With Canadian Oil Sands Ltd. Gone, How Should You Play Oil's Upside?

Description

Canadian Oil Sands Ltd. (TSX:COS) current shareholders (as well as potential shareholders) may be feeling slightly discouraged by recent developments in the oil market. Oil prices have rallied 42% since mid-February lows, but Canadian Oil Sands shares have only seen a fraction of the gain (around 17%) due to the recent **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) takeover, which pegs Canadian Oil Sands shares at 0.28 per Suncor share.

Canadian Oil Sands has long advertised its strong leverage to oil prices as a key selling point. A recent presentation stated that Canadian Oil Sands's share price has historically been 98% correlated to WTI prices. With such a strong correlation, both current and potential Canadian Oil Sands shareholders have lost an excellent vehicle to play upside in oil prices.

Suncor recently announced that 82% of Canadian Oil Sands shares have been tendered (Suncor plans to acquire the remainder), so Canadian Oil Sands may not be around for much longer, but that doesn't mean there aren't excellent ways to play oil's upside.

Why Canadian Oil Sands was so leveraged to oil prices

It is important to first look at why Canadian Oil Sands had such a strong correlation to oil prices. The first and most obvious reason is that Canadian Oil Sands produced 100% synthetic crude. Unlike other producers that may have a portion of their production from natural gas, Canadian Oil Sands cash flows came entirely from oil production.

Secondly, Canadian Oil Sands produced synthetic crude, which is bitumen that is upgraded. Synthetic crude is similar in composition to WTI crude (which is a light, sweet crude oil) and therefore typically trades at only a small differential to WTI prices (in fact, it is currently trading at a premium to WTI prices of about $6). This is in contrast to oil sands or heavy oil producers that sell diluted bitumen directly and receive a heavy discount to WTI for their production.

This is combined with the fact that Canadian Oil Sands also has high operating leverage, which means that increases in revenue from rising oil prices will largely fall to the bottom line (due to expenses not growing proportionately).

Is there another Canadian company that mimics these features?

Baytex Energy has similar leverage to oil prices

Fortunately for Canadian investors, **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) offers similar upside in the case of oil prices rising. Sprott Energy Fund manager Eric Nuttall has said Baytex will be the "go-to high beta stock" for Canadian energy investors in 2016, which means this is the stock that investors will flock to, so they can play rising oil prices.

Some of the same principles that gave Canadian Oil Sands its high leverage to oil prices apply to Baytex. Baytex is crude-weighted (with about 82% of production coming from crude oil in 2015), and Baytex is also heavily weighted towards producing light, sweet crude, which trades at or above WTI prices.

Baytex basically has two operating areas: Eagle Ford in Texas (which produces light, sweet crude) and western Canada (which produces heavy oil). Traditionally, about half of Baytex's production came from heavy oil, and the other half from light oil, but for the first half of this year Baytex made the decision to shut in 7,500 barrels per day of heavy oil production in Canada (due to low or negative margins) and instead focus 95% of its capital program on its Eagle Ford asset.

This decision will give Baytex strong leverage to oil prices. Firstly, production from Eagle Ford is priced off the Light Louisiana Sweet Benchmark (which typically trades at a premium to WTI). Secondly, Eagle Ford is one of the most economic regions in North America. In fact, at US$35 per barrel, Baytex's Eagle Ford production can not only break even and cover its operating and capital costs, but it would also earn at 10% return.

As oil prices increase, Baytex has the option to bring its heavy oil production back online, and this production is highly economic as prices rise above the $40-45 range because it is simple, inexpensive conventional production for the most part. The end result is that Baytex shares have exploded over the past few weeks as oil prices have risen, and investors can take advantage by buying on a pullback.

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