



Canadian Oil Sands Ltd.: Why the Potential Dividend Cut Could Be a Great Buying Opportunity

Description

Value investors are wired a little differently from the rest of the market.

Most of the time a company is valued on a multiple of its potential earnings. If the earnings are thought to be high quality or growing at a fast pace, a company will get a higher valuation. It's why a high-flying technology stock will have a much higher P/E ratio than a company like **Yellow Media Ltd.** ([TSX:Y](#)), which trades at just 4.6 times its earnings. The market doesn't believe Yellow Media can sustain its earning power, probably because its main business is the Yellow Pages, the phone book most people under 60 have abandoned in favor of the internet.

Sometimes, companies run into problems and the market doesn't really know how to value them. Regular investors sell because the potential earnings look to be suspect, which causes the stock to head lower. Once a stock is low enough, value investors will start sniffing, usually at a discount to book value. This investor will ride out the storm until earnings come back, and then sell the company back to someone who values it on earnings again, usually for a pretty good profit.

The trick is to identify companies that have a shot of recovering. I think this type of situation is about to play itself out with **Canadian Oil Sands Ltd.** ([TSX:COS](#)) and the company's seemingly generous 10.1% annual dividend.

Let me explain a little further.

With oil hovering below \$50 per barrel, Canadian Oil Sands cannot afford to pay investors a 10% dividend. With oil so low, it can barely afford to pay all its capital expenditures and operating expenses without losing money on each barrel of oil it extracts from the ground. Even though it owns more than 36% of the Syncrude project, the facility is operated by **Imperial Oil Ltd.** ([TSX:IMO](#))([NYSE:IMO](#)), which owns just a 25% stake. This puts Canadian Oil Sands in the tough spot of knowing it needs to get costs down, but having very little leverage to do so.

The company's next dividend will be declared on February 1, and is scheduled to be paid out

sometime during the middle of that month. Unless the price of oil heads up quickly between now and then, look for the dividend to be cut again, for the second time in just three months. But unlike the cut in November that sent the quarterly payment from \$0.35 to \$0.20 per share, it's likely this one will eliminate the dividend completely.

This could send shares reeling. Many dividend investors dumped the stock after the first cut, but some were convinced to hold on and collect the smaller dividend. Those investors will likely head for the exits once the dividend is completely gone.

But for value investors, it could represent a great buying opportunity.

Look at it from this perspective. Based on its share of the Syncrude project, Canadian Oil Sands is sitting on approximately 2.5 billion barrels of crude oil, 1.9 billion of which are easily recoverable using today's technology. Based on the company's enterprise value of \$5.8 billion, investors are paying \$2.32 for each barrel of oil in the ground, and that's with all the equipment already in place to extract it. And those reserves will likely get cheaper on any piece of bad news — like a dividend cut.

During the summer when oil peaked at more than \$105 per barrel, those same reserves were worth \$5.50 per barrel, or nearly 2.5 times more than today. There's no reason to believe the company wouldn't be worth a similar amount in a future with higher oil prices, which would represent a 200% gain from today's low levels. It's only a matter of when we can expect this, since oil is expected to be weak in the short-term.

Bottom line? If you think like a value investor and look at picking up distressed assets, Canadian Oil Sands could be a great buy in a couple of weeks if it eliminates the dividend. It might take the stock years to recover, but there's some serious upside opportunity when oil goes back over \$100.

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1. NYSEMKT:IMO (Imperial Oil Limited)
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