Canadian Oil Sands Ltd. Shareholders Win From Suncor Energy Inc.'s Latest Bid

Description

Things seem to have changed quickly for **Canadian Oil Sands Ltd.** (TSX:COS) in the recent hostile takeover saga with **Suncor Energy Inc.** (TSX:SU)(NYSE:SU). After Suncor spent months attempting a takeover of Canadian Oil Sands, a deal that was looking increasingly less likely looks ready to go through on friendly terms.

Originally, Suncor offered 0.25 shares for every Canadian Oil Sands share, a figure that the Canadian Oil Sands board claimed was unfair and did not reflect the upside Canadian Oil Sands would see if oil were to recover.

Now Suncor has changed its offer to 0.28 shares for every Canadian Oil Sands share and has won the support of the Canadian Oil Sands board. As of this writing, this means Canadian Oil Sands shareholders would get $8.74 per share—a 16% premium to prices before market open on Monday, January 18 and a 12% premium to the original offer.

Of course, the value of this deal would increase should Suncor shares increase. Here's why this deal is a win for shareholders.

Looking at oil prices going forward

It is widely known that Canadian Oil Sands is considered a "pure play" on the price of WTI crude; it's had a 98% correlation with the price of crude over the past 10 years. This is because Canadian Oil Sands produces only synthetic crude oil (which is essentially the same as WTI crude and usually trades at only slight discount), and it does so in an unhedged manner.

Currently, WTI prices are at 12-year low of $30 per barrel, and forecasts for where oil prices are headed vary wildly. While prices are almost certain to recover over a longer-term time period (with many analysts seeing $60 as a fair long-term price), it is uncertain where they will head over the next year or two.

Currently, the oil market exists in a state of heavy oversupply (about two million barrels per day over the past year or two). Low prices are having the effect of discouraging new drilling and investments, especially from higher cost U.S. producers, as well as reducing current activity.

The result is that production is declining in the U.S., and the IEA expects non-OPEC (mostly U.S.) production to decline by 600,000 bpd in 2016. While this should help reduce the oversupply situation, growing Iranian production, as well as Saudi Arabian production, will offset much of this impact to still result in an oversupply situation of as much as one million barrels per day in 2016.

In terms of prices, this means 2016 and 2017 could see weaker pricing; some top analysts such as **Goldman Sachs** and Shawn Driscoll from T.Rowe Price are forecasting oil to be stuck under $40 for the year.

Suncor's deal gives COS shareholders a nice premium given this reality

With oil prices likely to be weak for this year and possibly next year, Suncor's newest deal protects Canadian Oil Sands shareholders from the downside and provides a nice premium to shareholders to compensate them for the potential upside they would be giving up by continuing to hold their Canadian Oil Sands shares.

For example, Canadian Oil Sands was expecting to earn cash flow from operations of $1.31 per share in 2016, a massive increase from the projected $0.71 per share it earned last year. The problem is, the $1.31 in 2016 assumed an average WTI price of $50 per barrel. This is a fairly optimistic projection for the year, especially considering how it started.

Even if this were to be the case, however, the current deal would represent a multiple of 6.72 times cash flow (likely higher if Suncor shares appreciate before the deal finalizes). Over the past five years, Canadian Oil Sands has traded at around nine times the prior 12 months' cash flow on average (when prices were as high as $100 per barrel).

While Canadian Oil Sands may have had more upside over time by holding on, the current deal is fair, especially considering prices may remain low for another year or two, and it's a big improvement over the prior deal.

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