Why Suncor Energy Inc. and Cenovus Energy Inc. Have Downside Protection

Description

Perhaps one of the most pressing issues facing Canadian exploration and production energy companies, and the Canadian economy in its entirety, has been the chronic spread between West Texas Intermediate (WTI) and Brent crude prices, also known as the WTI-Brent differential, whereby WTI trades at a discount to Brent.

Even more concerning is the fact that Canadian bitumen from oil sands operations and Canadian heavy crude, which are priced based off the Western Canadian Select benchmark, trade at a discount to both WTI and Brent. The result has been that Canadian producers are selling their crude at huge discounts largely to Midwestern U.S. refineries, who are profiting from lower feedstock costs. This represents a massive loss of wealth for Canadian energy companies and the Canadian economy.

Fortunately, integrated players like **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) and **Cenovus Energy Inc.** (TSX:CVE)(NYSE:CVE) have been immunized themselves from these differentials by owning their own refineries. Due to this, both Suncor and Cenovus have been able to profit as WTI prices fell in the first quarter relative to Brent, effectively providing downside protection to their earnings compared with their peers.

Suncor beat Q1 2015 cash flow estimates on strong refining performance

Suncor reported Q1 2015 cash flow of $1.02 per share, which was a substantial drop from the $1.96 per share noted in Q1 2014, due to the large decline in crude prices. Nonetheless, Q1's $1.02 per share results beat analyst consensus of $0.96 per share, and strong refining performance contributed heavily to this beat.

Suncor reported $678 million in cash flow from its refining segment, which in total comprised 45% of Suncor's total cash flow from operations, and was also Suncor's largest cash-flow producing segment, beating out oil sands. While refining cash flows did see a decline from Q1 2014 levels largely due a higher WTI-Brent differential in Q1 2014, they increased substantially from the last quarter.

This increase is due to the fact that the WTI-Brent differential increased in Q1 2015 because of concerns about potentially running out of crude storage in the main WTI hub in Cushing, Oklahoma, which drove down WTI prices relative to Brent.

While this decline and increase in the WTI-Brent differential would have adversely affected Suncor's non-integrated peers, Suncor was able to benefit since its refineries (which receive 90% of their feedstock from cheaper WTI crude), were able to benefit from buying cheap WTI feedstock and selling refined products like gasoline and diesel based off higher Brent prices.

As a result, Suncor noted a 180% increase in refining cash flow from Q4 2014, which was able to offset weaker cash flows from the oil sands segment, which is largely sold as WTI to Suncor's refineries.

In addition, Suncor also benefited from rising crack spreads in Q1 2015. Crack spreads refer to the difference between a refineries feedstock and the prices of refined products like gasoline and diesel. The company's western North American refineries were able to benefit from strong crack spreads due to higher gasoline and refined product prices.

Cenovus cash flows are also being protected by its refining segment

Cenovus currently has 50% ownership in two refineries, one located in Illinois, and one located in Texas. Cenovus posted $95 million in cash flow from its refining segment in Q1 2015, which was in contrast to a $362 million loss in Q4 2014 because of a declining WTI-Brent spread.

As WTI prices fell relative to Brent in Q1, Cenovus was able to capitalize on the decline through its refining segment, providing some downside protection and insulation from a rising WTI-Brent spread.

Similar to Suncor, Cenovus is poised to continue profiting, should the WTI-Brent differential stay wide as it has for the past several years while its non-integrated peers suffer reduced margins. In addition, the larger WTI-Brent spread should lead to higher crack spreads, and with Cenovus earning US$90 million more in cash flow for every US$1 increase in crack spreads, there is potential for upside.

Analysts at **TD Bank** estimate Cenovus could earn $500 million more in cash flow than the company estimates as a result of crack spreads improving throughout the year.

CATEGORY

1. Energy Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:CVE (Cenovus Energy Inc.)
2. NYSE:SU (Suncor Energy Inc.)
3. TSX:CVE (Cenovus Energy Inc.)
4. TSX:SU (Suncor Energy Inc.)

Category

1. Energy Stocks
2. Investing

Tags

1. Editor's Choice

Date
2025/08/05
Date Created
2015/05/22
Author
amancini