Can Suncor Energy Inc. Successfully Integrate Canadian Oil Sands Ltd.?

Description

After minority shareholders voted in favour of a takeover last month, **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) began integrating **Canadian Oil Sands Ltd.** (TSX:COS) into its operations. According to Suncor's vice president of strategy, the company "now has to find ways to reduce operating costs and share some operations with its other oil sands sites."

Realizing potential synergies will be key to justify the buyout's $6.6 billion price tag, a price that was upped multiple times to appease prospective shareholders. Part of the deal includes assuming Canadian Oil Sands's debt load of $2.4 billion. Before the deal was completed, its credit rating was downgraded by three notches to junk at **Moody's**, making it the first large Canadian oil producer to receive a junk rating in at least a decade.

Suncor's credit rating was also downgraded to Baa1 from A3. Stretched finances and sub-$40 oil will continue to put a strain on the combined company.

Can Suncor make its latest acquisition make sense?

Buying when others are fearful

Despite the rating downgrade, Suncor has one of the stronger balance sheets in the industry. Last quarter Suncor finished with roughly $4 billion in cash. Its conservative use of leverage allowed it to manage the downturn fairly well. In the past 12 months, shares are only down 7.6%. It's also enabled Suncor to buy competitors assets at depressed prices.

Canadian Oil Sands stock had fallen by roughly two-thirds until Suncor got involved. It also acquired **Total's** Fort Hills project stake at a fairly attractive discount.

"Through its capital allocation approach, Suncor has clearly demonstrated its longer-term positive view on oil markets, having been one of the more aggressive companies on both M&A and organic growth capital, at a time when others have significantly pared back," said **JPMorgan** analyst Phil Gresh.

Only higher oil prices can truly justify the deal

Gresh also believes that for Suncor's strategy to ultimately make sense, oil prices would need to rise over the long term given the "breakeven economics" and "multi-decade cash flow dynamics" of its Fort Hills and Syncrude assets.

Last quarter, as a standalone business, Suncor posted a loss of $2.01 billion, largely due to non-cash write-downs. Still, that included a $26 million quarterly operating loss. With oil prices under $40 a barrel, it was also forced to further cut back its capital expenditures budget for 2016.

Adding Canadian Oil Sands to its project portfolio will only make sense if oil rebounds above $50 a barrel. According to the company's latest filings, Canadian Oil Sands had a breakeven production cost of $46. After fully upgrading its oil to market grade, however, its breakeven cost is closer to $50. Cost synergies and production gains will only go so far to offset this.

Investors need to anticipate higher oil prices for the deal to add shareholder value.

CATEGORY

1. Energy Stocks
2. Investing

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