and this is a good time to consider purchasing.

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