Investor Beware: This Canadian Market Darling Could Suffer a Correction

Description

Canadian oil stocks are starting to look great again through the eyes of investors after WTI's applaud-worthy rally past the US$70 level. Many analysts are calling for oil prices to reach an equilibrium in the US$60s, and if that's the case, many of Canada's less-economical oil sands players could stand to reward investors profoundly over the next three years, as they turn on the taps to new projects, while WCS's discount to WTI gradually shrinks in the background as transportation bottlenecks are dealt with.

While there are many opportunities within Alberta's troubled oil patch with some of the more battered names like **Cenovus Energy** (TSX:CVE)(NYSE:CVE), there are frothy names like **Suncor Energy** (TSX:SU)(NYSE:SU) that may have run a bit ahead of themselves and may be ripe for a mild pullback.

Now, there's no question that Suncor is one of the preferred choices to play Alberta's oil patch due to its stable integrated operations. Suncor provides a more predictable operating cash flow (OCF) stream, and that means shareholders won't get the carpet pulled from underneath them should some unexpected event send WTI prices south of US$40 again. But like many other producers in the oil sands, Suncor needs WTI prices to remain above a certain threshold to flip the switch on new projects in some of its most prized oil sands assets.

If oil flops again, new oil sands projects will be uneconomical, and the better course of action will be to keep new oil sands projects on hold, leaving untapped value trapped for an undisclosed amount of time. Lower oil prices will be a burden to growth, even if Suncor's integrated operations provide the safety net of superior financial health in harsh environments.

Exogenous factors that influence the price of oil will dictate when Suncor will be able to expand and unlock the real potential behind its assets. While Suncor may have upside with limited downside relative to its peers, I'd argue that you're paying a rich premium for this "downside protection" and the safe 2.7% dividend yield.

As a deep-value investor who's looking to find opportunities amid the carnage, there are far better options out there. Suncor is at a multi-year high, while many of its "riskier" peers are still +40% off from their highs before the 2014 plunge in oil. Everybody already knows that Suncor is a safe way to play the oil sands, and while it's riskier to invest in less-solvent oil sands operators, I believe investors are neglecting the fact that many of the oil sands companies that took major hits to the chin have restructured their operations to prevent another repeat of a post-2014 fallout.

Looking three to five years out, I believe Cenovus has more innovative extraction technologies that could allow for lower breakeven costs. Suncor, while an incredibly robust integrated operator, isn't necessarily positioned to become the most efficient upstream player in the oil patch.

Suncor stock trades at a 1.9 P/B, a 2.4 P/S, and a 9.8 P/CF, all of which are higher than the company's five-year historical average multiples of 1.4, 1.7, and 8.8. That's a hefty premium that I don't believe is warranted given the forward-looking trajectory. While Suncor is a potential must-own for conservative income investors seeking to minimize their downside risk, I'd argue that the company is too expensive here, especially when you consider the hefty WCS-to-WTI discount. As such, I expect Suncor to return to $46 over the medium term.

There are far cheaper names in the space if value and upside are what you seek, so I'd encourage investors to consider battered firms like Cenovus that have made a considerable amount of fundamental changes since the 2014 oil fallout.

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