Could Canadian Oil Sands Ltd. Increase its Dividend?

Description

For a long time, **Canadian Oil Sands Ltd.** (TSX:COS) had one of the highest dividend yields on the TSX. Canadian Oil Sands's yield often moved in the range between 5-9%, with the yield spiking as high as 17% during the oil price crash in late 2014.

This high yield is a central part of Canadian Oil Sands's basic value proposition to shareholders. As a pure-play oil company with 100% crude-weighted production from its 36.74% stake in the Syncrude oil sands mining project, Canadian Oil Sands offers investors direct exposure to the price of oil (specifically synthetic crude) without any diversification from natural gas, heavy oil, or refined products like its peers.

This 100% synthetic crude production is entirely unhedged (also unlike its peers, who have between 20-75% hedged, with only a handful being unhedged). This means Canadian Oil Sands offers investors an extremely high correlation with oil prices. To balance this out, Canadian Oil Sands offered investors a highly competitive yield. With the dividend at a historic low and oil prices having moved higher, will Canadian Oil Sands restore its high dividend policy?

The current state of Canadian Oil Sands's dividend

In January 2015 Canadian Oil Sands moved to cut its dividend by an enormous 85% from $0.35 per share to $0.05 per share. This represents the lowest dividend ever declared by Canadian Oil Sands, and the decision to cut was largely a good one.

Canadian Oil Sands has cash flow that is highly sensitive to the price of oil, with a US$10/bbl change in the price resulting in a 70% change in cash flow. As a result, with oil prices near $45/bbl in January 2015, Canadian Oil Sands would've seen a hugely decreased cash flow.

In fact, should oil prices have stayed at $46/per share, Canadian Oil Sands would have seen only$0.30 per share of cash flow, or $145 million in 2015. Canadian Oil Sands's previous dividend aloneworked out to $679 million, and this does not even include the estimated $430 million of capitalexpenditures. Combined, Canadian Oil Sands would have seen a $964 million loss should oil priceshave stayed the same and the dividend also remained.

This would quickly nearly max out the company's $1.1 billion of available credit facility space, and push their net debt significantly above their targeted limit of $2 billion. With the current dividend costing only $97 million annually, it seems sustainable.

Can it increase the dividend now that oil prices are higher?

Currently, oil prices are sitting at $58 per barrel, meaning Canadian Oil Sands will see much more cash flow. For 2015 Canadian Oil Sands is assuming WTI prices will be at $55 per barrel, meaning the company would receive $0.84 per share in cash flow, or $407 million. With estimated capital expenditures of $429 million, plus the $97 million dividend, it seems Canadian Oil Sands would not be able to increase their dividend, since free cash flow would be negative and result in increasing debt.

However, the market is now better than Canadian Oil Sands anticipated. WTI prices are now at $58 per barrel, and more importantly, the discount Canadian Oil Sands's crude (synthetic) receives to WTI has fallen sharply. In the 2015 guidance document, Canadian Oil Sands assumed a $4 discount to WTI, while the current discount is only around $0.93.

At a $0.93 discount to the current WTI price in Canadian dollars, Canadian Oil Sands would receive $71.25 Canadian per barrel, well above the $64.44 per barrel they are currently guiding. This would translate to $713 million in cash flow, which would give the company $284 million to spend on its dividend after its capital expenditures.

Will Canadian Oil Sands increase the dividend? If the environment stays similar to the current environment and stabilizes, it seems likely, especially since its shareholders are yield-focused.

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