Is Canadian Oil Sands Ltd.'s New Dividend Sustainable?

Description

Investors in **Canadian Oil Sands Ltd.** (TSX: COS) likely weren't shocked when they awoke on December 4 to a massive 45% reduction in their dividend – from $0.35 cents to the new dividend of $0.20 cents per share.

Canadian Oil Sands is a pure-play oil sands company that produces 100% high quality sweet synthetic crude oil. As a result, it has an extremely high sensitivity to oil prices, with a $20 reduction in WTI prices estimated to shave a full dollar per share off cash flow from operations.

With one of the highest yields on the TSX, Canadian Oil Sands dividend simply was not sustainable. The question is, will the new dividend be sustainable through 2015, or are more cuts on the way?

Before the cut

Canadian Oil Sands announced the dividend cut as part of their 2015 budget announcement, citing the current dividend as being unsustainable. Canadian Oil Sands is targeting net debt levels of between $1-2 billion, and with a net debt of $1.7 billion as of September 30, maintaining the current dividend would quickly increase the net debt above the target range.

Although shareholders were understandably upset, sending Canadian Oil Sands shares down by 16% on the news, it was an prudent decision by management, especially given the extreme weakness in WTI prices.

From January to September 2014, Canadian Oil Sands increased its net debt from $944 million to the current $1.7 billion, a staggering increase for a nine-month period. The reasons for this increase were threefold. First, capital expenditures were elevated throughout 2013-2014 due the company undergoing two major capital projects. Second, Canadian Oil Sands was funding an oversized dividend, totalling $678 million in 2013. Finally, cash flow from operations declined due to oil price weakness.

The result was that Canadian Oil Sands capital expenditures and dividend exceeded its cash flows, and as a result the company had been slowly dwindling its cash supply, which was left over from when the company generated free cash flow, as well as from a $700 million bond issue from 2012.

Canadian Oil Sands saw its cash position fall from $1.5 billion at the end of 2012, to $82 million at the end of Q2 2014. That was not enough to fund its dividend, and Canadian Oil Sands was forced to draw $200 million from its credit facility in the recent quarter, further increasing net debt.

Is it now sustainable?

Fortunately, after the dividend cut, the picture for Canadian Oil Sands in 2015 seems much more optimistic. First, the company's major capital projects are coming to a close, and as a result, Canadian Oil Sands is projecting capital expenditures of about $564 million in 2015, down from over $1 billion for the trailing 12 months.

In addition, Canadian Oil Sands is expecting cash flow from operations for 2015 of $730 million, based on a WTI price of $75 per barrel. Assuming oil prices remain near current levels, this would give Canadian Oil Sands free cash flow of $166 million. The new dividend would cost approximately $388 million, which means Canadian Oil Sands would still need to rely on its cash supply, debt, or equity issues, but its net debt would rise at a much more manageable rate.

With a strong balance sheet, Canadian Oil Sands seems very capable of maintaining its dividend throughout 2015 and possibly 2016, while maintaining its net debt under $2 billion, even if oil prices remain the same. With many analysts predicting that oil prices have bottomed out, we should see a rebound in 2015 or 2016, which will secure Canadian Oil Sands' dividend for the long term.

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1. Energy Stocks
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