What to Expect From Suncor Energy (TSX:SU) Stock in 2020

Description

Suncor Energy Inc (TSX:SU)(NYSE:SU) is at a crossroads. Bears point out that the stock still trades at the same price it did back in 2006. That's nearly 14 years of value destruction.

Bulls, meanwhile, point to the company's integrated business model, not to mention a recent investment from Warren Buffett, legendary head of **Berkshire Hathaway Inc**.

Heading into 2020, the stock has plenty of headwinds *and* tailwinds working for and against it. Analysts and investors are split on what to expect. But if you dig deeper, the long-term picture becomes clear.

Business is improving

After years of cost reductions and workforce improvements, Suncor now has a break-even production level of around US$45 per barrel. That break-even includes the dividend, so it's all-inclusive.

The company has maintained an investment-grade credit rating and currently has nearly $7 billion in available liquidity. Compared to past years, Suncor's underlying fundamentals are incredibly strong.

Based on current strip prices, Suncor should generate around $5.5 billion in free cash flow on an annual basis. If oil prices improved from US$60 per barrel to US$75 per barrel, free cash flow would jump by 60%!

Even assuming constant valuation multiples, that would likely cause the stock price to increase a similar amount.

It's more likely, however, that the valuation multiple would increase if oil prices surged to US$75 per barrel. Currently, shares trade at 5.2 times cash flow, but the stock's five-year average is 8.3 times cash flow.

If cash flow surged due to higher prices, and the valuation multiple trended toward its historical average, it's not unreasonable to expect Suncor stock to return at least 100% in 2020. A move of this magnitude has happened several times over the company's operating history.

Industry is collapsing

I must commend Suncor's management team, as they've managed to eke out positive returns for shareholders over the last five years. That's despite oil prices collapsing, the industry cost-curve undergoing a complete transformation, increased regulatory scrutiny, and a severe lack of pipeline capacity.

Just compare Suncor's stock price to its biggest peers and you get a sense of how savvy this management team is. Since 2014, Suncor stock has gained in value by 5.6%.

Over the same period, **Husky Energy Inc.** stock lost *two-thirds* of its value, **Imperial Oil Ltd** shares shed around 30%, and **Canadian Natural Resources Ltd** fell by 12%.

But note that even with the industry's most skilled management team, Suncor stock only increased by the single digits. Over the last five years, the **S&P/TSX Composite Index** generated *triple* the return of Suncor.

Looking ahead to 2020, there's a strong case that Suncor will struggle yet again — not because the company is mismanaged, but because it's fighting several rising rides.

The biggest near-term issue involves pipeline capacity. In the company's risk disclosures, management highlights that "Suncor's dependence on pipeline capacity and other logistical constraints…may affect the company's ability to distribute products to market."

The company also notes the risk of "mandatory production curtailments being greater or imposed for longer than anticipated." These risk disclosures refer to Canada's pipeline capacity constraints, which threw the industry into turmoil late last year.

Suncor can bypass some of these troubles given its integrated approach, but it's still exposed to transportation bottlenecks that may not completely clear up until 2030.

The second concern involves simple math. Despite massive cost improvements, oil sands production remains at the high end of the cost curve. Compare Suncor's US$45 break-even price against the latest mega-shale projects in the U.S. that target break-evens as low as US$15.

According to the U.S. Energy Information Administration, North American production should continue to rise in 2020, while exploration and drilling costs continue to fall. Oil sands operators like Suncor are simply at the wrong end of the cost curve.

If oil prices dip next year, Suncor will be immediately squeezed, likely pushing the stock back to 2016 levels, which would represent roughly 25% downside.

Suncor stock has a path to positive returns next year, but I'm sticking with the age-old advice of selling stocks that don't control their own future.

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