



## Why Canadian Oil Sands Ltd. Made the Right Decision

### Description

There is growing consternation among analysts that **Canadian Oil Sands Ltd.** (TSX:COS) has made an error in rejecting **Suncor Energy Inc.'s** ([TSX:SU](#))([NYSE:SU](#)) hostile takeover bid. Certainly, Canadian Oil Sands is facing a raft of problems in the current harsh operating environment, but management has made the right decision to reject Suncor's overtures at this time.

### Now what?

In the past I have certainly not been a tremendous fan of Canadian Oil Sands. The Syncrude project has been beleaguered by a range of problems, the most significant being unscheduled outages of the complex machinery that is used to convert bitumen to light synthetic crude. These have triggered cost blowouts and caused production to decline in recent years, all of which have been a considerable burden for Canadian Oil Sands.

Then you have the project's high operating costs, which will remain a burden for cash flow and profitability in a harsh operating environment dominated by weak crude prices.

For the second quarter 2015 Canadian Oil Sands's operating expenses were around \$53 per barrel, or almost double the \$28 per barrel reported by Suncor for its oil sands business.

As a result of a combination of high expenses and weak crude, Canadian Oil Sands's cash flow remains at risk and will generate negative cash flow for the remainder of 2015 and into 2016. This will be funded by debt, which has blown out sharply over the last year.

As of June 30, 2015 Canadian Oil Sands's debt had grown by 29% when compared with the end of 2014, and debt has grown by 51% year over year. As a result of this massive increase in debt, and the pessimistic outlook for crude, ratings agency Moody's downgraded Canadian Oil Sands's debt to one notch above junk status.

However, despite these red flags I believe that Canadian Oil Sands was right in rejecting Suncor's offer.

You see, the offer was opportunistic; it significantly undervalued the company and its assets. If we look

at Canadian Oil Sands's core asset, its long-life oil reserves of 1.4 billion barrels, we can see that they have an independently assessed value of \$9 billion after income taxes. This equates to \$18 per share, almost double Suncor's offer of 0.25 Suncor shares for every Canadian Oil Sands share.

On face value, this valuation may appear overly optimistic, with it relying on an average oil price of US\$89 per barrel, but it was conducted using a 10-year time frame. This is more than long enough to allow for a rebound in oil, especially after considering that there are signs that crude will rally over the course of the next year.

There are also a number of cost reduction initiatives being undertaken at Syncrude that should see 2015 operating costs fall to just under \$40 per barrel. This will certainly help to boost cash flows and reduce any shortfall for Canadian Oil Sands.

Furthermore, Canadian Oil Sands retains a high degree of liquidity; it has \$86 million in cash and \$985 million left undrawn on its credit facilities. This will allow it to weather any sustained weakness in crude.

### **So what?**

It certainly won't be clear sailing for Canadian Oil Sands at this time, but the company's outlook is better than Suncor's offer portrays. Let's not forget that it also has a range of levers at its disposal to further improve cash flow, including further reducing capital expenditures and cutting its dividend altogether.

### **CATEGORY**

1. Energy Stocks
2. Investing

### **TICKERS GLOBAL**

1. NYSE:SU (Suncor Energy Inc.)
2. TSX:SU (Suncor Energy Inc.)

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