Why Suncor Energy Inc. Should Abandon its Bid for Canadian Oil Sands Ltd.

Description

Canada's energy patch is still buzzing because of the letter sent by **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) CEO Steve Williams to shareholders of **Canadian Oil Sands Ltd.** (TSX:COS). In the letter, Mr. Williams laid out a comprehensive list of reasons why Canadian Oil Sands shareholders should accept Suncor's $4.3 billion offer.

He was not short of arguments. Williams claimed that Canadian Oil Sands won't find a better offer, that its shares would collapse if the bid is rejected, and that the company can't survive in a "lower for longer" oil-price environment. Just for good measure, he also noted how the Canadian Oil Sands board owns a combined 0.1% of the company's stock–that's not exactly a vote of confidence.

Ironically, Mr. Williams made a pretty strong case that Suncor should abandon its bid. We take a closer look below at the argument and the numbers.

The economics have only gotten worse

For context, let's take a look at Suncor's bid in early October. At the time, the WTI oil price was hovering around US$45 per barrel and Canadian Oil Sands shares were trading just above $6.

Then when Suncor made its offer, Canadian Oil Sands shares took off, as you would expect. But something else happened: Suncor's shares fell by more than 2%. And this was on a day when oil prices *rose*. There's only one conclusion to be drawn from this: Suncor's shareholders thought the company's offer to Canadian Oil Sands was too generous.

And since then, oil prices have marched steadily downwards. So, at this point, Suncor's shareholders must feel especially sour about the deal.

The numbers don't lie

Suncor's shareholders have a right to be worried. To illustrate, just take a look at the presentation that Canadian Oil Sands prepared in response to Suncor's bid.

On slide 15, Canadian Oil Sands claims that it would earn $0.36 per share in free cash flow at US$55 oil. In other words, even if oil prices increase by more than 50%, Suncor would still be paying 24 times free cash flow. That’s a steep price to pay for a heavily indebted oil sands company with few growth prospects.

Other options

If Suncor’s bid were rejected, then there are plenty of other struggling energy producers that should get taken out. And because oil prices have fallen so far since early October, Suncor would be able to get a much better deal.

Alternatively, Suncor could wait for one of these companies to go bankrupt, then buy the assets out of receivership. To borrow a word used by Canadian Oil Sands CEO Ryan Kubik, such a strategy would be very opportunistic indeed.

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