Does Canadian Oil Sands Ltd. Deserve a Second Look?

Description

There is widespread pessimism surrounding **Canadian Oil Sands Ltd.**(TSX:COS), and perhaps rightly so. One of Canadian Oil Sands' biggest draws for both retail and institutional investors was its high 10%+ dividend yield, which was slashed 85% from $0.35 to $0.05 per share.

Couple this with Canadian Oil Sands' entirely unhedged 100% synthetic crude production profile, and their single-asset exposure to the Syncrude mine, and the case seems bearish.

There is, however, reason to be optimistic for patient investors who are willing to take a long-term view.

Oil prices are likely at, or near, a bottom

Canadian Oil Sands is a pure-play oil company, and due to the entirely unhedged nature of their production, can be seen as a direct leveraged play on the price of oil. As a result, when WTI prices fell 50% in September 2014 to the current bottom in mid-March, Canadian Oil Sands had a 60% decline during the same period.

The sensitivity of Canadian Oil Sands' share price to WTI prices is a result of the extreme sensitivity of their cash flows to WTI prices. Currently, Canadian Oil Sands estimates that a $10/bbl increase in WTI prices would result an enormous 80% increase in cash flow.

This is bad news if you're bearish on oil, but it can be an opportunity if you're bullish or neutral. The price of oil is notoriously difficult to predict, but there are a few economic factors that are providing support to the current price levels. First, break-even costs for thermal in-situ oil sands projects are US$47/bbl. This is a critical point and it is unlikely that oil prices could stay depressed below these levels for long.

Second, although U.S. crude inventories have reached an all-time high at 466 million barrels, the Energy Information Administration expects non-OPEC production growth to decline by 54% in 2015and by another 40% in 2016. This is on the back of Saudi Arabia increasing prices for Asian buyers,and refineries restarting after routine seasonal maintenance—both positive demand indicators in theshort term.

With production declining, there seems to be little pushing oil lower, and this is indicated by the behaviour of oil prices over the past several months, which have seemingly stabilized.

Canadian Oil Sands has a low capital expense base

Canadian Oil Sands' only asset is its 36.74% interest in the Syncrude project. On one hand, this is risky since it gives the company less flexibility. On the other hand, Syncrude, has a non-declining production profile. This means that Canadian Oil Sands is not on a reserve-replacement treadmill like many other companies, where constant sustaining capital spending is needed to maintain production.

The result is that when oil prices return to reasonable levels, Canadian Oil Sands has the potential to see significant free cash flow. For example, Canadian Oil Sands is anticipating approximately $451 million in capital expenditures in 2015 (about $347 million of which are essential maintenance expenses, the rest being growth). If WTI prices were to recover to US$65/bbl, this would result in $660 million in cash flow, according to company filings, giving Canadian Oil Sands $208 million in free cash flow.

This would be enough to cover, and likely increase, its current $97 million dividend.

What if prices stay at current levels?

With CAD$60.75/bbl for its Syncrude asset and current WTI prices being about CAD$66/bbl, Canadian Oil Sands is still cash flow positive, and is benefiting from the weak Canadian dollar. When major capital projects are factored in, however, Canadian Oil Sands is estimating -$83 million in free cash flow, assuming oil prices stay near current levels.

With a $1.5 billion largely undrawn credit facility, the company has the liquidity wait out any weakness, and there is further potential for $105 million in further cost reductions that could create positive free cash flow.

For investors with a long-term focus who can stomach near-term risk, current price levels are an opportunity to gain ownership in the 40+ years. The non-declining Syncrude asset is a very affordable 1.2 times book value—the lowest in over six years. With a bargain like this, Canadian Oil Sands definitely deserves a second look.

CATEGORY

1. Energy Stocks
2. Investing

Category

1. Energy Stocks

2. Investing

Date
2025/08/26
Date Created
2015/04/10
Author
amancini