How Suncor Energy Inc. Used the Oil Rout to Become Canada's Best Operator

Description

With oil prices up 40% off the lows set earlier this year, many are saying that the oil rout has finally ended and prices are unlikely to set new lows. If this is true, investors should look to companies that came out on the other side of the crash with decent balance sheets, greatly improved cost structures, and a firm production-growth runway as these names will do better.

Few names meet these criteria better than **Suncor Energy Inc.** (TSX:SU)(NYSE:SU). Unlike peers that slashed dividends and undertook massive capital budget cuts in order to preserve their balance sheets (capital budgets were slashed by 40% on average from 2014-2015 and 30% from 2015-2016), Suncor actually boosted its dividend and reduced its capital budget by only 4% in 2015 and 7% in 2016.

Being able to maintain capital expenses is important, since they are the driver of future production growth, and Suncor managed to do this while keeping its balance sheet in better shape than its peer group average. While Suncor's ability to survive the crash was due to its integrated strategy and exceptional balance sheet before the crash, the actions it took during the crash are what truly turned it into a best-in-class operator.

Suncor was very successful at permanently reducing operating costs

One of Suncor's key corporate goals is operational excellence, which refers to operating the base business as efficiently, reliably, and cost effectively as possible. The rapid drop off in cash flows forced Suncor to double-down on this goal, and the results are impressive and should serve to enhance profitable growth going forward in a weak pricing environment.

The best place to see Suncor's success on this front is by looking at cash operating costs per barrel. Suncor ended 2015 with total oil sands cash operating costs of $27.85 per barrel, down from $33.80 in 2014 and $37.00 in 2013. In U.S. dollars, this equates to about US$20 per barrel, which shows how viable Suncor is in a low-oil-price environment.

This decrease in cost was broadly driven by three things: reducing operating costs, falling natural gas price, and improving production (which spreads costs across more barrels of production).

The important thing to realize is that most of the reduction in costs comes from actual operating expense reductions and reliability improvements as opposed to uncontrollable factors such as falling natural gas prices. Suncor set a goal in 2014 of reducing operating expenses by $600-800 million over two years, and in 2015 alone Suncor reduced operating expenses by $900 million.

For 2016, they set a further objective of reducing these costs by another $500 million. These costs have been achieved by reducing labour expenses (through layoffs), improving business processes, reducing low priority work, and improving supplier relationships. Overall, Suncor's operating, selling, and general expenses fell from $9.5 billion in 2014 to $8.6 billion in 2015 with $8 billion being the goal.

Looking at the $5.95 per barrel operating-cost reduction (from $33.80 to $27.85), about $3.35 of that is due to the 11% oil sands production growth (a rare occurrence in Canadian energy and thanks to low-cost de-bottlenecking expansions), $1.60 is due to lower natural gas prices, and $1 is due to lower operating costs. The result? The majority of this reduction is permanent and due to strong operating performance from Suncor.

Suncor also used the rout to make acquisitions at a discount

Suncor used its strong balance sheet to also make two acquisitions at very affordable levels. The first was Suncor's purchase of **Total's** 10% stake in Fort Hills. Suncor only paid $0.94 per barrel of reserves, which is much less than the $1.08 that Total paid, or the $1.61 that **Teck** paid for its share in Fort Hills.

Suncor also got a similar bargain on its acquisition of **Canadian Oil Sands Ltd.** and its 37% share in the Syncrude mining operation. Suncor paid only $1.99 per barrel of recoverable reserves compared to the average Syncrude purchase price of $2.51 per barrel of recoverable reserve.

These acquisitions give Suncor production growth at an affordable price, which should add to cash flows as oil prices rise over time. This is a perfect example of Suncor using the oil rout to its advantage to help secure long-term growth.

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