Why Canadian Oil Sands Ltd. Would Be Unlikely to Support a Takeover

Description

There has been ample talk recently of a **Canadian Oil Sands Ltd.** (TSX:COS) takeover. Most of the discussion surrounding a potential takeover, however, has centred on potential bidders, how the acquisition could help those bidders, and pricing.

What has been largely left out has been what benefit, if any, would come to Canadian Oil Sands' shareholders as a result of such a deal, and whether or not both the Canadian Oil Sands board of directors, and/or their shareholders would support it.

While it is largely speculation, potential bidders include Canadian Oil Sands Syncrude co-owners **Suncor Energy Inc.** and **Imperial Oil Ltd.** Whether either is interested is far from certain, especially given the fact that Canadian Oil Sands shares have recovered greatly over the past several months, and that Canadian Oil Sands—being fully located in Alberta—will be subject to any new royalty framework imposed by the new NDP government.

If such a bid were made, would Canadian Oil Sands' board and shareholders support it, and should they? Here's why it's unlikely.

Canadian Oil Sands attracts investors with yield and direct exposure to oil

Canadian Oil Sands' investors are primarily attracted to the stock because it has huge exposure to the price of oil, it produces 100% synthetic crude oil, and it's entirely unhedged. In addition to this, Canadian Oil Sands has traditionally offered its investors an extremely high dividend yield, with a median dividend yield of 6.3% since inception, often moving up into the low teens.

Canadian Oil Sands' direct exposure to the price of oil provides a unique investment opportunity in Canada due to its near identical movement to the price oil, while providing a strong yield that boosts returns during flat and increasing oil markets, while reducing downside when prices fall.

Through a takeover, investors would receive cash and/or shares from the purchasing company, and although investors would receive a premium to the current share price, they would lose the unique opportunity Canadian Oil Sands presents, as well as a huge potential for upside should oil recover in exchange for shares in a more stable integrated producer.

Should oil prices recover (which they have recently), Canadian Oil Sands' investors would lose out on huge upside as well as a growing dividend, and would likely see far less value created by selling shares at a premium or acquiring shares in an integrated producer. In addition to this, several improvements have already been made at Canadian Oil Sands, which is positioning itself for even stronger leverage to an oil price increase.

Canadian Oil Sands is reducing costs and improving reliability

The Syncrude asset (their only asset), in which Canadian Oil Sands owns 36.74%, has been called the most unreliable operation in Canada, suffering from continually falling utilization since 2010 due to frequent equipment breakdowns.

Fortunately, there are signs that these troubles are behind the company. Canadian Oil Sands recently completed several major projects, all of which are geared towards improving reliability, and this should reduce maintenance costs, increase production (which also reduces costs by spreading more barrels across fixed operating costs), and reduce capital expenditures since the major projects are all complete.

The largest of these projects has been the Mildred Lake Mine Train Replacement, which was a $400 million dollar capital project, and has already resulted in reduced maintenance costs. The results have shown in the Q1 2015 earnings report.

Canadian Oil Sands saw its operating costs per barrel drop from an extremely high $47 per barrel in Q1 2014 to a low $35.71 per barrel, which equals levels not seen since 2009. As a result, Canadian Oil Sands has seen its overall breakeven costs drop to US$49 per barrel, which is the proper breakeven level, including all operating, capital, and royalty expenses.

Canadian Oil Sands is on track to generate free cash flow

Canadian Oil Sands predicts a US$10 increase in oil prices will add 70% to cash flow. At current prices of near US$60/bbl, Canadian Oil Sands should see $700 million in cash flow according to **TD Bank** analysts, and as a result, the company could see $271 million in free cash flow.

With things improving for Canadian Oil Sands, it is very unlikely shareholders would, or should, support a takeover.

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