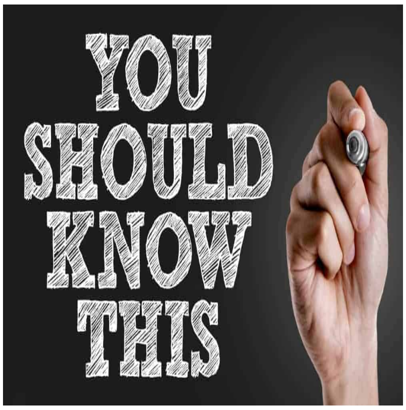

Is Suncor Energy Inc's (TSX:SU) Entire Business a Mirage?

Description

Suncor Energy Inc. (TSX:SU)(NYSE:SU) has done a terrific job destroying shareholder value—or at least not creating it. Since 2005, shares have returned roughly 0%. That's nearly 20 years of work and waiting with nothing to show for it.

If it has created zero net value for two decades, what has Suncor been doing? While some investors are constantly looking into the future for potential gains, there's a strong argument that the company will never generate meaningful returns for investors, even if its asset base is bigger than ever.

Suncor's assets may be the worst in the industry

More than 75% of Suncor's oil production comes from oil sands, an incredibly destructive method of extracting oil. Environmental concerns aside, oil sands are also an extremely unreliable and high-cost method of production.

While some North American producers can break even with oil prices down to US$20 per barrel or less, Suncor's assets require US$45 per barrel prices or more simply to maintain the current business and dividend. At that level, there would be no funds left over for growth projects, buybacks, acquisitions, or major project improvements. So even around current oil prices, Suncor is going nowhere fast.

Suncor's management team likes to show how much the business can improve with rising oil prices. In the sensitivity table in its latest investor presentation, management shows a range of cash generation possibilities assuming prices from US$64 to US$85 per barrel. So prices would have to rise by 20% simply to hit the lower end of those expectations. Clearly, Suncor's management knows that it must convince investors of higher oil prices; otherwise, its business isn't worth that much.

Long term, things won't get any better

Through 2020, Suncor anticipates growing production by 9% annually. While it wants investors to focus on its strong production growth, nearly the same percentage still comes from oil sands projects, meaning that its high breakeven costs aren't changing anytime soon.

For example, Suncor believes it can boost production by 300 mbpd by 2032 simply by developing its current assets organically. But because so much of this growth comes from oil sands, it will be difficult to justify its value without significantly higher oil prices.

Management is targeting US$50 per barrel breakeven prices for its growth initiatives. So at today's prices, the next decade of organic growth would, again, provide $0 net gains for shareholders. If you're not an extreme oil price bull, Suncor is not the stock for you.

Management has found even more ways to destroy value

Because many of its developments have been barely cash flow positive, management has needed to tap debt markets to finance asset growth. Today, nearly one-third of its enterprise value is composed of debt. With rising interest rates and languishing oil prices, it could be difficult to refinance these obligations into perpetuity.

With what little excess cash flow it has generated, Suncor has discovered plenty of ways to squander it. From 2011 to 2014, when oil prices surpassed US$100 per barrel, management opted to buy back more than $2 billion in stock at market highs. When oil prices crashed to US$40 per barrel in 2015, management ceased all buybacks, right when Suncor's stock was most attractive.

Looking at Suncor's Return on Capital, it has almost perfectly followed swings in oil prices. But even if oil prices surge, it's likely management will find ways to destroy that excess capital by purchasing assets or its own stock at high prices.

My recommendation: stay far, far away from this stock.

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