Canadian Oil Sands Ltd.: Promising Turnaround Candidate or Value Trap?

Description

One-time favourite among dividend investors **Canadian Oil Sands Ltd.** (TSX:COS) lost much of its lustre thanks to the sharp collapse in oil prices. This forced the company to slash its dividend not once, but twice, and reissue its 2015 guidance because it wrongly anticipated an early rebound in crude prices.

Since then, Canadian Oil Sands, along with its Syncrude partners, has instituted a range of measures to improve reliability and reduce costs at the facility. With its stock down by a massive 53% over the last year, its turnaround program gaining traction, and a number of takeover rumours, some analysts are claiming that it now represents a deep-value investment opportunity.

Now what?

The Syncrude project has been mired in a range of operational problems that have included production outages, cost blowouts, and equipment failures. In fact, Syncrude's average daily production has declined every year since 2010, impacting the revenue and cash flows of investors in the project. These operational issues are primarily caused by Syncrude's complex labyrinth of machinery, which has made it an unreliable operation.

As the largest single investor with a 37% interest in the project, these issues continue to weigh heavily on Canadian Oil Sands, particularly because it has no other productive assets, making it critically dependent on Syncrude. The end result has been a marked impact on Canadian Oil Sands' financial performance and an inability to deliver value for investors.

However, management is now claiming that the worst is over, but I believe that this couldn't be further from the truth.

While first quarter 2015 operating expenses were down by 24% year over year and crude sales volumes were up by 2% for that period, output from Syncrude continues to decline. During April alone, output dropped by just over half due to maintenance for coker and vacuum distillation units. This highlighted the fact that despite claims that reliability at Syncrude has improved, it still remains highly vulnerable to outages.

Let’s also not forget that late last year Canadian Oil Sands had to restate its forecast 2015 production because of unexpected maintenance outages at Syncrude. These forced it to revise its 2015 production target downwards by 6%.

Based on recent disruptions, I am expecting Canadian Oil Sands production volumes to decline yet again for the fifth straight year. This certainly doesn’t bode well for investors as it is struggling to remain profitable in the current harsh operating environment.

Even more worrying is that the majority of the reduction in operating expenses can be attributed to lower input costs because of lower diesel and natural gas prices rather than any significant gains in operational efficiencies. This means that when oil prices rebound Canadian Oil Sands will again become a high-cost operator.

So what?

While its long-life oil reserves and the sharp decline in its share price make it an attractive investment in the eyes of some, I believe that it remains a poor investment that is best avoided. This is because of the high volume of production outages and cost blowouts, along with declining oil output that make it extremely unpredictable and far too risky.

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