How Low Can Canadian Oil Sands Ltd.'s Dividend Go?

Description

Canadian Oil Sands Ltd. (TSX:COS) broke a rather unfortunate record earlier this year by declaring a $0.05/share dividend—the lowest ever recorded for the firm. The dividend represented a 75% reduction, and many argued that the company should have just eliminated the dividend entirely, instead of simply leaving a "token" dividend.

While the current 1.8% yielding dividend may not seem like much, there are very good reasons to think it is here to stay, even if oil prices decline another $5/bbl. Let me explain.

The current situation with Canadian Oil Sand's dividend

In 2014 Canadian Oil Sands saw pressure on its cash flow from operations from reduced production volumes and a decreased realized oil-selling price. Volumes decreased from 98,000 to 94,500 barrels per day, and utilization rates declined from 76% to 73%, largely due to reliability issues from their Syncrude mine. These included unplanned outages at a major coker and at a sour water treatment facility, which limited upgrading capacity.

As a result, Canadian Oil Sands saw a 52% decline in cash flow. In 2014, with their previous $0.34/share dividend, total annual dividend costs equaled a huge $678 million. This doesn't even include capital expenditures, which totaled $981 million. The result is that the company saw a short fall of -$231 million, which it needed to fund by drawing on its credit facility and using cash previously left over from a bond issued in 2012.

With cash flow almost certain to fall in 2015, Canadian Oil Sands made a wise move by slashing their dividend, and the new $97 million annual dividend should be maintained going forward.

Why the new dividend is sustainable

There are several positive trends going into 2015. First, Canadian Oil Sands will have significantly lower capital expenditures this year, as major projects are coming to completion. In addition, they have found an additional $100 million or so in potential capital expense savings.

The result is that Canadian Oil Sands is planning to have $451 million in total capital expenditures in 2015. When the $97 million in dividends is added to this, and total expenses should equal $548 million—much lower than the $981 million in 2014.

Since Canadian Oil Sands is a pure-play, unhedged crude oil company, their cash flows are tied to the price of oil. Despite this, even in a very pessimistic scenario the company should be able to fund their dividend.

For example, if prices stay at current levels (around US$50/bbl), Canadian Oil Sands is expected to produce about $348 million in cash flow. This would still create a budget and funding shortfall (since capital expenses are $548 million), but Canadian Oil Sands, fortunately, has plenty of debt capacity to be able to absorb these losses, even if they persist for several years (which is not being predicted by most analysts).

Currently, Canadian Oil Sands has a $1.5 billion credit facility, and has only $140 million drawn from it. The company currently has a long-term debt of about $1.9 billion, and is targeting a debt-to-total capitalization of less than 55%.

With current debt of $1.9 billion, Canadian Oil Sands has a debt-to-total capitalization of only 29%, and even if oil prices were to stay at current levels for several years, the company would still be well within its acceptable levels.

Of course, if oil prices increase to $55/bbl (or even higher), Canadian Oil Sands is poised to see a huge increase in free cash flow, and it would likely be able to increase its dividend once again.

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